



Business Posted on Thu, Jan. 20, 2005

Index Funds Beat Most Active Managers

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Associated Press

NEW YORK - Most mutual fund managers failed to beat the major market indexes last year, according to a report from Standard & Poor's, reflecting a trend that shows passive investing delivers better returns over the long haul.

Fund managers lagged indexes in eight of the nine "style boxes," or investment categories, tracked by S&P. Their performance was a sharp contrast to 2003, when they beat or matched indexes in six categories. But investors should view this short-term data with a grain of salt, said Srikant Dash, S&P's index strategist.

"Why did indices outperform active managers in eight of nine style boxes this year and not last year? I have no clue," Dash said. "There is no consistency over the short term. But over three- to five-year horizons, we consistently see indices ahead of the (managed) funds."

In 2004, the large-cap S&P 500 outperformed 61.6 percent of its actively managed counterparts, the midcap S&P 400 beat 61.8 percent of active funds invested in middle-market securities and the small-cap S&P 600 bested 85 percent of actively managed small-cap funds.

The S&P 1500 - a supercomposite of all three cap-based indexes - outperformed 51.4 percent of actively managed domestic equity funds.

The only place where managers wound up with an advantage was in the large-cap growth area. Some of the year's best stock returns came in the fourth quarter, when the large-cap S&P 500 returned 9.23 percent, representing 85 percent of the total return for the year. The post-election rally favored growth stocks, and helped large-cap growth managers outperform the index for the year.

The difference in performance over the two years was especially striking in the small-cap category, Dash said. In 2003, the S&P 600 outperformed just 39 percent of small-cap managers. But over the longer term, most small-cap funds have lagged the index. Over last five years, the S&P 600 has outperformed 72.4 percent of active managers.

The 2004 results are significant because active managers were unusually consistent in their styles, Dash said; 89 percent of managers stuck to their stated investing approach throughout the year, as opposed to just 72 percent in 2003.

Another factor that might have weighed on the performance of active funds was that so many managers maintained substantial cash stakes, said Eric Tyson, a former financial counselor and author of "Investing for Dummies." This was partly due to pessimism about the durability of the market's recovery, and concerns about valuations. Fund manager who were sitting on large amounts of cash during the last quarter missed out on the year-end rally.

"This underscores one of the virtues of indexing, in that it doesn't try to time the market," Tyson said. "An index fund that's fully invested is going to outperform a portfolio that has a portion of its assets in cash. If you're going to put your money in actively managed funds, where the manager is moving it in and out of cash, trying to guess where the market is going to go, sooner or later they're going to be wrong."

Expenses also dragged down total returns for actively managed funds. Fees for managed funds tend to be much higher, sometimes upwards of an entire percentage point, while index funds are generally much less expensive.

There will always be managers who can best the indexes, but few are likely to do so year after year. If you're looking to build a portfolio based on asset classes, indexing is generally the best and cheapest option. But if you like a particular fund manager's style, there's no reason to avoid active investing. Just remember that strategies that have worked well in the past might not deliver the same results in the future.

"It's not an either/or proposition. Many investors use both," Dash said. "Just be aware ... a fund manager might have a phenomenal record, but you're not buying his history, his yesterday. You're buying his tomorrow. And nobody knows what tomorrow's record will be."

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