MarketWatch
THE WALL STREET JOURNAL.

90% of fund managers beat the market - but their shareholders don't.

By Chuck Jaffe
Jan 21, 2015

Here's a sentence I never expected to hear from a respected mutual fund source: "Ninety percent of funds are superior stock pickers."

C. Thomas Howard, director of research at Athena-Invest, a Denver-based research/investment company not only believes that, but says 80% of funds are so good at picking stocks that they cover the fees they charge investors.

If you suspend your disbelief — and stop thinking that Howard must be taking psychotropic drugs — the way you choose and invest in funds may be changed forever.

To see why, however, you first must understand Howard's thinking and the common knowledge that makes it seem implausible.

Countless studies of performance show that active funds routinely deliver below-average results and fail to outperform comparable index funds.

If the performance numbers don't lie — and they don't — it seems far-fetched for Howard to suggest that money managers have real expertise that trumps the market.

But Howard is relying on a wide range of research, some of it his own but also several studies from 2013, showing that 80% or more of equity-fund managers beat their benchmark until the burden of fees and costs come into play.

Indeed, widely available numbers play this tune.

In industry jargon, a fund's "alpha" is the "excess return" — above and beyond the index, and adjusted for risk — that can be attributed to the skill of the manager. If the typical equity fund's alpha is roughly zero after expenses — and it is — that means average managers outperform the index in the raw, but are doomed by cost structures to lag the benchmark in the end.

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But if 90% of all managers are good stock pickers, as Howard insists, expense ratios alone don't explain why so many funds are mediocre.

That, according to Howard, is the result of what he calls "the portfolio tax," a drag on performance created by three significant burdens:

1) Asset bloat. When funds get big, the chances for superior performance shrink. That's why, Howard explained, so many small funds get off to a great start, attract assets because of their success and then regress when the manager struggles to extract market-beating returns from a larger portfolio.

2) Closet indexing, the phenomenon where active portfolios act mostly like an index fund because financial advisers and investors want returns in line with expectations for the sector or the market.

"Investors dislike underperformance twice as much as they like overperformance," Howard said, "so funds are managed not to disappoint shareholders. You're asking managers to track an index and beat it at the same time, and coming close to the index is the easy, safe part of the job. Pursuing the other goal of beating the index means diverging more from the index; if they do that and surprises happen — and they do — that's when investors are most disappointed."

3) Over-diversification. Howard cited studies showing that virtually all of a manager's ability to deliver superior performance comes from the top 20 holdings in a portfolio. Beyond that, adding stocks contributes little to performance, and may even hurt it.

"The bigger the fund, the worse the performance," said Howard, "the more you track an index, the worse the performance, and the more you over-diversify, the worse you do.…But fund companies have incentives to do what makes them money, and pursuing them means hurting a shareholder's chance of getting a superior return. Fund companies are okay with that."

David Snowball, founder of MutualFundObserver.com, has long favored small, lesser-known, concentrated funds, and said that while Howard's suggestion that most managers can beat the market at the stock-picking level is counter-intuitive, the effects of the portfolio tax are real.

"The industry is about making profit for the fund adviser and fund advisers make profits by drawing and holding assets, and the way you draw and hold assets is by not scaring people," Snowball explained. "So if you can get a couple of decent years together and a decent story and then slide quietly into mediocrity, it's a recipe for success for your fund company, and a recipe for disappointment for investors."

Overcoming that requires a huge change in mindset on the part of active investors: Instead of looking for the most-skilled managers, Howard said, "Look for funds that impose the least portfolio tax, and when those burdens start to rise as the fund becomes successful and grows, there comes a point where you get out and move on."

Barring that, he added, buy index funds and don't worry about beating the market.

If investors acted that way, it might discipline management companies to reduce their burdens and make funds better for shareholders. Meanwhile, investors should look for fund companies and sponsors that let managerial skill shine through.

"Finding good managers out there isn't hard," Howard said. "Finding them running a fund where their skill isn't overcome by burdens of size, style boxes and the management company is much harder. But if you want a fund that beats the market, that's what you have to look for."