REUTERS

'Closet index' funds charge high fees but lag indexes

BY TIM MCLAUGHLIN
BOSTON Mon Feb 3, 2014 10:32am EST

Investors are paying hefty fees for mutual funds that bill themselves as actively managed but in large part are mimicking a benchmark stock index.

Such funds have less chance of beating the market. And they charge fees comparable with those of funds that offer investors more stock pickings that are different from their benchmarks.

Since the height of the U.S. financial crisis, more funds are playing it safe, hugging their benchmarks and sometimes earning the unwanted reputation as "closet indexers."

About one-third of U.S. mutual fund assets, amounting to several trillion dollars, are with closet indexers, according to research published last year by Antti Petajisto, a former Yale University professor who now works for BlackRock Inc.

In general, Petajisto defines a closet indexer as a fund with less than 60 percent of its investments differing from its benchmark.

"The performance of closet indexers has been predictably poor: They largely just match their benchmark index returns before fees, so after fees, they lag behind their benchmarks by approximately the amount of their fees," Petajisto said in his study published last year in the Financial Analysts Journal.

For example, the $5.3 billion ClearBridge Appreciation Fund largely follows the Standard & Poor's 500 stock index and charges a minimum fee of 0.61 percent, compared with 0.10 percent or lower for an unmanaged index fund.

But ClearBridge Appreciation, which is run by Legg Mason Inc , has lagged the S&P 500 by 2.62 percentage points over the past five years, according to research firm Morningstar Inc .

One of ClearBridge Appreciation's largest investors is Colorado's Scholars Choice College Savings Program run by Legg Mason, U.S. regulatory filings show. With $3.2 billion in assets, it is one of the largest U.S. college savings plans sold by financial advisers.

The fund's return looks better over a longer period, said Angela Baier, a spokeswoman for the Colorado plan. ClearBridge Appreciation's 10-year return through the end of January was 7.01 percent, compared with the benchmark's 6.83 percent, Morningstar said.
ClearBridge Chief Marketing Officer Russell Mahland said the fund was not a closet indexer, but offered low volatility.

This allows the fund to outperform in down markets and capture upside during bull runs. It slid only 29 percent in 2008, for example, while the S&P 500 fell 37 percent. Last year, ClearBridge Appreciation rose 29.28 percent, lagging the S&P 500's return of 32.39 percent. Nevertheless, Morningstar data shows that the fund follows its benchmark more closely than most of its large-cap blend peers do.

The fund's active share in 2013, for example, was 56 percent, among the lowest in its category with at least $500 million in assets, according to Morningstar. The median active share among 164 funds in that group was 73 percent.

Principal Financial Group's $700 million Principal Large Cap Blend II Institutional Fund had an active share of just 41 percent last year and lagged its benchmark return by 1.44 percentage points, while charging an annual fee of 0.74 percent, Morningstar said.

UNRECOGNIZED PROBLEM

Most investors probably do not realize they may have money in a closet index fund, said Max Osbon, a partner at Osbon Capital Management in Boston.

"People don't look too deeply at these things," said Osbon, whose small money management firm emphasizes index investing. "They pay for a sense of security in a brand name."

Osbon said the growing popularity of index funds might reduce demand for more-expensive actively managed funds that adhere to their benchmarks.

That may already be happening for ClearBridge Appreciation, whose investors have pulled out money in each of the last seven years for a total of $2.4 billion, according to Thomson Reuters Corp's Lipper Inc unit.

To be sure, active share is not necessarily a predictor of performance, said Beth McGoldrick, spokeswoman for mutual fund group John Hancock Financial Services in Boston.

"It's something we look at when evaluating managers," McGoldrick said. "It is one tool in our due diligence process."

But Art Steinmetz, who oversees $232 billion in assets as president of OppenheimerFunds, said part of his job was to use active share to weed out timid portfolio managers.

"If you are no different than the index," he said, "you will underperform."