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Cast your fortunes with index funds

Even best active managers may only be lucky not skillful, study finds

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By Sam Mamudi, MarketWatch

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NEW YORK (MarketWatch) -- Investors who continue to send money to actively managed mutual funds in the hope that managers will be able to beat less-costly index funds are going to lose out almost all of the time, a new study finds.

The study by two noted finance professors claims that it's effectively impossible to tell whether a manager has performed well due to luck or skill -- which means that it's also impossible for an investor to know for sure.

"People don't understand the effects of chance [on returns]," said Eugene Fama, professor of finance at the University of Chicago Booth School of Business. "And it's impossible to tell how big an element chance is in [good performance]."

In other words, stop trying to pick market-beating managers -- instead, choose index-linked funds.

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Patrick Morris of Hagin Investment Management offers ideas for what stocks would be good to include in a portfolio in 2010, which he says may be challenging for stock investors. (Dec. 1)

Fama and Kenneth French, professor of finance at Dartmouth College Tuck School of Business, ran 10,000 simulations of what investors could expect from actively managed funds.

They found that outside the top 3% of funds, active management lags results that would be delivered due simply to chance.

"The simulations tell us that for the vast majority of actively managed funds, true [abnormal expected return] is probably negative; that is, the fund managers do not have enough skill to produce risk-adjusted expected returns that cover their costs," wrote the professors in the study.

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Fama and French's study, "Luck Versus Skill in the Cross Section of Mutual Fund Returns," looked at the returns of 3,156 U.S. stock mutual funds from January 1984 to September 2006. It included mutual funds that were liquidated and any fund launched before September 2001 that reached more than $5 million in assets. Find a copy of the report at the Social Science Research Network.

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Guesswork

The fact that some funds beat the simulations does suggest that by picking the right funds investors can consistently outperform the market. But there's just one problem, according to the professors: "[T]he good funds are indistinguishable from the lucky bad funds that land in the top percentiles."

That leaves picking the right fund a matter of guesswork. So even if investors stick with the top performers, they're running a risk because the manager's good results could be based on luck.

"You're taking the chance of being with somebody's who's not just lucky, but actually bad," added Fama.

The presence of both good funds and lucky bad funds means it's likely that investors focused on top performers will end up with returns close to the market.

"In other words, going forward we expect that a portfolio of low-cost index funds will perform about as well as a portfolio of the top three percentiles of past active winners, and better than the rest of the active fund universe," wrote the professors.

In an interview, Fama cautioned that this doesn't mean all index funds are viable options -- there are index funds that charge high fees, for example. Investors should stick to low-cost and efficiently managed index funds, he said, naming Vanguard Group's offerings as among the best.

Fama suggested that the continued faith in active management is due to both the fund industry's marketing efforts and the complicity of fund ratings agencies, whose existence is based on the assumption they can identify the best funds. But when it comes to picking the future winners, Fama is skeptical.

"I don't think anybody can do that," he said.

Sam Mamudi is a reporter for MarketWatch, based in New York

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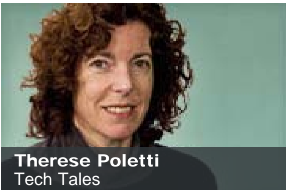

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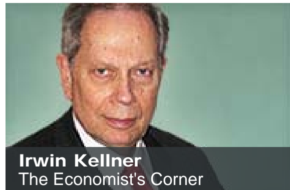

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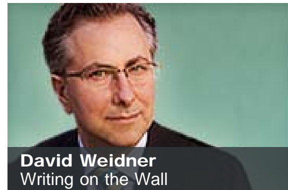

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