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STRATEGIES

The Index Funds Win Again

By MARK HULBERT
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THERE'S yet more evidence that it makes sense to invest in simple, plain-vanilla index funds, whose low fees often lead to better net returns than hedge funds and actively managed [mutual funds](#) with more impressive performance numbers.

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Basic stock market index funds generally aspire to nothing more than matching the returns of a market

benchmark. So in a miserable year for [stocks](#), index funds

may not look very appealing. But it turns out that, after fees and taxes, it is the extremely rare actively managed fund or hedge fund that does better than a simple index fund.

That, at least, is the finding of a new study by Mark Kritzman, president and chief executive of Windham Capital Management of Boston. He presented his results in the Feb. 1 issue of *Economics & Portfolio Strategy*, a newsletter for institutional investors published by Peter L. Bernstein Inc.

Mr. Kritzman, who also teaches a graduate course in financial engineering at [M.I.T.](#)'s Sloan School of Management, set up his study to accurately measure the long-term impact of all the expenses involved in investing in a mutual fund or hedge fund. Those include transaction costs, taxes and management and performance fees.

He is not the first to try such a measurement. But, he said in an e-mail message, it is surprisingly hard to measure these costs accurately. The bite taken out by taxes, for example, depends on the specific combination of positive years and losing ones, as well as the order in which they occur. That combination and order also affect the performance fees charged by hedge funds.

Mr. Kritzman devised an elaborate method to take such contingencies into account. Then he calculated the average return over a hypothetical 20-year period, net of all expenses, of three hypothetical [investments](#): a stock index fund with an annualized return of 10 percent, an actively managed mutual fund with an annualized return of 13.5 percent and a hedge fund with an annualized return of 19 percent. The volatility of the three funds' returns — along with their turnover rates, transaction fees and management and performance fees — was based on what he determined to be industry averages.

Mr. Kritzman found that, net of all expenses, including federal and state taxes for a New York State resident in the highest tax brackets, the winner was the index fund.

Specifically, he assumed that long-term capital gains were subject to a 15 percent federal tax and a 6.85 percent state tax; short-term capital gains and dividends were taxed at a

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combined federal and state rate of nearly 42 percent. The index fund's average after-expense return was 8.5 percent a year, versus 8 percent for the actively managed fund and 7.7 percent for the hedge fund.

Expenses were the culprit. For both the actively managed fund and the hedge fund, those expenses more than ate up the large amounts — 3.5 and 9 percentage points a year, respectively — by which they beat the index fund before expenses.

IF such outperformance isn't enough to overcome the drag of expenses, what would do the trick? Mr. Kritzman calculates that just to break even with the index fund, net of all expenses, the actively managed fund would have to outperform it by an average of 4.3 percentage points a year on a pre-expense basis. For the hedge fund, that margin would have to be 10 points a year.

The chances of finding such funds are next to zero, said Russell Wermers, a finance professor at the [University of Maryland](#). Consider the 452 domestic equity mutual funds in the [Morningstar](#) database that existed for the 20 years through January of this year. Morningstar reports that just 13 of those funds beat the Standard & Poor's 500-stock index by at least four percentage points a year, on average, over that period. That's less than 3 out of every 100 funds.

But even that sobering statistic paints too rosy a picture, the professor said. That's because it's one thing to learn, after the fact, that a fund has done that well, and quite another to identify it in advance. Indeed, he said, he has found from his research that only a minority of funds that beat the market in a given year can outperform it the next year as well.

Professor Wermers said he believed that it was "exceedingly probable that any fund that has beaten the market by an average of more than one percentage point per year over the last decade achieved that return almost entirely due to luck alone."

"By definition, therefore, such a fund could not have been identified in advance," he added.

The investment implication is clear, according to Mr. Kritzman. "It is very hard, if not impossible," he wrote in his study, "to justify active management for most individual, taxable investors, if their goal is to grow wealth." And he said that those who still insist on an actively managed fund are almost certainly "deluding themselves."

What if you're investing in a tax-sheltered account, like a [401\(k\)](#) or an [I.R.A.](#)? In that case, Mr. Kritzman conceded, the odds are relatively more favorable for active management, because, in his simulations, taxes accounted for about two-thirds of the expenses of the actively managed mutual fund and nearly half of the hedge fund's. But he emphasized the word "relatively."

"Even in a tax-sheltered account," he said, "the odds of beating the index fund are still quite poor."

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