

Not Everyone Can Pick Stock Funds. No, Really

By JONATHAN CLEMENTS

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Most stock funds fail to beat the market. Yet a lot of folks are still mightily confident they can pick the winners.

A tad delusional? Could be.

"We can't all be above-average investors," says John Rekenthaler, director of research at Chicago's Morningstar Inc. "If you survey investors, probably 80% say they're better than average. But at most, only 50% can be."

Investors' abundant self-confidence was on full display following my Oct. 5 column. In that piece, I detailed the results of a study by Ira Weiss, an accounting professor at Columbia Business School.

Prof. Weiss looked at fund performance over the 36 years through December 1997. His findings? Diversified U.S. stock funds gained 10.2% a year over that stretch, compared with 11.6% for the Standard & Poor's 500-stock index.

This 10.2% average included the performance of both existing and defunct funds and was dollar-weighted, so that the result reflected which funds were most popular with investors. All of these investors, no doubt, thought they were picking superior funds, yet they wound up trailing the market by 1.4 percentage points a year.

The result underlined a brutal truth: It is extraordinarily difficult for fund managers to beat the market, because of the drag on performance caused by trading costs, annual fund expenses and the need to hold cash to pay off departing shareholders.

To me, Prof. Weiss's study seemed like a slam-dunk argument for abandoning actively managed funds and dumping everything into market-tracking index funds. But my e-mail correspondents saw it differently. They argued that averages were immaterial, because they could pick winning funds.

But can they? Evidence is scant. Morningstar's five-star funds haven't generated market-beating returns. Ditto for the Forbes magazine honor roll, another seemingly intelligent system for picking funds. The honor-roll funds returned 13.6% a year over the 25 years through June 1998, compared with 14.3% for the S&P 500.

Meanwhile, studies suggest that past stock-fund performance has little predictive value. In a paper published in the March 1997 *Journal of Finance*, Mark Carhart found that funds that did well one year tended to do well the next. But Mr. Carhart, now co-head of quantitative strategies at Goldman Sachs Asset Management, attributes that to the momentum of the stocks owned by the funds, rather than to manager skill.

Moreover, Mr. Carhart found that after back-to-back years of good returns, a fund's stellar performance tended to peter out. "You really can't say whether a manager is skillful from short-term performance," he says.

In fact, to conclude with some conviction that a manager is skillful, you may need a 25-year track record, suggested Richard Brealey in the Summer 1990 *Journal of Portfolio Management*. Most stock-fund managers, of course, don't stick around nearly that long.

Still, if you insist on buying actively managed funds, careful fund analysis can help. "If you're a rational investor, you can stack the odds in your favor," says Morningstar's Mr. Rekenhaller. "But that doesn't mean things won't turn out poorly. And even if things work out well, that doesn't mean you'll beat the market."

As an experiment, Mr. Rekenhaller took all U.S. stock funds as of year-end 1988 and ran a series of statistical screens, to get rid of risky, unproven and high-cost funds. He tossed out funds with portfolio turnover of 200% and above, assets of \$50 million and below and expenses of 1% and over. He also got rid of sector funds and funds where the manager had been on the job for three years or less.

The resulting collection of funds gained 16.8% a year over the 10 years through December 1998, a marked improvement over the 16.1% average annual gain for all U.S. stock funds. But the selected funds still lagged behind the Wilshire 5000 index of most regularly traded U.S. stocks, which gained 18.1%.

"These simple rules helped," Mr. Rekenhaller says. "But they alone didn't get you close enough. It's an investment. There is risk involved."

Is it worth taking that risk? Dan Goldie, a financial planner in Portola Valley, Calif., doesn't think so. "If you buy an actively managed fund, you're taking a risk for which you will not necessarily be rewarded," he says.

That's why Mr. Goldie favors index funds. "With an index fund, you know what you're getting, you know it will be tax-efficient and you know it will be inexpensive," he notes.

Indeed, once you factor in taxes, actively managed funds look even worse. In the Spring 1993 *Journal of Portfolio Management*, investment experts Robert Jeffrey and Robert Arnott calculated that, to match an index fund's post-tax return, a fund with 100% portfolio turnover would need to outpace the market by 2.2 percentage points a year. This figure assumes you pay taxes on each year's distributed gains, but doesn't reflect the taxes owed upon liquidating a fund.

"The only reason to buy an actively managed fund is if you think you can find funds that will be superior performers in the future," Mr. Goldie says. "Studies show that there's no reliable way of doing that."