

# Quality Asset Management

*Grow Your Wealth with Peace of Mind*

## Can you select Superior Mutual Funds?

*By Gil Hanoch, October 6, 2006*

This article reviews an article published by the Journal of Financial Planning: [The Difficulty of Selecting Superior Mutual Fund Performance](#)<sup>1</sup> [February 2006]. This is one of many research projects that compare actively managed mutual funds with passively managed funds and past performance with future performance.

First, let's explain the two types of mutual funds:

**Actively managed mutual funds** tend to select stocks individually and time the market with the hope of outperforming the average market.

**Passively managed mutual funds** try to replicate the returns of the market, or a certain asset class, and are usually called index funds.

Several important results are presented:

1. **90% of Large Cap Active Managers underperformed Indexes, over a 20-year period.**
2. **97% of Mid Cap Active Managers underperformed Indexes, over a 20-year period.**
3. **Past Winners became Losers.** Actively managed funds that outperformed indexes over the first 10 years, underperformed the indexes in the following 10 years. Past winners became losers, hampering the chance of predicting outstanding fund managers.
4. **Higher Taxes.** The results were magnified when considering taxes: active managers lost 0.89% more of the returns to taxes, when compared to index funds (1.51% loss compared to 0.62%).

**What can we conclude from these results?** If you are looking to get the highest returns on your investment, you would not want to settle for average. You would like to find a superior fund manager that can beat the market.

Unfortunately, most fund managers underperform the market. When going to smaller companies, it is nearly impossible to find a fund manager that is better than the average market (3% chance!)

Even if you managed to find the rare fund manager who beat the market for many years, s/he is likely to do worse than the market in the future.

**You are at a dead-end.** Ads focus on recent returns of mutual funds. Returns of indexes that have a consistent investment allocation and that are measured over periods of 25+ years may be more reliable. The ads tend to focus on periods no longer than 10 years. Even Morningstar gives significant weight to returns over the past 3, 5 and 10 years. The whole mutual fund industry focuses on ratings that do not provide you with helpful information.

**The good news!** It turns out that if you settle for "average", you end up outperforming most investors. Once you are settled on average, you can focus on things you can control and measure very well: diversification, minimization of taxes and all other investment costs. You might think that you settled for average, but at this point, very few people, including most sophisticated money managers are doing better than you.

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<sup>1</sup> Referenced with permission.

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