

Quality Asset Management

Grow Your Wealth with Peace of Mind

Can you find Skilled Active Mutual Funds?

By Gil Hanoch, October, 2008

How would you like to choose mutual funds that will outperform benchmarks of the stock market? This is an ongoing pursuit of millions of people. Up until recent decades, people intuitively believed that if you pay professionals to spend hours every day researching stocks, they would outperform a brainless benchmark. It was only a matter of how big the outperformance would be – at least that was what people believed. Since then, multiple studies compared the performance of actively-managed mutual funds with benchmarks, and found out that it is not as trivial as intuitively seemed.

The task: This article reviews an academic study that tried to find out what portion of actively-managed mutual funds outperformed benchmarks due to skill, as opposed to random luck. This can help you decide whether you want to pay someone to try to outperform the benchmarks by picking the right stocks or by timing the market.

The [study](#) is by Russ Wermers, a professor of finance at the University of Maryland, Laurent Barras of the Swiss Finance Institute, and Oliver Scaillet of the University of Geneva. It observes returns of actively-managed mutual funds over the 32-year period of 1975 to 2006. It avoids short-term biases by including only funds with at least 60 months of returns, and is free of survivorship bias, by including funds that existed at any time in the period observed.

How do you decide? Given the alternative of passively managed funds that track diversified benchmarks, combined with the fact that globally diversified stock investments recovered from all declines in hundreds of years to achieve handsome long-term averages, you have to make a good case for trying to beat benchmarks, while risking doing worse.

You may choose to use an actively managed mutual fund if the odds of outperforming the benchmark are substantially higher than the odds of underperforming it. A smart speculator would do so given any chance of success over 50%, while a more risk-averse individual may want much higher odds.

The results: Can you guess what the chance for success was based on this study?

During the 32 year period studied, from 1975 to 2006, only 0.6% of funds delivered higher returns than their benchmark through skill (not even counting sales loads).

Feel free to reread the number above – the number is indeed less than 1%.

The decision: Based on these results, choosing actively managed funds seems unlikely to make you excess money while adding the risk of one person making wrong predictions. Neither the conservative investor nor the smart speculator should see any benefit in taking this chance.

Accepting the results of passively managed funds may sound boring, without the excitement of trying to “beat the market”, and plain “average”, but when compared to the dismal results of actively managed funds, it seems like the more sensible approach. It may be average compared to the benchmarks, but outstanding compared to most investors that still use actively managed funds.

What can you control? By narrowing it down to passively managed funds, you can avoid the risks of stock picking and market timing. Instead you can focus on things you can control such as minimizing costs, minimizing taxes and maximizing diversification. By using such criteria for selecting mutual funds you can peel off the speculative layer, turning yourself from a speculator to an investor, with a more direct link to the productive capacity of the world.

Past performance may not be indicative of future results. Simulated data was used for periods prior to the inception of mutual funds (see [Performance Data Disclosure](http://www.qualityasset.com/disclosure.htm) at <http://www.qualityasset.com/disclosure.htm>). Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this article, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Note that services are limited to investment advice and do not include financial planning and/or non-investment related consultation services. You should not assume that any discussion or information contained in this article serves as the receipt of, or as a substitute for, personalized investment advice from Quality Asset Management. If you have any questions regarding the applicability of any specific issue discussed above to your individual situation, you are encouraged to consult with the professional advisor of your choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.