

## Passive Outperforms Active in 2014

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Proponents of actively managed funds often tout the ability to beat the market as a leading advantage over passive counterparts. However, according to Denys Glushkov, Senior Researcher at University of Pennsylvania's Wharton Research Data Services, only 9.3% of mutual funds invested in large U.S. stocks beat their indices through September 30, 2014.<sup>1</sup> A study by Lipper, a research arm of Thomson Reuters, tells a similar tale with approximately 15% of active large-cap funds beating their benchmark as of November 25<sup>th</sup>.<sup>2</sup> While 2014 has not yet come to an end, these figures are well under the 38.6% average of the past 25 years. As Mr. Glushkov states, 2014 "is likely to enter the record books as the year when active equity funds delivered their worst performance relative to the index, net of fees, since at least 1989."

Investors may find their faith in the actively managed fund market wearing thin, but the educated investor will question this phenomenon, as well as its causes and longevity.

### Foreign Stocks

According to Morningstar, non-U.S. stocks typically account for 5% of a U.S. stock fund. Foreign markets are lagging U.S. markets by about 14%, a contributor to the underperformance. Since the S&P 500 does not hold primarily foreign funds, it was left unscathed.<sup>1</sup>

### Sector Rotation

Not all industries perform well at the same time but money managers can typically predict which industries will prosper based on the state of the economy. "Sector rotation" refers to investing in an industry that is expected to flourish in the current economic cycle then moving assets to another industry when the economy shifts.

However, fluctuation in the market makes picking promising industries a daunting task. For example, energy stocks were up 22.3% in 2013 while utilities were up 9%. The combination of falling oil prices and interest rates this year left energy stocks down 3% with an even bigger downturn in late November. On the contrary, utilities are up 18.5%.<sup>1</sup> By diversifying portfolios with sector rotation, active managers are more susceptible to certain sectors falling out of favor.

### Dispersion

The term "dispersion" refers to the difference between the earnings of the best and worst performing stocks. Currently, the market is experiencing low dispersion meaning the

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<sup>1</sup> Zweig, Jason. As Indexes Soar, Active Stock Pickers Can't Get Off the Ground. The Wall Street Journal. 28 November 2014. <http://blogs.wsj.com/moneybeat/2014/11/28/as-indexes-soar-active-stock-pickers-cant-get-off-the-ground/>

<sup>2</sup> Kerber, Ross. Poor performance catching up with active stock fund managers. Reuters. 28 November 2014. <http://www.reuters.com/article/2014/11/28/us-funds-active-performance-idUSKCN0JCO9O20141128>

returns of the best performing stocks are barely higher than the worst performers. As Ann Holcomb, Co-Manager of the T. Rowe Price Capital Opportunity Fund, explains “When you aren’t getting big payoffs from your outperformers then it’s harder for your good decisions to add more value than your bad ones detract.”<sup>3</sup> Low dispersion feeds off of a mostly stable market and low interest rates. As Ms. Holcomb predicts, rising interest rates in 2015 should fuel volatility in the market and increase the disparity between the best and worst performers.

## Conclusion

The factors leading to the meager performance of actively managed funds are likely temporary. As said by John C. Bogle, the father of the index fund industry and the founder of the Vanguard Group, “I’m concerned that people will say that indexing will always win or always win this big. This level of outperformance just doesn’t happen for long.”<sup>3</sup> Looking forward, quality active management has a good chance of topping the performance of index funds. The pendulum swings both ways .

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<sup>3</sup> Zweig, Jason. As Indexes Soar, Active Stock Pickers Can’t Get Off the Ground. The Wall Street Journal. 28 November 2014. <http://blogs.wsj.com/moneybeat/2014/11/28/as-indexes-soar-active-stock-pickers-cant-get-off-the-ground/>