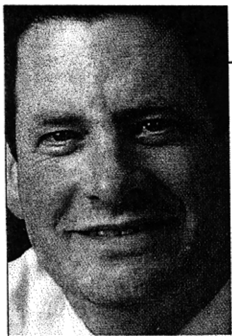


Forbe's Magazine's Portfolio Strategy columnist and Fisher Investments chief executive KEN FISHER explodes the myth that active managers perform poorly against passive indices – it is simply a question of whether large cap beats small cap

Funds vs indices – don't believe the hype

Active managers lag passive indices – regularly and by a lot – right? Wrong. This, like most media myths, has enough right about it to mislead folks into believing that which is patently false.

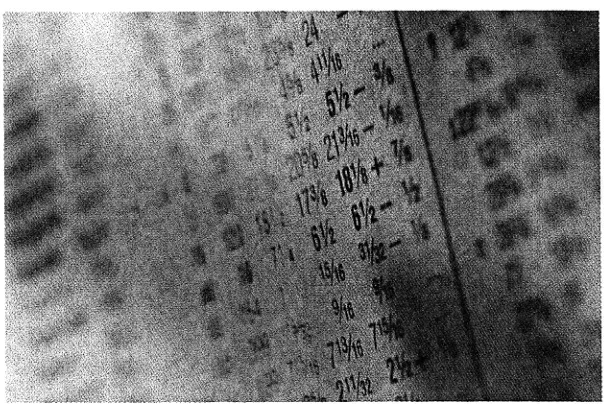
Not all, but almost all, of whether active bests passive or vice versa in a given quarter or year derives solely from whether small cap bests big cap – nothing else. Tough to fathom. But in the last 12 years in the US fully 84% of the matter came from nothing but size. How?

Morningstar is the standard in measuring US mutual funds. Imagine the years starting from 1990, those for which Morningstar has integral data. The S&P 500 is the standard US measure of big cap (and the index most used for passive management) and the Russell 2000 is the standard US small cap index.

Now ask: for each quarter, what percentage of equity funds beat the S&P 500 versus lagged it? Then lump each quarter into one of three groups:

- one where the S&P 500 beat the Russell 2000 by more than 0.75%, meaning that big cap beat small cap by more than a little;
- another where the Russell 2000 beat the S&P 500 by more than 0.75%, meaning small beat big by more than a little; and
- a third where the spread between the two indices was less than 0.75% meaning that size wasn't material.

Obviously, our first group had a big cap effect. There were 25 of those quarters. And in 100% of those quarters, more funds lagged the S&P 500 than



beat it. On average, only these funds beat the S&P in these quarters only 28% of the time.

Our second group, by definition, had a small cap effect. There were 19 of those quarters. In 18 of the 19, more funds beat the S&P 500 than lagged it and overall beat the S&P 64% of the time. The only quarter where it wasn't true was 2001's first quarter. So? So, nothing is 100% perfect.

Our third group had no pronounced size effect. There were merely eight of these and their results were mixed with a bias toward lagging the S&P, on average lagging the S&P 45% of the time. Simply, when big cap markedly beats small cap, funds lag the market, and highly so. When small cap markedly beats big cap funds beat the market pretty well. When there isn't much difference, there isn't much difference – although funds lag a hair.

This makes sense. Think how size impacts funds versus the S&P 500, which is cap-weighted. Its biggest stocks drive

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its capitalisation, which is, amazingly, \$105bn (£73bn). If the same stocks weren't cap-weighted but equal-weighted, their average cap would be only \$21bn. Few funds can own solely the S&P's largest stocks. The more a fund diversifies, the more it owns smaller stocks, driving down its average cap.

Then, too, funds buy similar amounts of most stocks they own – whereas the S&P 500 feels a move from GE 100 times as much as it does from Delta Airlines. Funds rarely buy in such unequal amounts. Funds act equal-weighted while indices are and act cap-weighted. The average fund's average market capitalisation is \$26bn – proxying the \$21bn equal-weighted average – and a quarter the cap-weighted average. That size spread is fully enough to cause the size effect demonstrated above.

Note that funds in total are a big enough slice of total equities that on balance they should lag stocks in the long term, but only as fees and transaction costs drag down returns.

That is, if one fund buys and another sells, one is right, the other wrong, and on average the two should have average results before transaction costs and fees – but slightly sub-average results after all costs and fees. There is no other logical reason for funds to do vastly worse than indices – counter to the standard mythology.

So, did funds beat the market in the first quarter, or vice versa? The S&P 500 was flat and the Russell 2000 was up 4%. You decide. Next month? How simply terribly most investors choose funds. BM