GinsGlobal Monthly Review – August 2015

The latest data compiled by Standard & Poors for mid-year 2015, clearly shows that the vast majority of US fund managers consistently underperform their respective index benchmarks over the past 1, 3, 5 and 10 year periods. This is true of both equity and fixed income (bond) fund managers. The latest results are a sad indictment on most active fund managers, who rarely outperform their index benchmarks. Typically between 80%-90% of fund managers failed over the past 5 year period!

Globally the trend is getting far worse for active fund managers. While it may be fun investing with the current star fund manager, active manager underperformance is proving incredibly costly to investors. Few global fund managers remain stars – more often than not they are bright comets that flame out, shortly after reaching their brightest moment.

For the five and ten year period ending (June 30, 2015), 81% and 80% of US equity managers failed to beat the S&P 500 benchmark, respectively. The sorry tale also continues for US Mid-cap and Small-cap managers, with 87% and 81% respectively underperforming their benchmarks over the recent ten year period. Even over the shorter five year period, 78% of mid-cap managers and 79% of small-cap managers failed to beat their respective index benchmarks.

The results clearly show that the vast majority of US equity managers consistently fail to beat their domestic US benchmarks.

% of US Equity Managers underperforming the Index (June 30 2015)

	1 year	3 year	5 year	10 year
Large-cap (vs. S&P 500)	65.3%	64.5%	80.8%	79.6%
Medium-cap (vs. S&P 400)	48.2%	67.7%	78.4%	87.0%
Small-cap (vs. S&P 600)	58.5%	73.2%	78.8%	80.6%
All US Equity (vs. S&P 1500)	67.1%	66.6%	83.1%	84.1%

Source: Standard & Poors, Mid-Year 2015 SPIVA Scorecard

Not surprisingly, in the US the popularity of passively managed funds continues to grow. Perhaps most surprising, is the weak performance amongst Fixed Income (bond) fund managers. Less than 7% of US bond managers beat the US Treasury long bond benchmark index over the past 1, 5 and 10 year periods. Amongst High Yield bond managers, fewer than 16% beat the index over the past 5 and 10 year periods. While in the Emerging Market bond space, 94% and 97% of managers underperformed their benchmark over the past 3 and 5 years, respectively.

% of US Bond Managers underperforming the Index (June 30 2015)

	1 year	3 year	5 year	10 year
US Govt long bonds (vs. Barclays Long Govt)	98.8%	85.4%	97.8%	93.3%
US Inv Grade short bonds (vs. Barclays 1-3 yr Govt/Credit)	86.7%	80.0%	59.1%	75.6%
High Yield Funds (vs. Barclays High Yield)	51.1%	77.3%	84.3%	92.9%
Global Income Funds (vs Barclays Global Aggregate)	30.7%	35.2%	46.4%	56.5%
Emerging Markets (vs. Barclays Emerging Markets)	90.4%	93.9%	97.0%	81.3%

Source: Standard & Poors, Year-End 2015 SPIVA Scorecard

The majority of US fund managers running global portfolios also underperformed their respective global index benchmarks. Over the past ten years 92% of fund managers failed to beat the Emerging Markets equity index, while 83% underperformed the global developed markets index outside the US.

% of Global Equity Managers underperforming the Index (June 30 2015)

	1 year	3 year	5 year	10 year
Global (incl US) (vs. S&P Global 1200)	50.0%	68.4%	72.9%	78.1%
Global (ex US) (vs. S&P 700)	34.4%	55.3%	60.7%	82.5%
Global Small Cap (vs. S&P Developed Ex-US Small Cap)	50.7%	49.3%	55.4%	56.5%
Emerging Markets (vs. S&P/IFCI Composite)	73.3%	70.9%	74.5%	92.2%

Source: Standard & Poors, Mid-Year 2015 SPIVA Scorecard

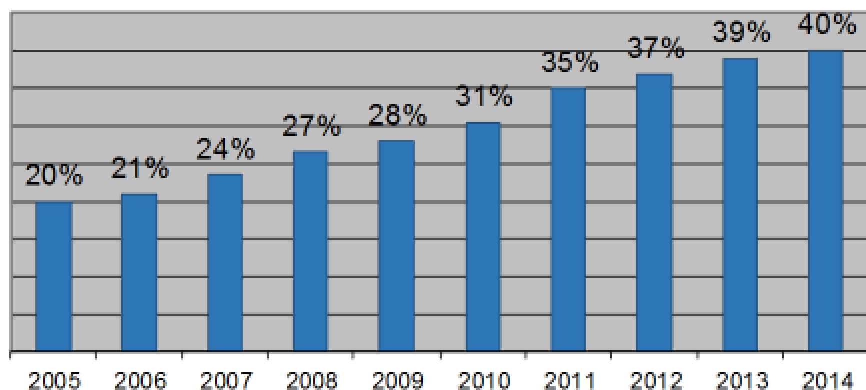
Those who list top-performing unit trusts as evidence that indexing doesn't work are in fact doing investors a terrible disservice. Although each year some active unit trusts will always beat the indexes, few consistently do over a 5 year period. Finding such needles in a haystack may not be worth the risk of underperforming the index.

The turmoil of the past five years saw approximately 23% of all US domestic equity funds being closed or merged out of existence. Similarly almost 24% of international oriented funds closed and 17% of fixed income funds.

While it is commonly believed that active management works best in inefficient markets (small cap, emerging markets) – the latest data disputes this. The vast majority of managers in the small-cap and emerging market space under-performed by a sizable extent.

Background

Using index funds, the investor need have no concern whether the unit trust manager is fickle, nearing the end of a hot streak, or may move to another investment firm. When building a long-term investment portfolio, investors should begin to emulate many of the world's most sophisticated investors. In the US approximately 37% of all pension fund assets are now invested in index funds. This number is set to increase as ETFs also become increasingly popular. CALPERS the largest US pension fund commonly indexes over 30% of its $250bn portfolio.



The index outperformance is largely due to the constant trading (churning) which occurs within most unit trust portfolios, in a mostly futile attempt to outperform the stock or bond markets. The high trading commissions and related fees most unit trusts incur coupled with the narrow portfolio focus on only a limited number of stocks or bonds - more often than not ensures a weaker performance than the selected index benchmark.

Index funds incur few transaction charges from buying and selling different stocks. The typical US unit trust portfolio suffers from an extremely high turnover rate of 100% pa. – most studies agree that this effectively burdens a unit trust with an additional 2.5%-3% of costs. By contrast most index funds have an incredibly low turnover of between 5%-10%.

Given the efficiency of international markets and the lack of any dominant sector in such indices as the FTSE 100 and S&P 500 (unlike resources that dominate the JSE ALSI) – it is not surprising that the vast majority of fund managers struggle to beat the indices.

Index funds when used as a core portion of either a local or a global portfolio, provide the necessary diversification and low costs to complement active fund managers.

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