Vast majority of Fund Managers continue to underperform their Index Benchmarks

"The best way to own common stocks is through an index fund." - Warren Buffet, Berkshire Hathaway Inc. 1996 Annual Report

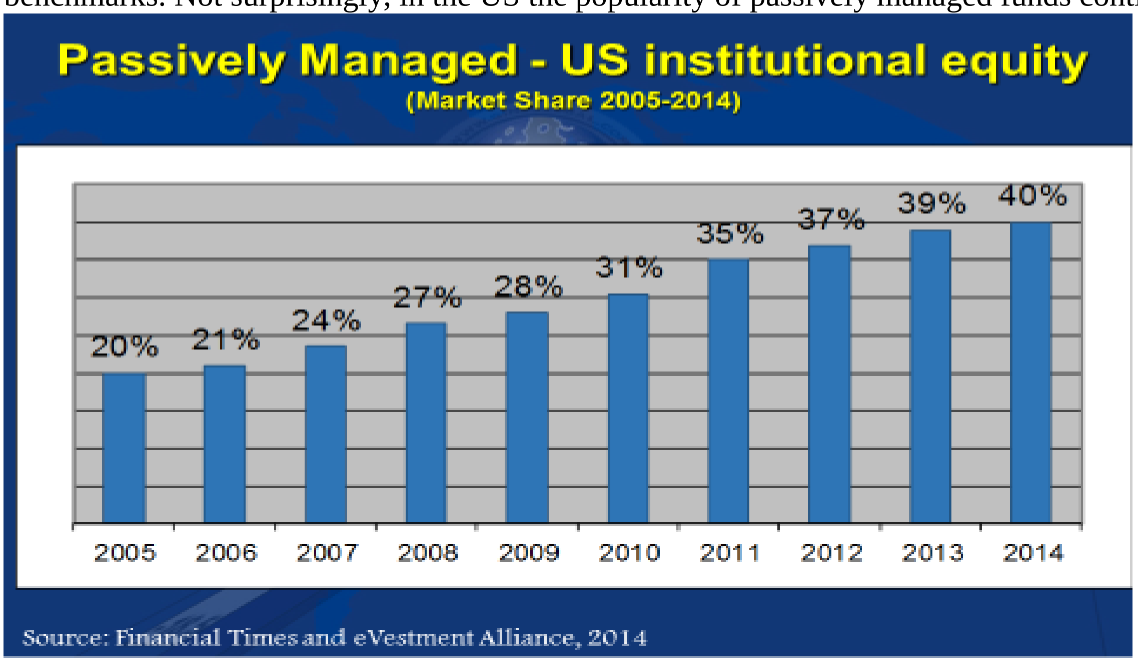
The latest data compiled by Standard & Poors for December 2014, clearly shows that the vast majority of US fund managers consistently underperform their respective index benchmarks over the past 1, 3, 5 and 10 year periods. This is true of both equity and fixed income (bond) fund managers.

Globally the trend is getting far worse for active fund managers. The latest results are the clearest indictment yet of poor active fund performance over the past decade. 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 year period ending (December 31, 2014), 89% of US equity managers failed to beat the S&P 500 benchmark. Over the latest three year period 76% had failed. The sorry tale also continues for US Mid-cap and Small-cap managers, with 85% and 87% respectively underperforming their benchmarks over the recent five year period. Even over the shorter one year period 86% of large-cap managers and 73% of small-cap managers failed to beat their respective index benchmarks.

Sadly over 10 years the results are equally unfavourable – with 82% underperforming the S&P 500, with 90% losing out to the mid-cap (S&P 400 Index) and 88% weaker than small-cap (S&P 600 Index).

The results clearly show that the vast majority of US equity managers consistently fail to beat their domestic US benchmarks. 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 5% of US bond managers beat the US Treasury long bond benchmark index over the past 1, 3, 5 and 10 year periods. Amongst High Yield bond managers, fewer than 15% beat the index over the past 3 and 5 year periods. While in the Emerging Market bond space, 93% and 90% of managers underperformed their benchmark over the past 3 and 5 years, respectively.

% of US Equity Managers underperforming the Index (Dec 31 2014)

	1 year	3 year	5 year	10 year
Large-cap (vs. S&P 500)	86.4%	76.3%	88.7%	82.1%
Medium-cap (vs. S&P 400)	66.2%	70.5%	85.4%	89.7%
Small-cap (vs. S&P 600)	72.9%	80.4%	86.6%	87.8%
All US Equity (vs. S&P 1500)	87.2%	76.8%	80.8%	76.5%

Source: Standard & Poors, Year-End 2014 SPIVA Scorecard

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The majority of US fund managers running global portfolios also underperformed their respective global index benchmarks. Over the past ten years 90% of fund managers failed to beat the Emerging Markets equity index, while 79% underperformed the global developed markets index outside the US.

% of Global Equity Managers underperforming the Index (Dec 31 2014)

	1 year	3 year	5 year	10 year
Global (incl US) (vs. S&P Global 1200)	76.9%	73.6%	75.5%	79.2%
Global (ex US) (vs. S&P 700)	68.9%	58.5%	62.5%	84.1%
Global Small Cap (vs. S&P Developed Ex-US Small Cap)	69.4%	50.8%	51.9%	58.1%
Emerging Markets (vs. S&P/IFCI Composite)	68.7%	66.0%	72.2%	89.7%

Source: Standard & Poors, Year-End 2014 SPIVA Scorecard

GINSGLOBAL INDEX FUNDS

The turmoil of the past five years saw approximately 24% 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.

% of US Bond Managers underperforming the Index (Dec 31 2014)

	1 year	3 year	5 year	10 year
US Govt long bonds (vs. Barclays Long Govt)	97.7%	96.7%	97.7%	95.5%
US Inv Grade short bonds (vs. Barclays 1-3 yr Govt/Credit)	56.8%	55.8%	56.8%	67.5%
High Yield Funds (vs. Barclays High Yield)	73.1%	77.0%	88.8%	93.0%
Global Income Funds (vs Barclays Global Aggregate)	36.1%	36.7%	45.8%	46.8%
Emerging Markets (vs. Barclays Emerging Markets)	84.3%	93.2%	89.7%	75.0%

Source: Standard & Poors, Year-End 2014 SPIVA Scorecard

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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.

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.

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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