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SECTIONS

What's driving the decade of outflows from actively managed mutual funds

Much of the movement away is led by advisers looking for cheaper and easier ways to build client portfolios

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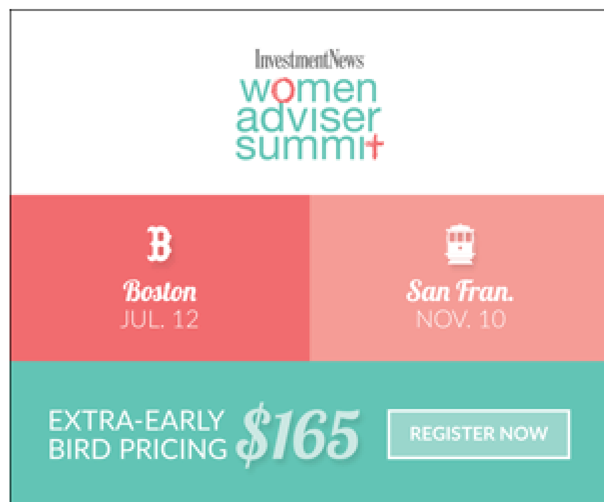
After a decade-long run of steady net outflows, the actively managed mutual fund space could use a good old-fashioned bear market. A down market, some argue, is where active managers will really stand out and prove they can still earn their keep.

Even though actively managed funds make up about 65% of all mutual fund assets, the steady performance of inexpensive market beta has left a lot of active management shops claiming they will be there when it's time to play some defense.

“The only market in which passive outperforms active is the market we're in right now with increasing asset prices and increasing p/e multiples, and the reason that's been the case is because of the extraordinary policies of the **Federal Reserve**,” said Bob Rice, chief investment strategist at Tangent Capital.

“When everything is flying higher, and the correlations are all at one, you don't need anybody to pick your assets,” he added. “The poor value-based active managers won't touch the stuff because it's too bubblish, and that's what has happened to the market over the last five



years."

PATTERN OF OUTFLOWS

The pattern of outflows has been most vivid among actively managed U.S. equity funds, which have experienced nearly $890 billion in net outflows over the past 10 years through the end of March, including $175 billion in net outflows last year.

Jonathan Golub, chief U.S. equity strategist at RBC Capital Markets, linked the outflows to the inability of most active funds to beat their benchmarks, and he attributed that to market cycles.

But he still doesn't think abandoning active funds in favor of passive indexed strategies is the right move at this time.

"It has been a horribly challenging environment for active managers," he said.

According to Mr. Golub, the current environment for actively managed funds looks a lot like it did in the late 1990s, but the primary difference is the absence of economic growth this time around.

"When growth is extremely normal, value investing works," he said. "But when economic growth is high, like it was in the 1990s, or low, like it is right now, it is difficult for active managers."

Much of the movement away from actively managed funds is led by financial advisers looking for cheaper and easier ways to build client portfolios. The Department of Labor's new fiduciary rule is likely to only make matters more challenging for active managers, as fees become more of a focal point.

“My thoughts are, you don't really need active management,” said Steve Burkett, a financial adviser at Palisade Investments.

“I think an important reason that advisers are moving towards embracing passive strategies is that clients and investors have absolutely no need to beat the markets; they simply need to capture the returns of the capital markets,” he added. “Sure, it'd be nice to outperform, and the allure of doing so is what drives billions being spent on trying to do so. But the odds of outperformance are low.”

A STREAM OF RESEARCH

That kind of attitude has the active-fund camp quaking in their boots, which has led to a steady stream of research and analysis on how and why actively managed funds can and do work.

American Funds, which dominates the actively managed fund space with $1.4 trillion under management, has rolled out its internal research showing that low fund expenses and high portfolio manager ownership in the fund are effective screens for identifying better-performing active funds.

For example, last year large-cap equity funds averaged a decline of 32 basis points, while the S&P 500 Index gained 1.41%. But, viewing it as American Funds did, on 1-year rolling periods over each month of the past 20 years through 2015, large-cap equity funds averaged an 8.7% gain, while the S&P averaged 9.8%.

The gap between active and passive clearly narrows when the performance is spread out over 20 years and averaged over 240 individual time periods, but active funds overall still only beat the index 35% of the time, American Funds' says.

FEES A BIG HURDLE

However, when only those funds with low fees and high manager ownership are included, the average return jumps to 10.1%, with those funds beating the index 55% of the time.

Fees are the biggest hurdle active funds face when being compared to a benchmark that is typically calculated with zero fees. But even when index-fund fees are factored in, there are

strategies that can be had for as little as a handful of basis points.

In terms of fund managers investing in their own funds, Steve Deschenes, senior vice president in client analytics and research at American Funds, said, “It's about having some skin in the game.

“Good advisers have done a good job of identifying the funds that are more likely to do better than the index, and those funds have had positive inflows,” he added.

Fidelity Investments has also started touting its in-house research, showing why it's important to weed through the mountains of actively managed funds for the real gems.

In this case, Fidelity says combining low fees with the backing of major asset management complexes can help identify active-management standouts.

Looking at large-cap equity funds, for example, Fidelity found that funds in the lowest quartile in terms of expense ratios that are offered by the five largest fund complexes beat their respective indexes by about 18 basis points annually.

When the cost of indexed investing is factored in, the screened universe of active funds had about a 22-basis-point edge over index funds.

“The story has grown louder and louder about passive funds outperforming and active funds lagging, and we needed to understand the numbers, because they didn't look like our numbers,” said Timothy Cohen, Fidelity's chief investment officer.

The active-passive debate has become especially fertile ground for the academic community.

Martijn Cremers, professor of finance at the University of Notre Dame, has written multiple research papers and even helped launch a website, ActiveShare.info, aimed at uncovering the truly active managers.

In this case, the focus is on active managers who are not afraid to stray from the benchmark, which Mr. Cremers believes is the only way active managers can beat their benchmarks.

In his research, Mr. Cremers describes funds with at least 40% of the portfolio overlapping the benchmark as low on the active-management side.

He grades benchmark-hugging not just by owning the same stock as the index, but by owning it in the same proportion. For instance, if both the fund and the index have a 5% weighting in Apple Inc., that's an overlap.

The more a portfolio is overlapping its benchmark, the more the higher fees of active management come into play as a drag on performance.

“If you have the same holdings as the index it doesn't matter what those holdings do because they will not affect the relative performance of the fund,” Mr. Cremers said.

Robert Braglia, president of American Financial & Tax Strategies Inc., is embracing an attitude that active-management shops appreciate, because he is looking past the broad category averages to the individual funds.

“The old argument that most actively managed funds under-performed their index, while true, seems irrelevant, because I'm not investing in most funds; I'm just investing in a handful that I feel have a good chance of outperforming,” he said.

Mr. Braglia hedged his perspective to point out that exchange-traded funds are putting mutual funds at a disadvantage in terms of tax management.

“Think about it, a mutual fund is the only product I can think of that you buy without even knowing the price you will pay until the next morning,” he added. “There will probably always be certain cases in which [actively managed] mutual funds are appropriate but they will be fewer and fewer.”

Kashif Ahmed, president of American Private Wealth, thinks much of the movement toward passive strategies is the result of successful marketing campaigns.

“I'm not a proponent of indexing, because not everything in an index is worth buying,” he said. “There are plenty of active managers out there that earn their keep for long periods of time. And as advisers, it is our duty to be constantly looking out for them on behalf of our

clients."

Advisers like Mr. Ahmed notwithstanding, active managers have to be coming to grips with the idea that their general appeal is slowly waning, and it might not just be about market cycles.

"We've heard time and time again how active managers will out-perform in down markets, but it never seems to happen, because active managers seem to mess up in bear markets as well," said Don Phillips, a managing director at Morningstar.

"There is a subset of active managers that can and will beat the index, and I think you can make smart choices among active managers, but you need to find the ones that keep costs low and take a longer term view," he said. "But just buying the indexes is never a terrible choice, which is why the outlook is not good for active management, in terms of net flows."

Nobody yet is ready to call for the eventual extinction of actively managed funds, but some believe the shrinkage will continue.

"I don't think active funds can reverse the trend or stem the outflows, but they might be able to slow the outflows," said Todd Rosenbluth, director of mutual fund and ETF research at S&P Capital IQ.

"The DOL rules will discourage advisers from using expensive actively managed mutual funds, and encourage them to use passively managed funds and ETFs," he added. "This isn't the death of active management, but I do think the bleeding will continue."

What do you think?

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