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Index Investing

We contend that it is hard to know which fund manager is going to beat the market regularly. We often recommend index investing or variants on this as ways of getting exposure to an asset class.

We have reached this conclusion after many years in the industry and a huge number of man-hours of research. But we have to keep checking our advice and our figures. Standard & Poor's figures to 1 April 2007 may not be traditional page turners for the mainstream British public but there is some good information in there. Here's a précis of the most recent update:

Over the first 3 months of 2007 66% of actively managed funds large cap funds outperformed the relevant US index. This is pretty impressive and explains the chap at the pub (please substitute as appropriate) who boasts of slaughtering the index with his IFA's recommendations.

Over five years between 70% and 80% of the main market funds, the mid cap funds, and the small cap funds perform *less* well than the relevant index. Over ten years the figures are even more compelling.

However, what I have been reminded of in this bulletin is a banana skin that has caused some very eminent analysts some difficulty over the last thirty years.

If I were examining active funds vs passive funds over ten year periods I would obtain performance statistics for all current active funds. I might then reasonably exclude all those funds with a history of less than ten years. I would then produce a stack of spreadsheets and attempt to draw some conclusions.

What is wrong with that approach?

It ignores survivorship bias. Any fund that existed within the last ten years but not at the end of the period might (or might not) be excluded from my data. But during that time those funds were available to investors and advisers.

In fact we know that it tends to be poorer performing funds that are merged, wound up or have their aims and objectives changed. So unless one acknowledges survivorship bias results of an analysis are likely to be tilted towards the better funds because the poorer funds (that were within the universe of funds at any one point) are effectively excluded from the analysis.

The S & P report advises that in the US market in the last five years 29.3% of domestic equity funds had merged or liquidated and 28.6% of sector funds have been liquidated. I find these figures surprising. In five years, one in four of the mainstream investment funds have disappeared. It is very unlikely that in more than a handful of cases these funds were closed because they were doing so well. They were I suspect closed because they were underperforming, not selling well or failed to reach a fund size target.

Be wary of investment performance statistics (yes even ours). I believe that a dispassionate and accurate review of the statistics supports index type investing for main market exposure.

Ben Sherwood - Principal
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