

## FOUR PROBLEMS WITH ACTIVELY MANAGED MUTUAL FUNDS!

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Since the early days of John Bogle, Vanguard founder, there has been a debate over which is better, actively managed mutual funds or index funds. Last month we discussed why market timing was not a winning tactic; let me tell you three reasons why I think index mutual funds are the key to greater stock market returns.

First; there is a low probability of selecting a risk adjusted winning fund. If you look at the universe of funds you will find that about 4% of the funds are either terminated or combined with another fund each year. This is known as the survival rate. If you consider the active 355 funds that existed in 1970, by 2009 there were 112 remaining. Over this 40 year period 64% either closed or merged. Furthermore when you compared the survivors to the Wilshire 5000 index, only 41 funds beat the index, that is 12% of the original 355 funds. Only 5 funds beat the index by more than 2 percent.

Second; the alpha or gain greater than the market, from active winning funds are well below a fair payout. If you look at the Vanguard S&P 500 Index Fund, and compare it to the large capitalization funds that survived for the last 25 years we find only 33% beat the index fund, while the other asset classes show similar results. Of the winning funds, they beat the market by .96%. The lower third were 2.6% below market average and the middle third was .8% below average, the winning funds need to beat the market by 3.4% to break even.

If you still think ; "I know a fund that beat the market and by more than the annual expenses ratio," consider the third problem. A diversified portfolio consisting of several active funds has a very low chance of success. Let us consider the probability that a portfolio of an all index portfolio will beat a comparable portfolio of all active funds. Most of the portfolios I designed have 5-10 different mutual funds. An analysis in "The Power of Passive Investing", by Rick Ferri; he shows with a 5 fund portfolio, the index funds will win 86% of the time over a five year time frame. If we extend the analysis to 20 years the index portfolio wins 98% of the time. For a 10 fund portfolio, the index wins 91% of the time for 5 years, and 99% of the time for 20 years.

Fourth; once you find the winning fund, how many keep on winning? Standard and Poor's Fund Persistence Scorecard takes the top 25% of funds based on their three year performance, then compares their performance ranking for the next three year period. Their finding; winning is not persistent. The winning funds from one three period were evenly spread among each quartile from top to bottom over the next three year period.

Most of you have 40 to 60 years of investing ahead of you; to win with active mutual funds you will not only have to pick the winning one percent, but you have to pick the one for each asset class in your portfolio, and you will have to pick them in advance. With index funds you know you will get market returns.

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Should I contribute to my employer 401k plan or an IRA?

Generally if your employer matches any portion of your funds, contribute enough to get the entire match. A typical matching formula is 100% of the first 3% and 50% for the next 2%. If you contributed 5%, your employer would contribute 4%; this gives you an 80% gain instantly.

After you have reached the limit of the employer match, then I feel it is best to fund your IRA. Oh, but which kind. It depends on your unique situation, but I usually find a Roth IRA is the best choice. Although you contribute to a Roth IRA after tax, the withdrawal can be tax free. Also unlike the traditional IRA, there is no required minimum distribution at age 70 1/2. Also depending on your age, it is highly likely that you are in a lower tax bracket today than you will be years out in the future.

There are limits to Roth contributions, but by using a conversion, you can have one.