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The Death of Active Investment Management?
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There has been a strong case made for passive investment management over the years, and therefore a proliferation of products such as index mutual funds and exchange-traded funds (ETFs). The appeal of index funds is easy to understand. Why pay higher investment fees for active management when a small percentage of these products actually outperform an index? Some interpretations of ERISA and the Prudent Investor Rules have even surmised that passive management is the only truly prudent approach for fiduciaries.

Investors have just experienced the worst 10-year period in the history of the stock market. Through March 31, 2009, the S&P 500 Index has delivered a 10-year cumulative loss of over 26% (-3.0% per year). The first decade of the 2000s has been harsh so far, with two bear markets and a decade-to-date loss of over 36% (annualized return of -4.72%) for the S&P 500 Index. The pain has been felt around the globe, as international stock markets are also in the red for the decade with a total loss of over 26% (annualized return of -3.29%) for the MSCI EAFE Index.

Proponents of active investment management have argued that professionally and prudently managed portfolios can be effective in providing some downside protection for investors. Active managers can utilize techniques as simple as raising cash in a portfolio to limit losses that might be generated by a passive approach. Professional money managers can also skew portfolios to sectors of the stock market that may perform better than market indices. Clearly, this was a challenge during the most recent stock market crash, as nearly all sectors were punished in a panic-selling environment in which there was no place to hide.

So, how did active management fare versus the indexes during this brutal decade? We decided to analyze the data and the results were clear…a significant percentage of active equity managers have outperformed their respective indices over the past 10 years. The following is a summary of our analysis:

U.S. Large Cap Core Equity Managers

Active managers in the U.S. Large Cap Core Equity Universe strive to generate returns in excess of the S&P 500 Index. We plotted the S&P 500 Index return against this universe of active managers. For periods ending March 31, 2009, the percentage of active managers that outperformed the index is as follows:

- 3-Year Period – 72%
- 5-Year Period – 84%
- 7-Year Period – 85%
- 10-Year Period – 91%
- Decade of 2000s – 91%

If we evaluate the U.S. Large Cap Core Equity Universe over rolling periods of time since the beginning of the decade, we find similar results. Over rolling 3-Year periods during this decade, the percentage of active managers that outperformed the index is as follows:

- Period ending March, 2003 – 76%
- Period ending March, 2004 – 68%
- Period ending March, 2005 – 67%
- Period ending March, 2006 – 65%
- Period ending March, 2007 – 63%
- Period ending March, 2008 – 69%
- Period ending March, 2009 – 72%

On a risk/return basis, over the past ten years, the S&P 500 Index has delivered a lower annualized return (-3.00%) than the median active manager in the U.S. Large Cap Core Universe (-0.66%), with a slightly higher measure of volatility (Standard Deviation). On a *cumulative* basis, the results are magnified, with the index return over the past ten years of -26.25% and the median active manager return of -6.43%.

International Large Cap Core Equity Managers

Active managers in the International Large Cap Core Equity Universe typically attempt to generate returns in excess of the MSCI EAFE Index. We plotted the MSCI EAFE Index return against the universe of active International Equity Managers, and found similar results to those of active U.S. Equity Managers. For periods ending March 31, 2009, the percentage of active managers that outperformed the index is as follows:

- 3-Year Period – 67%
- 5-Year Period – 73%
- 7-Year Period – 77%
- 10-Year Period – 92%
- Decade of 2000s – 79%

Again, we evaluated this group of active International Large Cap Core Equity managers over rolling periods of time. The following are the percentage of active managers that outperformed the index over rolling 3-Year periods:

- Period ending March, 2003 – 67%
- Period ending March, 2004 – 68%
- Period ending March, 2005 – 47%
- Period ending March, 2006 – 58%
- Period ending March, 2007 – 60%
- Period ending March, 2008 – 79%
- Period ending March, 2009 – 67%

On a risk/return basis, over the past ten years, the MSCI EAFE Index has delivered a lower annualized rate of return (-0.84%) than the *median* active manager in the International Large Cap Core Universe (+1.21%), with a lower measure of volatility. On a *cumulative* basis, the EAFE Index lost money (-8.05%), while the median manager gained +12.84%.

U.S. Small Cap Core Equity Managers

Active managers in the U.S. Small Cap Core Equity Universe normally attempt to generate returns in excess of the Russell 2000 Index. We plotted the R2000 Index return against the universe of active U.S. Small Cap Core Equity Managers, and again found comparable results. For periods ending March 31, 2009, the percentage of active managers that outperformed the index are:

- 3-Year Period – 44%
- 5-Year Period – 61%
- 7-Year Period – 71%
- 10-Year Period – 89%
- Decade of 2000s – 90%

Here are the percentages of U.S. Small Cap Equity Managers that outperformed the index over rolling 3-Year periods:

- Period ending March, 2003 – 87%
- Period ending March, 2004 – 80%
- Period ending March, 2005 – 82%
- Period ending March, 2006 – 57%
- Period ending March, 2007 – 74%
- Period ending March, 2008 – 61%
- Period ending March, 2009 – 44%

Looking at the risk/return profile of the R2000 Index plotted against the U.S. Small Cap Core Equity Universe over the past ten years, we observe that the index has generated a lower annualized return (+1.93%) than the median active manager (+5.1%), with a slightly higher level of volatility. On a *cumulative* basis over the past ten years, the R2000 Index earned +21.12% and the median active manager generated +64.38%. During this decade, the R2000 Index has lost money, while the median active small cap manager has generated positive returns.

Investment Management Expenses

Of course, the primary focus of passive management is the lower level of investment management fees. The theory is that the higher investment management fee charged by active managers creates such a headwind that it is unlikely they could generate returns greater than their index on an after-fee basis.

We reviewed the range of investment management fees charged by active managers in the same categories as our returns analysis. The following table illustrates this range of annual investment management fees:

	U.S. Large Cap Mgrs	Int'l Equity Mgrs	U.S. Small Cap Mgrs
High	3.00%	3.00%	1.25%
5th Percentile	1.00%	1.00%	1.00%
25th Percentile	1.00%	0.80%	1.00%
Median	**0.75%**	**0.75%**	**0.90%**
75th Percentile	0.60%	0.70%	0.85%
95th Percentile	0.50%	0.43%	0.65%
Low	0.25%	0.25%	0.08%

While the cost of active investment management is undoubtedly higher than the expenses associated with passive management, indexing is not free. The annual expense ratio of comparable Vanguard index funds is:

- Vanguard 500 Index Fund 0.18%
- Vanguard Developed Markets Index Fund 0.29%
- Vanguard Small Cap Index Fund 0.28%

If we eliminate the "outliers" (the high and low manager in each universe), the range of annual investment management fees is roughly 50 – 100 basis points. If we compare the annual investment management fee of the median active manager to the annual expense ratio of the index fund, the resulting *additional* fee for active management is:

- U.S. Large Cap Core Management +0.57%
- International Large Cap Core Management +0.46%
- U.S. Small Cap Core Management +0.62%

Summary Conclusions

Over the past 10-Year period ending March 31, 2009, the median active U.S. Large Cap Core Equity Manager has generated an annualized excess return of +2.34% versus the S&P 500 Index. This excess return is significantly larger than the additional active management fees charged by the median manager, resulting in a *net* +1.77% excess annualized return over this period. In this category, the net excess return represents significantly less cumulative loss to investors.

Similarly, over the past 10-Year period, the median active International Large Cap Core Equity Manager has delivered an excess annualized return of +2.05% over its benchmark index. The *net* excess annualized return for the median manager in this group is +1.59%. In this category, the net excess return meant the difference between losing money with an index approach versus earning money with active management.

Finally, for the 10-Year period ending March 31, 2009, the median active U.S. Small Cap Core Equity Manager earned excess annualized returns of +3.17% as compared to the R2000 Index. In this category, while both indexing and active management earned positive returns, the *net* excess annualized rate of return for the median active manager is +2.55%.

It is helpful to understand the construction of the most widely-referenced stock market indices. The stocks contained in the indices are weighted by their market capitalization. A company's market capitalization is roughly equivalent to its total outstanding shares multiplied by the price of its stock. Of course, if investors are heavily buying shares of a specific company or certain industry, the price of those shares will be driven higher and the weight of that company/industry will increase in the index. This has created situations where indices and index funds were heavily weighted in what turned out to be over-valued sectors (internet stocks in 1999 and financial stocks in 2007).

Most certainly, there have been and will be periods during which passive management performs better than many active money managers. Prior research seemed to indicate that this was true during the bull market from 1982-2000. However, the evidence reveals that active management has been rewarded during severe bear markets. While it is certainly prudent for investors and fiduciaries to seek reasonable fees when evaluating investment products, recent court cases have concluded that "nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund." It is clear that active management resulted in net (after expenses) excess rates of return over the past ten years in each of the three categories studied.

In recent years, the common theory among many investment professionals has been that it is extremely difficult for active large cap money managers to generate returns in excess of their benchmark index. Many institutional investors have implemented index funds for their U.S. and International large cap allocations, and sought excess returns in other parts of the equity markets. Perhaps, while lowering investment management fees, this has been a costly exercise.

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Endnotes:
This research was conducted using the eVestment Alliance (eA) database and analytical system. Copies of supporting charts are available upon request.