Underperformance rife among active mutual fund managers

UK investors would be 1.44% p.a. better off switching to a passive tracker fund

Study also claims funds should split at critical size to protect investor returns

Almost all active fund managers fail to outperform the market once fees are extracted from returns, according to new research.

Ninety-nine per cent of all equity mutual fund managers are unable to deliver outperformance from stock selection or market timing, according to a 10-year study* by the Pensions Institute at Cass Business School, part of City University London.

The study, which examined the monthly returns of 516 UK domestic equity (open-ended) mutual funds (unit trusts and OIECS) between 1998 and 2008, revealed an average annual post-fee alpha return of minus 1.44 per cent.

"This suggests that a typical investor would be almost 1.44 per cent a year better off by switching to a low-cost passive UK equity tracker," said Director of the Pensions Institute, Professor David Blake.

Yet active management remains the dominant investment strategy and there are recognised 'star' fund managers

Based on the findings, just one per cent of fund managers are 'stars' who are able to generate superior performance in excess of operating and trading costs. But they extract all of this for themselves via fees, leaving nothing for investors.

The Pensions Institute also released a second paper** showing fund size has a strong negative effect on the average fund manager's benchmark-adjusted performance.

Using the same data set of UK mutual funds, academics found that a one per cent increase in funds under management led to a nine basis point drop in alpha per year.

Large funds tend to underperform small funds. This is because funds which attract inflows scale up their existing investment, driving up asset prices and pushing down yields.

Professor Blake said the findings suggested funds should consider splitting when they reach a critical size. "The most likely explanation for the negative relationship between fund size and performance is the negative market impact of large funds attempting to trade in size," he said.

"This suggests that funds should split themselves up when they get to a certain size in order to improve returns for investors."

The studies were conducted using bootstrapping, a statistical technique allowing the researchers to construct a distribution of returns which a fund manager could achieve by luck alone.

**New evidence on mutual fund performance: a comparison of alternative bootstrap methods* by David Blake, Tristan Caulfield, Christos Ioannidis and Ian Tonks (pensions-institute.org/workingpapers/wp1404.pdf)

***Improved inference in the evaluation of mutual fund performance using panel bootstrap methods* by David Blake, Tristan Caulfield, Christos Ioannidis and Ian Tonks (pensions-institute.org/workingpapers/wp1405.pdf)

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