

CANADIAN MUTUAL FUND MANAGERS:

Missing the Mark(et)!

Mutual funds have appreciated considerably over the past 10 years thanks to the strong performance of stock and bond markets but even so, most have not managed to outperform the respective index benchmarks against which their success should be measured. Why? Two reasons: first, stock and bond markets have become extremely "efficient", making it very difficult for anyone - even the pros - to predict future stock prices better than their peers. Second, costs embedded in the management of mutual funds are substantial, significantly reducing the ultimate return to investors. These costs include management fees, transaction costs, legal and administrative charges, etc. A quick glance at the chart below illustrates that, on average, only 16% of managers have managed to outperform index benchmarks over the last 10 years - and that's excluding loads.

Mutual Fund Performance (Period ended June 30, 2005)

Mutual Fund Category	Benchmark Index	% of Under-performing Funds over Past Five Years	% of Under-performing Funds over Past 10 Years
Canadian Bond	SM Universe	98%	92%
Canadian Equity	S&P/TSX 60 Capped	88%	90%
US Equity	S&P 500	65%	85%
International Equity	MSCI EAFE	74%	67%

Source: Morningstar

Further investigation reveals that actual results are even worse than indicated above - primarily for two reasons: "survivorship" bias and taxes.

Survivorship Bias - It is important to remember that only those funds which have actually "survived" the whole period are included in published results. Those that have been wound up or merged into other funds are excluded. As a result, the reported performance looks much better than it really is. (The main reason funds don't survive is poor performance.) According to a prominent U.S. study, the published returns may be inflated by as much as **1.5% per year** for the average fund over a 10-year period.

Taxes - In a taxable portfolio, another significant cost arises when securities are sold because taxes on realized capital gains must be paid to the Canada Revenue Agency annually. Almost all mutual funds are "actively" managed, meaning capital gains are being realized regularly to the detriment of the taxable investor.

For this reason, a "buy-and-hold" strategy holds a real advantage over "active" strategies because taxes are deferred for a long time. When taxes are eventually paid,

the impact on performance is much smaller. Researchers estimate this low-turnover strategy holds an advantage of as much as 0.7% annually over 10-year periods, 1.3% annually over 20-year periods and snowballs further after that. While these amounts may appear small, locking in a 1% premium over time is staggering to ending wealth values and it's certainly enough to leave even more "active" managers far behind.

An "indexed" approach is widely considered to be the ultimate "buy-and-hold" strategy because it is high-quality, well-diversified, and the performance of indexes regularly rank well into the top 10% of all money managers. In the future, it is likely these professionals will slip even further behind index benchmarks as technology continues to accelerate the pace of market efficiency around the world. (Today, money managers have the poorest results in the most widely watched market, the US, and only mixed results in the less efficient markets of emerging countries.)

Is it possible to just pick the 15% or so who outperform indexes? It's very tough to do. Most investors try by choosing last year's winner, hoping its success will continue. Unfortunately, this strategy rarely works (a recent study by Dalbar concluded that while the S&P500 returned over 12% on an annualized basis from 1984-2002, the average mutual fund investor earned a paltry 2.6% per year). A number of studies on this phenomenon of "**performance persistence**" (do any managers consistently provide predictable performance?) conclude overwhelmingly that yesterday's best managers regularly become tomorrow's under-performers (**PDF Table**). Why? Out-performance or under-performance is attributed to other factors besides skill.

For example, a particular style works well in one type of market environment but not in others. At best, even the top professional managers revert to the trend - the market - over time (less fees and costs). This problem is so well-recognized by pension fund consultants that a number of respected advisors actually recommend firing the top manager once they have had their "day in the sun" and replacing them with the below-average manager who is probably about to shine.

And those who stay on top longer may actually be a result of, not superior skill, as we all want to believe, but just plain luck. The Law of Averages does allow a handful of apparently brilliant "Peter Lynch's" to emerge in a sample of thousands of observations (in this case, the number of possible money-manager choices).

Given the poor report card on professional mutual fund managers, investors should consider alternatives for future success. It is no longer necessary to let your manager effectively gamble your money in markets where their chances of success are so low. Literally thousands of analysts follow large-cap, blue chip companies where new information is assimilated in the market price instantaneously, leaving very little opportunity for any value-added. For such investments, it is better to buy the large-cap index itself for the core part of your equity portfolio, ensuring top-quartile performance over time and avoiding the possibility of ever slipping to the bottom. This core portfolio should consist of the major indexes in the U.S., Europe and Japan.

In less efficient markets, such as small to mid capitalization stocks, higher transaction costs make it difficult for managers to add value over relevant indices. If using active management in these areas, it is important to watch closely to ensure your managers are actually adding value over the appropriate benchmark index. And you should add

1% or 2% to your return expectation to compensate yourself for taking the added "manager" risk.

As for the bond market, many would argue that it is the most efficient market of all, given that all managers are focused on only one thing: the future trend of interest rates. So don't pay for an actively traded "vanilla" bond fund. Instead, consider buying an assortment of high-quality bonds directly (without overpaying in commissions) with staggered maturities so as to reduce interest rate risk. This strategy will beat the vast majority of mutual fund bond managers.

Indexed investing is growing at double-digits rates for large pension accounts in Canada and represents **30% to 35%** of pension investments in the U.S. and the U.K. And pension funds don't pay taxes. For private investors, it is far more advantageous than mutual funds, given the added benefits of deferring taxation and significantly lower costs. The fact that many private investors still choose mutual funds is somewhat surprising. One can only observe that, while the investment skills of the mutual fund industry are less than stellar, their marketing skills remain excellent!

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