

# Indexing: Above Average Performance from the Market Averages

Indexing is a strategy that focuses on matching the performance of a market index, for example, the S&P 500. Unlike active managers, who attempt to outperform the market benchmarks, index investors simply try to achieve the same risk/return characteristics as the market.

## A Tale of Two Strategies

The merits of active management versus indexing have been debated for as long as indexing has existed. At first glance, active management would seem to be the preferable alternative. After all, who wants to settle for the average market return that indexing provides when above average returns are possible? The problem is that no strong evidence exists to prove that active management is capable of providing returns higher than the market on a consistent basis. On the contrary, there is plenty of evidence that most active managers lag the returns of the overall market, largely because of the high costs they generate. Moreover, statistics show that those managers that have outperformed in the past are less likely to outperform in the future. Indexing has, therefore, become increasingly popular as academic and empirical findings confirm its merits, which include superior performance, lower costs, greater tax-efficiency, and the potential for more consistent returns.

## Great Expectations

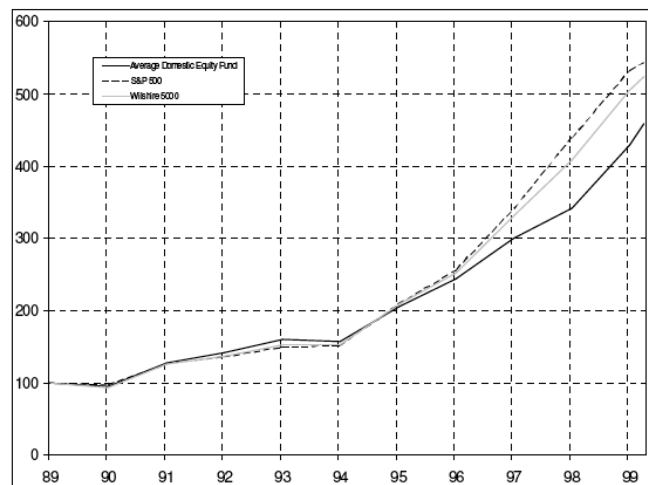
Data from Morningstar for the period ended 6/30/2000 show that of 5,253 domestic, non-index, equity funds, 769 have performance records of 10 years or more. Of these 769 funds, only 195 have generated an annualized return greater than that of the Wilshire 5000 index over the past 10 years, after accounting for the impact of fees and sales loads. That means that your chances of picking a winning active manager over the long-term are less than 25%. Using the S&P 500 as a benchmark yields even worse news for active management, as only 21.8% of the 769 funds beat the S&P 500's performance over a 10-year period. The average performance of the 5,253 funds used in this study is plotted vs. the performance of the Wilshire 5000 and the S&P 500 on the following page. As illustrated, the longer the time period examined the greater the return differential between the indices and the active managers.

While the Morningstar data looks only at the last decade, over longer periods the performance of actively managed funds has been similarly sub-par. In his book *Winning the Loser's Game: Timeless Strategies for Successful Investing*, author Charles Ellis notes that "in the 25 years ending with 1997, on a cumulative basis, over three-quarters of professionally managed funds underperformed the S&P 500 Market Stock Average." According to Ellis, only 25% of the actively managed funds provided value above and beyond what you could have earned by just investing in a market index fund over a 25-year period, and that is before the impact of taxes is considered.

These results are not an anomaly. In fact, there are studies on investment returns dating back to at least 1945 showing that the majority of active managers fail to outperform their appropriate benchmark. This has been true in all market environments and holds true in all market segments.

The academic argument for the underperformance of active managers, as explained by Nobel laureate William F. Sharpe's essay "The Arithmetic of Active Management" is as follows:

## Active Management vs. The Market Indices



Source: Morningstar



“Over any specified time period, the *market return* will be a weighted average of the returns on the securities within the market, using beginning market values as weights. Each passive manager will obtain precisely the market return, before costs.

From this, it follows (as the night from the day) that the return on the average actively managed dollar must equal the market return. Why? Because the market return must equal a weighted average of the returns on the passive and active segments of the market.

If the first two returns are the same, the third must be also””.

Sharpe’s point is that since all investors, in aggregate, make up the market, the average returns for both active and passive management have to equal the return of the market. The returns on active and passive management, therefore, have to be precisely equal. Indeed, the returns are equivalent, but the reason active managers fail to beat the market consistently is because of the fees they charge and the expenses they incur during the investment process.

A Penny Saved is a Penny Earned The cost benefits of indexing are immediately obvious when you compare the fees charged by active managers with those of indexed products. According to the Vanguard Group, even for no-load funds, the annual fee for an actively managed mutual fund averages 1.5%. The management fees for broad-based index products range from 0.09% to 0.35%. This is a huge savings that you lock in year after year.

An investor’s return is also affected by trading commissions, the cost of cash, bid/ask spreads, and market impact costs. Admittedly, trading commissions and the loss attributable to the bid/ask spread also come into play with indexing, but because a long-term, buy-and-hold strategy is inherent to indexing, portfolio turnover is dramatically lower. Less turnover means lower costs. The nature of active management is that securities are regularly bought and sold in order to attempt to provide a return in excess of the market’s return. If active managers did not buy and sell on a frequent basis, they would not be able to justify their large fees. However, if they turned over their portfolios less frequently, their performance would likely improve and investors might be more willing to pay those fees.

Market impact costs may not be much of an issue for investors who buy only large capitalization, highly liquid securities. However, investors interested in the potentially higher returns of the midcap and small-cap markets may find that when they place an order for a stock, their buying activity could push up the price of the stock. When buying a large block of stock the transaction may not be executed all at once. The initial transaction could push up the price

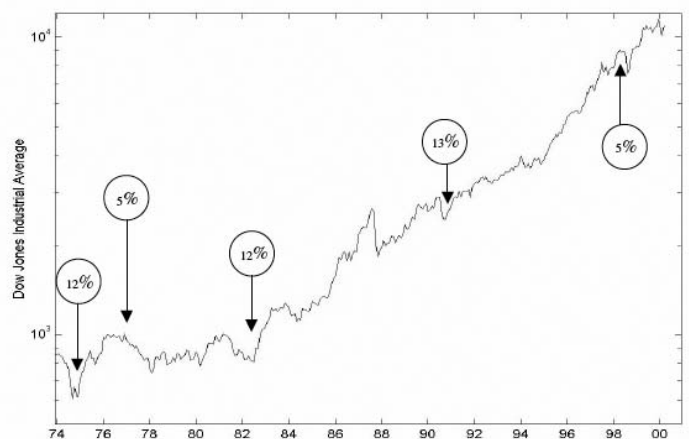
of the stock before the subsequent transactions are completed, thus raising the price of the overall transaction. Market impact costs are not prevalent when buying indexed securities because the market price of indexed investment products is based predominantly on the aggregate prices of all the securities that make up the index, not on supply and demand for the index itself.

The cost of cash is the opportunity cost you incur by having a portion of your assets held in cash within your portfolio. This is not to say that holding some cash is inappropriate, but we advocate holding a percentage of your portfolio in cash separate from the equity portion of the portfolio.

Many equity mutual funds hold some portion of the portfolio in cash rather than investing in stocks in case of shareholder redemptions or to guard against market downturns. However, investors could unwittingly have a larger portion of their portfolios allocated to cash than they had intended if their equity managers hold cash. Active managers argue they will be able to anticipate market downturns and adjust the portfolio towards a more defensive stance at market peaks. However, there is no academic evidence that this type of market timing works; in fact there is much evidence to the contrary. The chart below, based on data from John Bogle, founder of The Vanguard Group, shows that active managers have not been able to predict market downturns. Cash holdings (defined as a percentage of portfolio value) have been largest at market bottoms and smallest at market tops, opposite to what active managers would have us believe. The chart suggests that even professionals who get paid to predict the market are unable to do so.

Even active managers claiming to offer reasonable rates cannot be as cost-effective as indexing strategies. The hidden costs described above all serve to reduce investors’ returns and, of course, we have yet to take into account the largest expense of active management—taxes.

## Mutual Fund Cash as a Percentage of Assets vs. Dow Jones Performance



Source: Vanguard Group, Alesco Advisors LLC

## Taxation Without Minimization is Tyranny

If you are investing in a retirement account or other account that enjoys tax-free status, fees and performance are the only criteria to consider when evaluating active and indexing strategies. However, for most accounts taxes are an issue. Historically, indexing has exceeded the average performance of active management on an aftertax basis, largely because of the frequent trading we discussed earlier.

Selling a stock or a bond is a taxable event. Since active management usually involves more frequent security transactions than does indexing, the tax consequences have the potential to be more dire. Indexing involves holding securities for as long as they are part of the underlying index, typically several years or more, resulting in fewer trades and usually minimal tax consequences. According to Morningstar data, the average turnover ratio for domestic equity funds was 91% last year. Compare that to the roughly 6% turnover of the S&P 500 in 1999 and it becomes obvious that the tax liability of active management is much higher than that of an indexed investment strategy.

## Indexing: A Best of Breed Approach

At Alesco we embrace a "best of breed" philosophy. We don't sell index funds and we receive no commissions or other benefit from using them for our clients. We regularly evaluate all kinds of investment products, including actively managed funds, when we decide how best to meet our clients' objectives. However, any fund we use must show an ability to outperform (after fees and taxes) a very high hurdle: index funds. In most cases, indexed strategies have proven to provide superior returns with lower costs and greater tax efficiency. We use funds that track a broad range of market indices in order to create a customized, diversified portfolio that meets each client's individual needs.



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