GETTING GOING / BY JONATHAN CLEMENTS

Stock Funds Just Don't Measure Up

It's time to settle the question once and for all.

Should you buy actively managed stock funds in an effort to earn market-beating returns, or should you abandon this quest and instead plunk your money in market-tracking index funds? It's a question that goes to the heart of stock-fund investing.

To get at the answer, I turned to Ira Weiss, an accounting professor at Columbia Business School. Mr. Weiss, in turn, tapped into a database maintained by the Center for Research in Security Prices at the University of Chicago's Graduate School of Business.

What is so special about the CRSP database? For starters, it allows us to take the long view. Diversified U.S. stock funds may have kept pace with the Standard & Poor's 500-stock index in 1999, but they trailed the index in each of the prior five years, prompting much carping among investors.

The recent comparison, however, isn't entirely fair. The S&P 500's performance is heavily influenced by the biggest stocks, which have posted astonishing gains of late. By contrast, stock funds tend to own somewhat smaller companies. By tapping into the CRSP database, Mr. Weiss was able to analyze results since year-end 1961, a period that encompasses patches of strong performance by both large and small stocks.

More critically, the CRSP database includes not only funds still operating, but also those that have disappeared, because they were liquidated or merged out of existence. As you might imagine, these funds usually disappeared for a good reason: They stunk.

In fact, many fund statistics suffer from "survivorship bias." As rotten funds are put out of their misery, the average performance for the remaining funds creeps upward, making funds seem like a better bet than they really are.

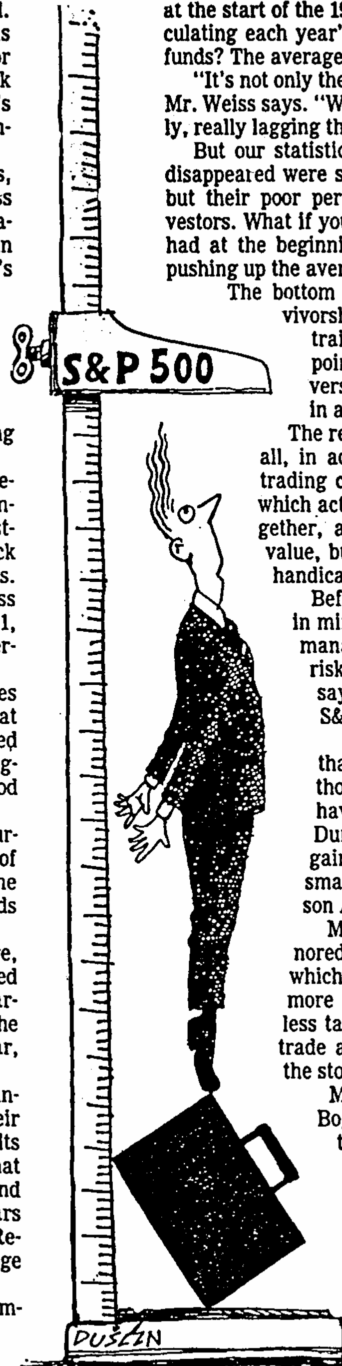
To make sense of this statistical quagmire, Mr. Weiss studied performance for diversified U.S. stock funds over the 36 years through year-end 1997. The 109 funds that were around for the entire period gained an average 10.9% a year, compared with 11.6% for the S&P 500.

Thousands of funds, of course, have been introduced during this stretch. To include their performance, Mr. Weiss next calculated results for each of the 36 years, using those funds that were around in each year and are still around today. He then linked together these 36 years and calculated an average annual return. Result? Funds look a tad better, with the average climbing to 11.2%.

That, however, is as good as it gets. Remember, we are still looking only at existing funds. Over half the funds that were around at the start of the 1970s aren't around today. What if, in calculating each year's return, you include these now-defunct funds? The average plummets to 9.9%.

"It's not only the case that the survivors lag the market," Mr. Weiss says. "When you put in all the funds, they're really, really lagging the index."

But our statistical journey isn't over. Many funds that disappeared were small. They may have performed poorly, but their poor performance wasn't inflicted on many investors. What if you weight returns by the assets each fund had at the beginning of each year? That helps modestly, pushing up the average to 10.2%.



The bottom line? After adjusting for size and survivorship bias, Mr. Weiss found that funds trailed the S&P 500 by some 1.4 percentage points a year. As it happens, that is what diversified U.S. stock funds currently charge in average annual expenses.

The result is not an unmitigated disaster. After all, in addition to annual expenses, funds incur trading costs. They also tend to hold some cash, which acts as a drag on performance. Put it all together, and maybe fund managers added some value, but not enough to overcome these various handicaps.

Before you accept Mr. Weiss's results, keep in mind a few quibbles. As advocates of active management note, funds typically take less risk than the index. That is true, Mr. Weiss says. But he found that funds trailed the S&P 500, even after adjusting for risk.

Fans of active management also note that funds often buy smaller stocks than those in the S&P 500. But this turned out to have been an advantage over the 36 years. During this stretch, the S&P's 11.6% annual gain lagged behind the 14.8% return for smaller stocks, as tracked by Chicago's Ibbotson Associates.

Moreover, in his calculations, Mr. Weiss ignored both fund sales commissions and taxes, which would have made fund returns seem even more bleak. Historically, funds have been far less tax efficient than index funds, which don't trade actively but instead simply buy and hold the stocks that constitute a market index.

Mr. Weiss's results don't surprise John Bogle, senior chairman of Vanguard Group, the Malvern, Pa., fund company, and the fund industry's most vocal proponent of index funds. For him, it is just another reason to index.

"If you earn 11.6% for 36 years, a dollar grows to $52," Mr. Bogle notes. "If you earn 10.2%, the dollar grows to $33. Which would you rather have, $52 or $33? To ask the question is to answer it."