More Actively Managed Funds Tied to Indexes

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Investors can have a hard time identifying "closet indexing"—when an actively managed fund actually is built around an index—but new measures might be useful to predict fund performance.

Antti Petajisto and Martijn Cremers, two Yale University professors, developed an easy way of measuring to what degree a fund’s holdings are actively managed, as opposed to passively mirroring an index, according to The Wall Street Journal. The measure, called the "active share" of a portfolio, matches the holdings reported by Securities and Exchange Commission filings against the components of an index, and then measures the percentage of overlap.

For example, if General Electric and Exxon Mobil each account for 4% of an index and a fund had a portfolio exactly mirroring the index except it had 8% in GE and nothing in Exxon, its active shares would be 4%. The more a portfolio differs from an index, the higher the active share percentage.

Additionally, the study found that the average fund using the Standard & Poor’s 500 Index as a benchmark has an average active-share percentage of 66%. Basically, the average large-company stock fund had a portfolio that was 66% different than the benchmark and the rest essentially mirrored the index.

The study also revealed an increase in funds that could be depicted as closet indexing during the 1990s, a period of major growth in the mutual-fund industry. The study looked at data from 1980 through the end of 2003 and closet index funds contained about 30% of all assets in 2003, up from practically no assets in the 1980s.

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