Is your fund manager a closet indexer? In other words, are you paying high fees for a supposedly active portfolio which essentially looks like the passive benchmark index?

To answer this question, we can decompose a fund’s portfolio into active and passive components. Whenever the portfolio weight on an individual stock exceeds the stock’s index weight, the fund is taking an active long position in the stock; similarly, a position less than the index weight implies an active short position in the stock. The sum of the active positions then indicates how active the fund is.

For example, consider the mutual fund giant Fidelity Magellan which is benchmarked against the S&P500 index. In recent years, investing $100 in Magellan has essentially meant investing $100 in the S&P500 as well as $34 in active long positions and $34 in active short positions. Thus we can say that Magellan has an “active share” of 34%.

The active share of “active” all-equity mutual funds in the US ranges from 30% to 100%, with an average of 66% for large-cap funds. This means that the average large-cap fund essentially indexes one third of its assets, while the worst closet indexers index two thirds of their assets. Today closet indexing is much more of a problem than before – in the 1980s, virtually all funds were reasonably active.

Historically closet indexers have simply matched their benchmark index returns before expenses, but once expenses are taken into account, the closet indexers have lost to the benchmarks by about 1.4% per year. Examples of funds in this category include Fidelity Magellan, Oppenheimer Main Street Fund, and Wells Fargo Diversified Equity Fund. They have moved very closely with the benchmark index, except for a small but persistent drag due to higher expenses.

In contrast, the most active funds have outperformed their benchmarks by about 2.7% before expenses and 1.4% after expenses. This group has an active share of 95% or higher, and it includes for example the Oakmark Select Fund and Longleaf Partners Fund.

Interestingly, the tracking error of a fund has no predictive power for future returns – if anything, high tracking error is related to lower future performance. Even though both tracking error and active share measure active management, they capture somewhat different aspects of it: tracking error emphasizes systematic risk a fund may take relative to the index, while active share emphasizes individual stock selection. Apparently the stock selection dimension of active management is rewarded in the market while systematic risks are not.

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When choosing funds to invest in, closet indexers should be identified and avoided. Their expenses are almost as high as those of truly active funds, so whatever modest skill they may possess and apply for their small active positions, the net effect has still been disappointing. A randomly selected active fund has performed better but still loses to low-cost index funds.

However, there is hope for those investors believing in active management: you just have to pick those funds that aggressively deviate from their benchmark indexes. The evidence suggests that these managers are not simply the most overconfident or least risk-averse – instead, that confidence appears justified by their record of outperformance.

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