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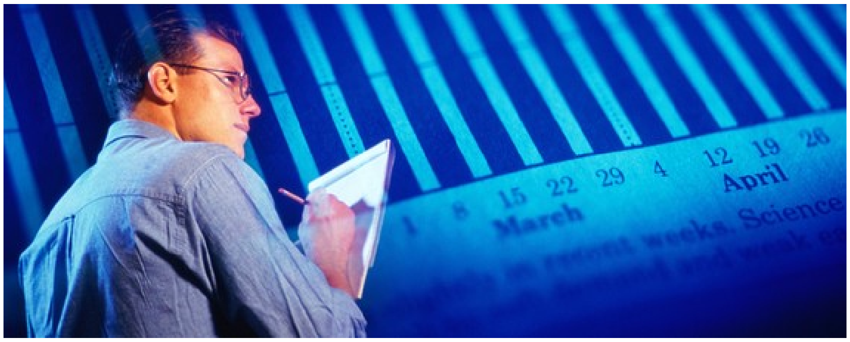
When Fund Managers Fake It



In the fund industry , there may be no bigger insult than to call a portfolio manager a "closet indexer." It implies they're too cowardly to pick stocks, choosing instead to hug the index they're supposed to beat. But offensive or not, their ranks are growing – at the expense of investors who pay for their guidance.

While it's difficult to know just how many index funds are posing as actively managed funds, the number is clearly rising, according to research by Antti Petajisto, a visiting professor of finance at New York University. Closet index funds claimed about 31% of all stock mutual fund assets at the end of 2009, the latest data available – up from 19% in 2006, according to Petajisto's research. It's also far more than the assets invested in pure index funds, which are significantly cheaper than actively-managed funds, and therefore tend to outperform funds run by closet indexer.

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- *Fund Fee Analyzer: Cost Control* [2]
- *Is Your Index Fund Broken?* [3]

A couple of decades ago there were essentially no "closet index" funds, says Martijn Cremers, a professor of finance at the Yale School of Management who worked with Petajisto on a previous study of this issue. But as index investing has become more popular, individual investors have become "more benchmark aware," he says. "Your performance relative to the benchmark has become more salient." As a result, investors are now quicker to bail out of funds if they fall short of their benchmark indexes, creating an incentive for managers to at least match their benchmarks -- and a disincentive to make big bets that could go wrong, Cremers says. And during a downturn, that incentive to shadow the index is even stronger, he says.

So might a closet index fund look like? Take a peek at the **Prudential Large-Cap Equity Fund** (*PTMAX* [4]) , and you'll find some familiar names – Exxon Mobil, Apple, General Electric, Chevron, Microsoft, and dozens of other stocks in the S&P 500 index. You'll also notice returns that are nearly identical to the index -- that is, until you subtract the hefty 1.48% management fees. (A Prudential spokeswoman declined to comment.) The Legg Mason Clearbridge Appreciation Fund, which also holds many of those household names, has also been highly correlated to the S&P 500 in recent years and charges a just-above-average 1.05% in expenses.

The Prudential and Legg Mason funds are just two of dozens that move in lockstep with the broader market. Most funds, especially those that invest in big companies, do this to some degree. But of the 514 actively managed funds in the Morningstar's large-cap blend category, 79 mimic the index almost exactly . And that means they're almost guaranteed to underperform, because "you'll get the market return – less the fees," Shannon Zimmerman, the associate director of fund analysis at Morningstar.

Consider: The average expense ratio in the large-blend category is 1.01%, compared to the 0.18% charged by the **Vanguard 500 Index Investor fund** (*VFINX* [5]) , or the 0.09% charged by the **SPDR S&P 500 index ETF** (*SPY* [6]) . That means if your actively managed fund matched the S&P 500's 15% return in 2010, you likely trailed the index by more than a percentage point after expenses.

Not surprisingly, fund managers take exception to the implication they're indexing. Robert Flanagan, the president of fund company First Investors, says that while the**First Investors Blue Chip Fund** (*FIBCX* [7]) has been 99% correlated to the S&P 500 over the past three years, it's "not an S&P 500 index fund." He explains that because of the fund's conservative strategy it outperforms in bear markets -- it beat the S&P by 5.9 percentage points in 2008 -- but lags in bull markets. Scott Glasser, co-manager of the Legg Mason Clearbridge Appreciation Fund, says that while his fund has been highly correlated to the S&P -- and charges an expense ratio of 1.05% -- it is more conservative than the index and has outperformed its benchmark over the past three-, five- and ten-year periods. "This fund may have higher fees, but it's earned those fees over time," he said.

So how can you check to see if a fund is merely an index in disguise? A metric called "R-squared" measures how closely a fund is correlated to its index – the closer to 100 that number is, the closer the fund will track its benchmark. Zimmerman says an R-squared of more than about 98.5 would be at the high end for a large-cap fund, and would be a sign of a fund that might just be replicating index performance. It would be worth considering ditching a fund that's that highly correlated to an index, particularly if its expenses are high, Zimmerman says.

But correlation to an index isn't the only way to judge if a fund's active management is worth paying for. Comparing a fund's performance to its benchmark index will help investors determine if correlation is meaningful or coincidental, says Tom Roseen, a senior research analyst at Lipper. For example, the **First Investors Blue Chip Fund** (*FIBCX*[8]) has been 99% correlated to the S&P 500 over the past three years, and more than 98% correlated over the past five and ten years, while underperforming the index over all those periods, and charging a higher-than-average 1.46% in expenses. And eventually, whether underperformance is due to the combination of closet indexing and high fees or just poor stock picking, it's a good signal to investors that their investment may not be worth its price.

1 http://www.smartmoney.com/investing/stocks/3-investments-to-avoid-now-1297633927282/
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