Don't buy actively run funds from a broker

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) — Investors by now are familiar with the line that active mutual-fund managers can't beat index funds. But that doesn't stop them from trying.

Now a recent study suggests that the problem for active managers may be not so much their trading activity than but the structure of their fund.

According to research from Boston College professor Jonathan Reuter and University of Oregon professor Diane Del Guercio, active management works as well as indexing under the right conditions.

Just don't buy an actively managed fund from a broker.

The professors' study recognizes that virtually all research into active versus passive management styles assumes that all equity funds are created equal, without regard to the layers of costs and fees that are determined by how the fund is sold.

Weak sales force

This latest research instead separated domestic-equity funds into three distinct groups: institutional funds; issues sold directly to the retail consumer, and funds sold through brokers. Next, it compared how actively managed funds compared to index-fund rivals within each group.

Broker-sold funds, in this case, are those that collect fees directly from the investor to compensate the adviser. Many consumers work with advisers who, in turn, use funds sold directly to the public but are compensated separately.

The results — which covered fund returns from the mid-1990s through the bear market following the bursting of the Internet bubble — should make a lot of consumers who use financial advisers consider what they want when it comes to investment advice.

With broker-sold funds, active managers underperform the index funds by more than

1% per year. In the direct-sold market, by comparison, the after-fee returns of actively managed funds "are statistically indistinguishable" from index funds.

There are a lot of possible reasons why one group of active managers lag the index but another doesn't, but Reuter suggested much of it involves the incentive active managers have to deliver superior performance.

You'd think it's a no-brainer that active managers would fight to beat the benchmark, but the real motivations come from shareholders.

In direct-sold funds, buyers are particularly sensitive to risk-adjusted returns; in short, if they don't get returns consistent with the risks they are taking, they leave, and they take their money to funds that are delivering that kind of performance.

Meanwhile, the customers of the broker-sold funds, mostly, stand pat, Reuter said.

"The more sensitive you are to performance, the more you compete to deliver it," Reuter said. "In the broker-sold channel, we did not find any sensitivity to risk-adjusted performance. That could be because the investors aren't interested, or it could be that the brokers are sticking to a strategy and suggesting people stay put, or something else, but … if you are not being rewarded or punished by investors, you don't have to be as concerned about it, and you don't seem to invest as much in management."

Index funds worth the cost

The distinctions are important because the study would suggest that anyone buying funds through a broker should want index funds, if only to capture that 1%-plus of superior performance over the years.

The problem, Reuter said, is that it's a tough sell. Broker-sold index funds are, comparatively, expensive compared to the low-cost issues offered by a Vanguard or Fidelity, funds that are popular in the direct-sold group. (Ironically, they might turn to an adviser who buys those funds and pay as much as 1% per year to get those funds, although those fees are not part of the fund's management costs).

In the broker-sold world, however, high-cost index funds are still better bets than actively managed funds.

“If you sit down with a broker and want them to customize a portfolio and they give you a listing of index funds, you may not be happy with it, like it's from a black box and not designed for you,” Reuter said.

“If you're the broker,” he added, “you know the client might look at your firm's fund and think they can do better with a Vanguard fund — even though they are paying you really for the asset allocation decisions and designing the plan rather than for picking the fund.”

Said Reuter: “People who want advice are given the sort of products that appeal to them, either it's because that's what they want or they don't know better. Now they should know that if they go to a broker, they're paying for the allocation decisions and should go with the index funds.”

Meanwhile, investors who are comfortable investing without a broker and who favor active management in part because they believes it gives their money an additional layer of guidance can go with active funds without feeling like the choice automatically puts them behind the 8-ball.

“Basically, when active management has the right incentive to act, it breaks even with the indexes,” Reuter said. “That's not saying people should run out and invest in actively managed funds, but it is saying there is skill set out there, and if you are buying funds on your own and having those skills is what makes you comfortable about a fund, you can feel better about taking that chance.”