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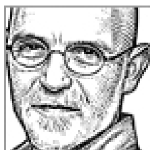
As Indexes Soar, Active Stock Pickers Can't Get Off the Ground

ByJason Zweig

Christophe Vorlet

It's been another turkey of a year for stock pickers.



The Intelligent Investor
By Jason Zweig
COMMENTARY

Among all mutual funds that invest in big U.S. stocks like those in the S&P 500, only 9.3% are beating the index through Sept. 30, according to Denys Glushkov, a senior researcher at Wharton Research Data Services at the University of Pennsylvania. Although the year isn't over, that is well under the previous annual low of 12.9% in 1995 and the average of 38.6% over the past quarter-century. Data through Oct. 31 from Lipper, a fund-research firm, show results nearly as dismal.

That means 2014 "is likely to enter the record books as the year when active equity funds delivered their worst performance relative to the index, net of fees, since at least 1989," Mr. Glushkov says.

The decline seems even worse than it was three months ago, when I wrote that "active fund management is outmoded, and a lot of stock pickers are going to have to find something else to do for a living." Can stock pickers redeem themselves, or should you just redeem their funds and turn your whole portfolio over to cheaper "passive" funds designed to match the returns of an index?

Before deciding what to do, it helps to know what is causing active managers to underperform so poorly.

Portfolio managers and industry analysts say several forces are at work—and most of them are probably temporary.

The average U.S. stock fund has 5% of its assets in non-U.S. stocks, according to Chicago-based investment researcher Morningstar. Markets in the rest of the world have trailed the U.S. by 14 percentage points so far this year. Since the S&P 500 has no holdings listed primarily on foreign exchanges but active U.S. stock funds do, that alone accounts for about 0.7 percentage point of underperformance, explains Ben Inker, co-head of asset allocation at GMO, a Boston-based firm that manages $120 billion.

So far this year, the Russell 2000 index of small stocks is up 3.1%, including dividends, while the S&P 500 is up 13.9%—the widest gap in favor of large stocks since 1998. Fund managers who bought anything but the very largest stocks in search of value have thus been "hurt big time," says Stuart Kaye, co-founder of Matarin Capital Management in Stamford, Conn., which manages $240 million. (His firm's actively managed portfolios are beating their benchmarks this year, at least partly because they don't make big bets on particular industries.)

The returns for various industrial sectors have been fluttering around like poultry on the run. Last year, energy stocks were up 22.3% and utilities up 9%, according to S&P Dow Jones Indices. But with oil prices and interest rates falling in 2014, energy stocks had lost 3% even before they collapsed at the end of this past week, while utilities have gained 18.5%.

Such "extreme sector rotation" is at unprecedented levels, says Joseph Mezrich, head of quantitative investment strategy at Nomura Securities in New York. Since the index holds everything but active managers don't, such rapid rotation leaves many stock pickers in the lurch.

Another factor: the one-year average of a technical measure called "dispersion"—which tracks the difference between the returns of winning and losing stocks—is at its lowest levels in modern history, says Mr. Mezrich.

If the best stocks don't perform much better than the worst, it's hard for stock pickers to distinguish themselves. "When you aren't getting big payoffs from your outperformers," says Ann Holcomb, a co-manager of the $689 million T. Rowe Price Capital Opportunity Fund, "then it's harder for your good decisions to add more value than your bad ones detract." (Capital Opportunity is 1.5 percentage points behind the S&P 500 this year, according to Morningstar; last year it beat the market by 0.3 point.)

If the S&P 500 keeps soaring like an eagle over the heads of most stock pickers, "even the true believers in active management would have a hard time maintaining their belief," says Harindra de Silva, president of Analytic Investors in Los Angeles, which manages $11.5 billion in active funds and is generally outperforming its benchmarks this year, with the weakest returns coming in large U.S. companies. If stock pickers' bad performance persists for, say, two more years, "you'd have a huge reduction in the money allocated to active managers," he says.

But low dispersion is driven largely by the market's lack of sharp swings this year—which, in turn, appears to be fueled by low interest rates. "The prospect of a rise in rates next year," says Ms. Holcomb, "should eventually increase volatility and widen the difference again between winners and losers."

Meanwhile, index-fund investors shouldn't get cocky about the margin by which they have beaten investors in actively managed funds, says John C. Bogle, founder of the Vanguard Group and father of the index-fund industry. "I'm concerned that people will say that indexing will always win or always win this big," he says. "This level of outperformance just doesn't happen for long."

— Write to Jason Zweig at intelligentinvestor@wsj.com, and follow him on Twitter at @jasonzweigwsj.

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