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Active Management Loses in Risk Study

Report Is Another Boost for Index Funds

By SAM MAMUDI

While it has been established that most actively managed mutual funds lag behind their indexes over time, a new study further twists the knife: Active management suffers even more by comparison on a risk-adjusted basis.

The study found that in many cases where an actively managed fund beats its index on an absolute basis, the additional risk it took didn't justify the returns earned. Not only should that be a warning sign for investors -- because greater risk means greater volatility -- but it also suggests that fund managers aren't living up to what is expected of them.

The study by Morningstar Inc. found that, over the past three years, while about half of actively managed funds outperformed their respective Morningstar indexes -- which cover the nine different Morningstar investment styles -- only 37% did on a risk-, size- and style-adjusted basis. The numbers are similar for five and 10-year returns.

"It's not enough to beat an index in a way that [assumes more risk]," said Travis Pascavis, director of equity indexes at Morningstar. A riskier fund should provide greater returns, he added.

"The hurdle is higher for a more-risky fund," said Mr. Pascavis.

While investors ultimately care about their returns, Mr. Pascavis argued that risk-adjusted performance is important in determining a manager's ultimate performance.

The key to thinking of risk in terms of returns versus an index, he said, is that, in theory, if investors wanted to take on more risk for greater returns, they could simply buy an index fund and lever up their exposure. That would also increase returns while adding risk -- and do so at a cheaper cost than most actively managed funds. It is against this standard that actively managed funds should be judged, he said.

"I think adjusting for risk is a good idea," said Matt Hougan, senior editor of the Journal of Indexes. "I'm excited to see Morningstar move into this space."

Mr. Pascavis said it is important for investors to be comfortable with the risk they are taking on when they buy a mutual fund. What is more, his study found that if a fund has higher risk, it is often a sign of an underperformer: Funds performing in the top 25% over the past three years had much lower risk and volatility than their peers.

"There is generally a positive relationship between risk and return, where better-performing

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funds are riskier; however, this has not been the case over the last three years," noted the study, which added that poor returns of the recent market likely helped less-risky funds.

Even in absolute terms, the results highlighted the shortcomings of many actively managed funds. Over the past five years across the nine Morningstar-style boxes -- value, core and growth in the small-cap, midcap and large-cap sectors -- only large-cap growth and midcap value saw more than half of active managers beat their indexes.

Morningstar's figures include funds that have been liquidated or merged away.

Russ Kinnel, director of research at Morningstar, suggested investors looking for active management should head into the less-risky funds.

"It's generally better to be in a lower-risk fund," he said. "There's more consistency [of performance], and timing when you invest is less critical [in determining your returns]."

Human nature also plays a part, said Mr. Kinnel.

"It's harder for people to stay with funds that go up and down extremes," he said.

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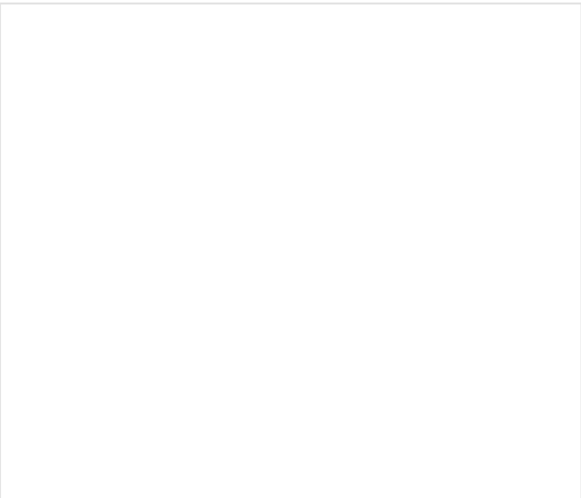

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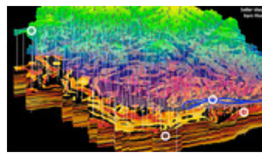

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