The case for index fund investing for UK investors

Adviser brief

March 2015

Advisers who build client portfolios using passive funds can benefit from some distinct advantages inherent in indexing: lower costs, broad diversification and minimal cash drag. The sum of these parts can translate to a long-term performance edge.

Primarily because of their low-cost structure, well-managed index investments can perform positively relative to higher cost investments.

The performance record of active management

Active managers typically attempt to outperform a given benchmark. Over a reasonably long period of time, covering multiple market cycles and environments, a skilled active manager should aim to deliver positive excess returns versus their benchmark for the full time period.

While the theory is appealing, the actual track record of actively managed funds suggests that an active manager with such skill is difficult to find.

Research key findings*

- On average, accounting for survivorship bias, the majority of UK-based active equity managers have failed to beat their prospectus benchmarks over five, ten and fifteen years.
- Accounting for survivorship bias, large majorities of UK active bond managers have also failed to beat their benchmarks over five, ten and fifteen years.
- Fund performance rarely persists, with many top ranking funds in one five-year period dropping to the bottom or closing in the following five-year period.
- Average active portfolios in the main equity and bond asset classes were either more volatile, returned less or both than index portfolios over the long term
- There is no systematic tendency for active managers to outperform in bull or bear markets.
- The distribution of returns of active managers shows that the market is a 'zero-sum game', that is stacked against fund investors as a result of high fund costs.

* This brief references the research paper 'The case for index fund investing for UK investors' by Peter Westaway, and Todd Schlanger, issued by Vanguard Asset Management, Limited, March 2015. The full research paper is available in Financial Adviser section of our website: vanguard.co.uk.

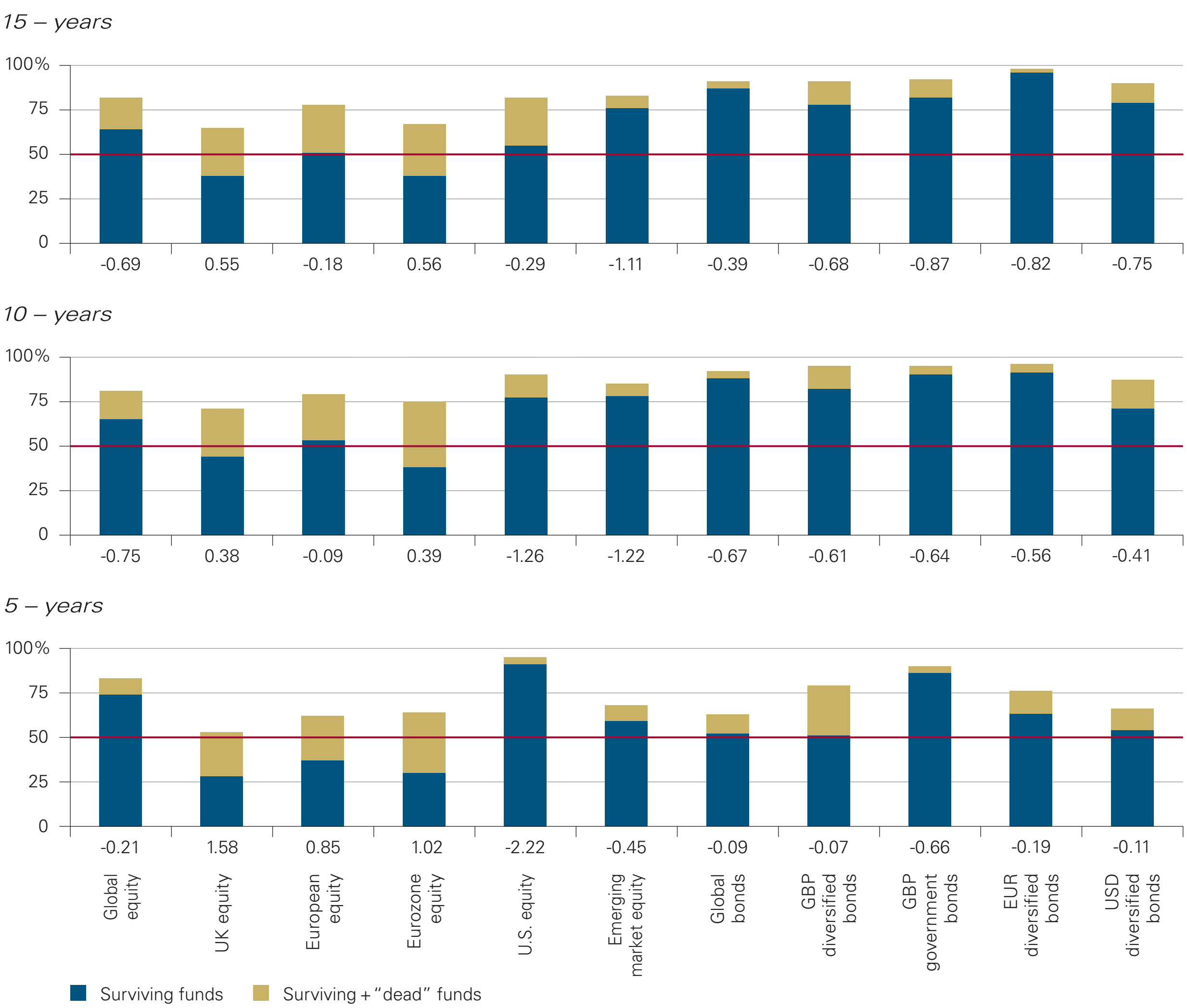
The active equity management results Figure 1 shows the relative performance of different categories of actively managed equity and bond funds over 5, 10 and 15 years versus a benchmark that is specified in the funds' own prospectus. It shows that in most sectors, over most periods, the majority of funds failed to keep pace with their benchmark.

Misconceptions about active management

Misconception 1: All you have to do is pick a good fund Figure 1 indicates that some actively managed funds both survived and outperformed their benchmark. Finding and investing in such funds is the primary objective of investors who use actively managed funds. But finding them is very hard to do, especially if you rely on past performance to find 'good' funds.

To test the persistency of outperformance, we ranked all actively managed equity funds in terms of risk adjusted return for the five years ended 2009. We then separated out the top 20% of funds, the next best performing 20% of funds and so on and tracked each band's performance over the following five-year period (to 31 December 2014). A random outcome would result in

Figure 1. The percentage of surviving actively managed funds (using prospectus benchmark) that underperformed during the period



Notes: Fund universe includes funds available for sale in the UK, filtered according to the description above, from the following Morningstar categories: UK equity – flex cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Europe equity – Europe OE: flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Euro zone equity – flex-cap, large-cap, mid-cap, small-cap; Global – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; US equity – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Emerging markets equity – emerging markets; Europe bond – EUR diversified; US bond – USD diversified; Global bond – global un-hedged bond; UK bonds – UK diversified, UK government. Performance is for periods ending on 31 December 2014. Performance is calculated relative to prospectus benchmark. Fund performance is shown in GBP terms, net of fees, gross of withholding tax, with income reinvested, based on closing NAV prices.

Sources: Vanguard calculations, using data from Morningstar, Inc.

Figure 2. Rank persistence of active equity funds available for sale in the UK

Initial Excess Return Quintile, 5-years ending Dec.2009	Number of funds	Subsequent 5-year excess return rank, to December 2014: Highest quintile	2nd quintile	3rd quintile	4th quintile	Lowest quintile	Liquidated/ merged
1st	287	25.1%	13.6%	10.5%	14.6%	20.6%	15.7%
2nd	289	15.2%	17.6%	13.8%	14.5%	12.8%	26.0%
3rd	288	11.5%	17.7%	18.1%	13.5%	11.5%	27.8%
4th	288	8.0%	14.6%	13.5%	14.2%	11.1%	38.5%
5th	288	8.3%	4.9%	12.5%	11.1%	12.5%	50.7%

Notes: The far left column ranks all active equity funds based on their excess return over their respective prospectus benchmark return during the five-year period through 31 December 2009. The columns going across the right of the table rank these funds according to their subsequent excess returns over the five-year period through 31 December 2014. Random performance across the six subsequent possibilities (5 quintiles, plus funds that die) would infer a value of 16.67%. The fund universe includes all active equity funds available for sale in the UK, investing in the equity classes as defined in Figure 1. Returns are in GBP terms, calculated net of fees, gross of tax withholding, with income reinvested.

Source: Vanguard calculations, based on data from Morningstar, Inc.

approximately 17% dispersed evenly across the six subsequent buckets (if we assume that a fund closing down is just as probable as any other outcome). Figure 2 displays the results for the investments of UK investors in equity funds. Interestingly the results do not appear to be significantly different from random.

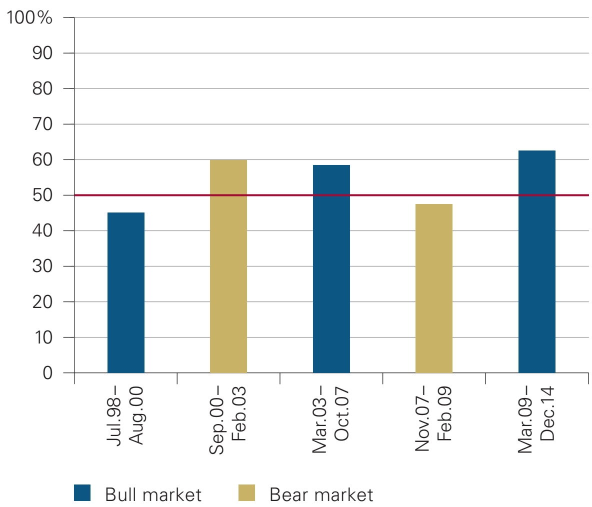
The most striking result in Figure 2 is that more than 50% of the top ranking funds in the first five year period fell to the bottom two ranks or were closed or merged in the second five year period. It is also interesting to examine the subsequent performance of those funds that were in the bottom rank in the first period. Over 50% had disappeared by 2014 and only 13.2% managed to 'right the ship' and rebound to either of the top two ranks. Indeed, persistence has tended to be stronger for previous losers than previous winners, where 'past performance has not been a strong indicator of future success'.

Misconception 2: Active managers can guard against the bear and maximise the bull

Some proponents argue that actively managed funds can outperform their benchmarks in a bear market by boosting cash levels or switching to defensive sectors to protect a portfolio. In reality, our research shows that managers rarely time such moves successfully.

Few market-changing events are predicted ahead of time. To succeed, an active manager would not only have to time the market and accurately pick winning stocks during each stage of the cycle, but also do so at a cost that was less than the benefit provided. Figure 3 shows how the median

Figure 3. Percentage of active managers underperforming market during bull and bear cycles



Notes: Displays the percentage of surviving funds that underperform their prospectus benchmark over the time period shown. Bull and bear markets are the local peak or trough in the global equity market, defined as the MSCI All Country World IMI. The fund universe and categories are as defined in Figure 1. Returns are calculated in GBP net of fees, gross of tax, with income reinvested.

Source: Vanguard calculations, based on data from Morningstar, Inc.

active fund manager performed relative to their respective benchmarks across all regions over the last three bull/bear cycles. The results show that in general, there is no systematic tendency for active managers to do better at any particular stage of the cycle.

Combining these results with those from Figure 2 shows the challenges for long-term investors when electing to use active management.

The advantage of index funds: cost

The results of this research provide a compelling case for advisers to consider the use of index funds in their portfolio construction process. As a result of the zero-sum game[1], costs and the general efficiency of the financial markets, consistent outperformance by active managers is a difficult prospect.

The results in this paper have shown that actively managed funds often underperform their benchmarks.

Some fund managers within the total active distribution will outperform for any given period, but the challenge for investors is to pick those fund managers in advance.

Our results also suggest that a lack of persistence of performance by specific funds makes it difficult to use past performance as a guide for future outperformance.

Advisers can add value for their clients by selecting well-managed low-cost investment solutions. Costs can have a significant impact on investment returns and are one of the few things known in advance. The lower costs and robust performance associated with passive funds make them a viable option for a broad range of investors.

1 See separate adviser brief, 'Investment as a zero-sum game', 2015.

Is indexing the only answer?

The data suggests that active management has a reduced chance of long-term success. And yet many investors remain drawn to the prospects of outperforming a benchmark. Can these investors somehow improve their chances of success?

The answer is yes. Finding a talented active manager with a proven philosophy, discipline and process can increase the chances of success. Yet, identifying such a manager is a resource-intensive process that requires some up front and ongoing due diligence.

A good active manager should have a proven long-term investment philosophy and the processes and discipline to stick to it even when returns are flagging – as they sometimes will. Investors, too, need to stick to the active funds they've chosen through the inevitable periods of underperformance.

Another crucial factor is, of course, cost. Data suggests that low-cost funds tend to outperform more expensive funds. Active funds are no exception and cost is the one characteristic investors know in advance. Looking for a cost-efficient active fund also lowers the hurdle for the manager to deliver performance to the investor.

While there is no guarantee, sticking to these principles increases investors' chances of picking an outperforming fund.

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VAM-2015-03-30-2474