Investment Research: Do Actively Managed Funds Outperform In Down Markets?

by Mark W. Riepe, CFA

Whenever proponents of active management are asked about indexing, there's a good chance that one of the arguments trotted out will be that, relative to indexers, active managers shine in down markets. They shine, or so their story goes, because active managers can do any of the following:

1. Raise cash levels
2. Move into defensive sectors
3. Avoid the so-called mega-cap names that can sometimes drive the performance of market-cap weighted indexes
4. Hedge (such as short futures)

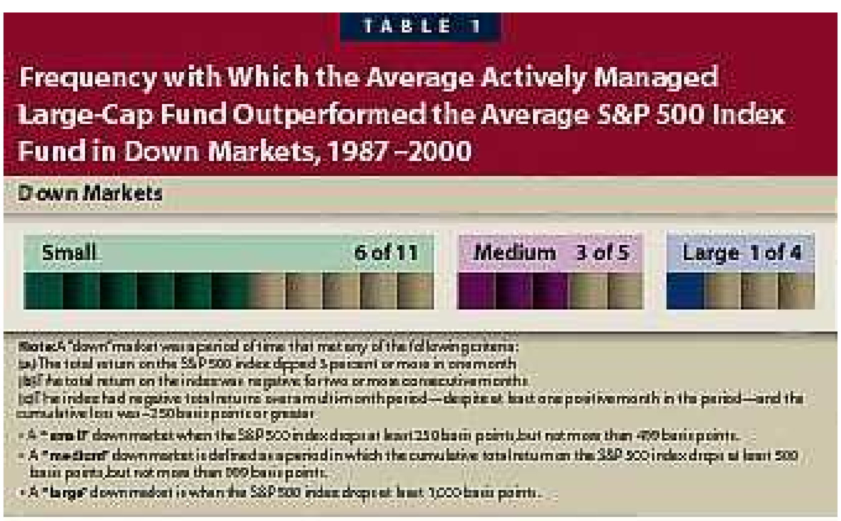
Since we're in one of these down markets (at least, as of this writing), this is an opportune time to check the historical record to see how well active managers have performed relative to indexers in down markets.

Schwab colleagues Steve Mula, Bryan Olson and Robin Vroom assembled data on the relative performance of actively managed large-cap funds and S&P 500 index funds during 20 down markets from 1987 to 2000.

The universe of active funds included not only existing large-cap funds, but nearly all large-cap funds that were in existence at the time of a given down market. For the years 1987 to 1996, the large-cap active universe was defined as all growth, equity income, and growth and income funds as classified by Morningstar. For the years 1997 to 2000, the large-cap active universe was defined as all funds classified as large-cap growth, large-cap value or large-cap blend.

Note that I said *nearly* all large-cap funds were included. A small number of funds were eliminated from the sample because the funds disappeared during a given down market (that is, the fund was around at the beginning of a particular down market, but disappeared from the database during the down market). This decision should help—ever so slightly—active funds because those disappearing funds probably had poor performance anyway. Funds that shifted their style out of large-cap during a given down market also were eliminated. In this way, it was ensured that the S&P 500 remained a relevant benchmark.

As reported in Table 1, the average actively managed large-cap fund outperformed the average S&P 500 index fund in 6 of 11 "small" down markets, 3 of 5 "medium" down markets and 1 of 4 "large" down markets. If we aggregate the results, we see that active funds have outperformed index funds in 10 of 20 down markets dating back to 1987.



Average Comparison Important

The use of the "average" fund to make a performance comparison is important. This decision actually hurts index funds because just a few players dominate the S&P 500 index fund category and there is a strong relationship between assets under management and fees in the indexing category. By using the average index fund, we make indexers look much worse than if we used an asset-weighted average. On the other hand, it can be argued that use of the average active fund makes active managers look better. So, if you believe that small assets under management enable greater mobility and nimbleness, and big active funds become lethargic and morph into mediocre performers, then using the average casts active mangers in a better light than if an asset-weighted calculation was used.

Calculating numbers is the easy part, while trying to draw meaningful conclusions is more difficult. So what, if anything, are we to make of these results? I'll close with a couple of thoughts.

Flexibility only helps if you can exploit it. Even in this age of rampant style police, there's no question that active managers have the flexibility to protect their shareholders from at least some of the ravages of a down market. However, it does not appear that, as a group, large-cap fund managers have successfully employed their flexibility to consistently outperform in down markets. So if down-market performance is a criterion I'm using to evaluate a fund, I don't want to hear all about the flexibility the fund has to weather down markets. I want the fund manager to convince me that he or she can use the flexibility effectively—particularly in the face of evidence that the average large-cap fund has failed to do so.

Averages don't tell the whole story. Table 1 tells the story of how the average large-cap fund did during down markets. Clearly, the average large-cap fund hasn't been too impressive relative to the indexed alternative. This is not to say, however, that there aren't individual managers likely to beat the 50-50 odds of outperforming the indexed alternative in a down market. So Table 1 doesn't make any sort of ironclad case for indexing, given that it focuses on average performance. But it does serve as a counterpoint to active apologists who sometimes write or talk as if it's a no-brainer that active funds will blow away index funds in down markets.

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