Rekenthaler Report

Do Active Funds Have a Future?

By John Rekenthaler | 08-06-14 | 11:20 AM | Email Article

Fading Fast

Do active funds have a future? To cut to the chase: apparently not much.

The post-2008 pursuit of index funds was no mere infatuation. Passive investing is now *the* mainstream approach. Below are the net sales over the past 12 months for all exchange-traded funds, passive mutual funds, and active mutual funds. The tally: 68% passive, 32% active.

Net Sales, U.S. ETFs and Mutual Funds—Trailing 12 Months Through June 30, 2014

Morningstar Category	$ Billions	Market Share
ETFs	146	35%
Passive Mutual Funds	138	33%
Active Mutual Funds	134	32%

Source: Morningstar Data.

The story gets worse upon closer examination.

To start, target-date funds account for $30 billion of active funds' inflows; remove that amount, and active management took in barely more than $100 billion. Target-date sales are in a sense accidental, as target-date funds sell into a captive audience that must purchase funds from the target-date family that is placed in front of it. After all, it’s not as if those investors deliberately chose active fund management. And that happy accident is dissipating. After a slow start, passive investing is taking over target-date investing, with Vanguard gaining market share and several other target-date fund managers adding passive options.

Indeed, aside from alternative investing, there’s no place remaining where active managers are safe from passive competition.

Net Sales, Active and Passive Mutual Funds—Trailing 12 Months Through June 30, 2014

Morningstar Category	Active Funds $ Billion	Passive Funds $ Billion
International Stock	103	35
Allocation	50	1
Alternatives	35	0
Sector Stock	22	4
Commodities	(11)	1
Taxable Bond	(12)	32
U.S. Stock	(16)	64
Municipal Bond	(37)	1

Source: Morningstar Data.

To be sure, the story looks terrific for international-stock active management. Over the past 12 months, actively run international mutual funds have outsold their passive competitors by a 3:1 margin. (The gap, of course, narrows when ETF sales are considered.) Those assets have been critical for active management. Without international and target-date funds, active funds wouldn't have picked up a dime of net new money this past year.

However, that pendulum could soon swing. Active international-fund managers have largely been riding their 1990s' success. They began that decade holding far less Japanese stock than did the indexes because they disliked placing so much money into a single country and because Japanese equities were so expensive. That bet paid off handsomely, thereby leading to the common investor mind-set of indexing domestically and investing actively overseas.

If active international-stock funds are to continue their sales success, they need a booster shot. For performance, Vanguard Total International Stock Index (VTIAX) has moved comfortably ahead of most surviving international-stock funds over the trailing 10 years, beating the typical foreign large-blend fund by about 70 basis points (0.70%) per year. For comparison's sake, Vanguard Total Stock Market Index (VTSAX) and Vanguard 500 Index (VFINX) are 100 and 35 basis points, respectively, above their category averages. Vanguard Emerging Markets Stock Index (VEMAX) is also leading the competition, by a margin of 45 basis points per year.

As Morningstar's international-research team reminds me, one difference between domestic and international active investing is that the top international funds tend to stay that way. While star domestic funds tend to come and go, successful international funds generally remain above average. (For that reason, the postselection performance of Morningstar International-Stock Fund Managers of Year is quite strong.) Such consistency supports the decision to invest actively overseas. Still, the indexes are knocking on the door, and knocking hard; Vanguard Total International Stock Index and Vanguard Emerging Markets Stock Index are each in the top 20% of their groups so far this year. Active managers won't be able to resist such pressure for long.

I've already touched on allocation funds, as $30 billion of the $50 billion inflow shown for allocation in the second chart comes from target-date funds. That figure is under gradual siege. And the remaining $20 billion faces a steep challenge. Traditionally, investors have been more likely to index individual asset classes than to purchase a composite index. That surely will change as they become aware of the performance tables. Vanguard Balanced Index (VBIAX) lands in the top quartile of its category for the decade, beating the average rival by 90 basis points per year for the decade. Once again, the passive results for an investment arena that is not traditionally indexed ended up matching what domestic index funds have achieved.

It is true that the final area of active-management success, alternatives, is an outright victory for active management. Alternatives may be the new kids on the investment block, but they are decidedly old school in their marketing: active management, high fees, and the argument that investors get what they pay for. Except that they haven't. Over the past five years, the only alternatives category to post acceptable total returns has been long-short equity, at 8.1% annualized. Every other alternatives category has either gained less than 4% annually or lost money. So, its victory may prove Pyrrhic. It has held off the index funds, but the results may not be sufficient to attract continued inflows.

As defenders of active management point out, investing can't become 100% passive because then nobody exists to set prices. Neither will the mutual fund industry become fully passive (although conceivably, it could do so, with active management from hedge funds, individual buyers, and other nonfund parties setting security prices). Indeed, with better performance from PIMCO Total Return (PTTRX), active fund investing could make a brief comeback through better taxable-bond sales. However, the trend seems clear. Active managers have become the periphery. As the slogan goes, there is core and then there is explore. Active management is no longer core.

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