

Index Funds Still Beat 'Active' Portfolio Management

By Burton G. Malkiel

A recent report from Standard & Poor's adds impressive support to the large body of evidence suggesting the superiority of simple index investment strategies over traditional stock picking. At the start of every year, "active" portfolio managers declare that the current year will be the "year of the stock picker." But the results consistently fail to support that view.

There is no better way for individuals to invest in the stock market and save for retirement.

For years S&P has served as the de facto scorekeeper demonstrating the dismal record of "active" portfolio managers. During 2016, two-thirds of active managers of large-capitalization U.S. stocks underperformed the S&P 500 large-capital index. Nor were managers any better in the supposedly less efficient small-capitalization universe. Over 85% of small-cap managers underperformed the S&P Small-Cap Index.

When S&P measured performance over a longer period, the results got worse. More than 90% of active managers underperformed their benchmark indexes over a 15-year period. Equity mutual funds do beat the market sometimes, but seldom can they do it consistently, year over year.

The same findings have been documented in international markets. Since 2001, 89% of actively managed international funds had inferior performance. Even in less efficient emerging markets, index funds outperformed 90% of active funds. Indexing has proved its merit in various bond markets as well.

The logic behind the empirical results is irrefutable. In any national market, all the securities are held by someone. Thus if some investors are holding securities that do better than average, it must follow that other investors do worse than average. Investing has to be a zero-sum game. For every winner there will be a loser.

But in the presence of costs, the game becomes negative-sum. The index investor will achieve the market

return with close to zero cost. Actively managed funds charge management fees of about 1% a year. Thus, as a group, actively managed funds must underperform index funds by their difference in costs. And empirical evidence suggests that active funds underperform index funds by approximately the difference in their costs. Moreover, actively managed funds tend to realize taxable capital gains each year. Passive index funds are more tax-efficient, making the after-tax gap even larger.

In 2016 investors pulled \$340 billion out of actively managed funds and invested more than \$500 billion in index funds. The same trends continued in 2017, and index funds now account for about 35% of total equity fund investments. Now a new critique has emerged: Index funds pose a grave danger both to the stock market and to the general economy.

In 2016 an AB Bernstein research team led by analyst Inigo Fraser-Jenkins published a report with the provocative title "The Silent Road to Serfdom: Why Passive Investment Is Worse than Marxism." The report argued that a market system in which investors invest passively in index funds is even worse than an economy in which government directs all capital investment. The report alleges that indexing causes money to pour into a set of investments without regard to considerations such as profitability and growth opportunities. Detractors also accuse index funds of producing a concentration of ownership not seen since the days of the Rockefeller Trust.

What would happen if everyone began investing in index funds? The possibility exists that they could grow to such a size that they would distort the prices of individual stocks. The paradox of index investing is that the stock market needs some active traders to make markets efficient and liquid.

But the substantial management fees that active managers charge give them an incentive to perform this function. They will continue to market their services with the claim that they have above-average insights that enable them to beat the market, even though they cannot all achieve above-average market returns. And even if the proportion of active managers shrinks to a tiny percentage of the total, there will still be more than enough of

them to make prices reflect information.

Americans have far too much active management today, not too little. The S&P report reveals that ever-increasing percentages of active managers have been outperformed by the index. If anything, the stock market is becoming more efficient—not less so—despite the growth of indexing.

It is true that there will be a growing concentration of ownership among the index providers, and they will have increased influence in proxy voting. The possibility of excessive market power needs to be monitored by antitrust authorities, but index funds don't

have an incentive to use their votes to encourage anticompetitive behavior.

Index funds have been of enormous benefit for individual investors. Competition has driven the cost of broad-based index funds nearly to zero. Individuals can now save for retirement far more efficiently than before by assembling a diversified portfolio of index funds. There is no better way to preserve and grow one's savings.

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ity, the police are able to arrest multiple suspected accomplices. That suggests the police knew the attackers' identities in advance but did nothing—in other words, that most of the time terrorists can act with impunity even if known. Here, then, is further evidence of a society that will not defend itself seriously. This is not just a British problem. The April murder of a policeman on the Champs Elysées in Paris was committed by a man who had already tried to kill three policemen, who was known to have become fanatized, and who was found with vicious weapons in his home. The authorities waited patiently until he struck.

Theodore Dalrymple is the pen name of Anthony Daniels, a British physician.