Are Active Managers Smarter Than Your Average Bear?

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When Canadian and international stock markets fell 20% from their mid-year highs this fall, they officially dipped a toe into bear-market territory. Never is the active-versus-passive debate more heated than during turmoil like we’ve endured in 2011. When the markets plummet, index funds do, too, while active managers have the ability to move to cash or other defensive positions. That’s true as far as it goes. But whether money managers can consistently outperform the indexes in bear markets is not at all clear.

A number of researchers have looked at the performance of active managers during bear markets to see whether this conventional wisdom holds true. As you’ll see in the findings discussed below, the results are mixed. During some periods of market stress, a majority of active funds have indeed outperformed the indexes, and overall, active funds do seem to perform better during down markets than they do when the bulls are running.

However, the results are hardly a ringing endorsement of active managers. For starters, managers who have success in one bear market usually do not repeat it during the next. And when stock prices inevitably recover, many are late to the party, which means their overall performance during complete market cycles trails their benchmark.

That ‘70s Show

The first retail index fund was introduced in 1975 by Vanguard; it simply bought all the stocks in the S&P 500. The whole idea of a passively managed fund would have seemed preposterous to Wall Street at any time — for many people, it still seems absurd. But the timing was particularly unfortunate for Vanguard, as the U.S. had just endured a horrendous bear market. From January 1973 to September 1974, the Dow Jones Wilshire 5000 declined by 46.4%. What sort of kamikaze would trust a passively managed fund during a period like that?

But here’s the thing, active managers did even worse. The average U.S. equity fund lost 47.9% during the 1973-74 bear market, underperforming the broad market by 1.5 percentage points.

This is one of the findings revealed in a 2009 white paper called “The Case for Indexing”, published by Vanguard, with data from third parties such as Dow Jones, and Lipper. The paper also looks at the bear-market performance of U.S. equity funds since 1980 and finds that it has been inconsistent. The average fund did outperform the benchmarks during the downturns of 1980-82, late 1987, and 2000-03, but not during 1990, 1998, nor 2007-08.

The track record was similarly mixed for European equity funds; a majority of active funds beat the MSCI Europe Index in three of the six bear markets examined since 1990.

Interestingly, in several periods the European managers outperformed when U.S. managers lagged, and vice-versa. European active managers beat their benchmarks as a group in 1990 and in 2007-08, but not in 1998 or 2000-03, which means that if you were a Canadian investor with a global portfolio, you may well have seen one manager’s good calls being undone by the poor performance of another.

The Tech Bubble

Standard & Poor’s publishes quarterly scorecards that compare the performance of actively managed funds to their relevant benchmarks. After the long and dismal bear market that followed the dot-com crash in 2000, S&P published a special report that looked at how Canadian funds fared from the August 2000 peak to the December 2002 trough.

This was a unique period for Canadian equity managers to compare themselves to the S&P/TSX Composite
This popular benchmark is capitalization-weighted, which means that the biggest companies get the largest share. At its peak in 2000, Nortel’s share price had ballooned so much that it represented over 36% of the index. Mutual fund managers, however, are usually not permitted to concentrate more than 10% in any single company. So “index hugging” was impossible, and the 10% rule worked to the funds’ benefit when Nortel tanked.

A more meaningful benchmark during this period is the S&P/TSX Capped Composite Index, which also imposes a 10% maximum on any single company. In aggregate, Canadian equity managers did achieve higher returns than this index during the period. However, less than 39% of individual funds outperformed the same benchmark. How can the group do so well when a majority of individual funds underperform? The answer is that a small number of overachievers pulled up the overall average.

S&P also found that without the anchor of Nortel around its neck, the small-cap sector performed much better than the broad market during this period – the S&P/TSX SmallCap Index was down a modest 1.94%. However, the performance of active managers in this space was dismal. Only 30% outperformed the index, and their overall return was minus 14.33%.

**The 2008-09 Meltdown**

The financial crisis of 2008-09 and its subsequent recovery are a telling example of active management’s double-edged sword. It is easy enough for a portfolio manager to move to cash during a meltdown, and doing so allowed a majority of Canadian equity funds to outperform their indexes in both the third and fourth quarters of 2008 (the figures were 59% and 53% respectively, according to S&P). But whenever managers take defensive positions they risk being on the sidelines for the recovery, and that’s exactly what happened after the market bottomed in 2009.

In the charging bull market that followed, most active managers missed the boat and only 30% of Canadian equity funds outperformed in 2009. Again, however, the results were not uniform across the spectrum – small- and mid-cap Canadian funds, U.S. equity funds and global equity funds, as a group, did add value.

**The Lesson**

What to make of all these data? The best we can say is that active management can add value during market downturns, but this value is elusive at best. There is no way of knowing in advance which active managers will provide downside protection, and which will drag investors down along with the indexes.

There’s also a larger issue to consider. No one argues that passive investing consistently outperforms a majority of active strategies during bull markets – this is simple math. So, even if active management did have a better than even chance of outperformance during a bear market, what would that mean for investors?

In his paper “Fact and Fantasy in Index Investing”, Eric Kirzner, professor of finance at the University of Toronto, identifies the problem. “Even if you realistically believe you (or your fund manager) can correctly determine when a bear market is about to start, why would you pursue a strategy that’s likely to work only about 30% of the time, since the ratio of bull to bear markets is about 70/30?”

Over most market cycles – and certainly over a typical investment lifetime – the overall returns delivered by active managers are unlikely to outperform an indexed approach. Even if an active manager is right more often than she is wrong, the relentless compounding of fees, trading costs and taxes are likely to undermine any value added by timing decisions.

The lesson, then, is that all investors need to carefully consider their ability and need to take risk. Bear markets are routine, and losses of 30% or more are not as unusual as investors may believe. If you’re not prepared for declines like this – either emotionally, or because of a short time horizon – the solution is not to run into the arms of active managers. The best way to protect yourself from downside risk is to change your strategic asset allocation. Keeping a healthy percentage of your portfolio in government bonds and cash at all times remains the most reliable protection from the ravages of a bear market.

**References**

- “The Case for Indexing” and other white papers and reports on the active-versus-passive debate are available at institutional.vanguard.com.
- Standard & Poor’s Indices Versus Active reports are released quarterly and published at www.standardandpoors.com/indices/spiva/en/us
- Eric Kirzner’s “Fact and Fantasy in Index Investing” can be downloaded at www.bylo.org/pdf/fact.fantasy.in.index.investing.pdf

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