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Almost no one can beat the market

Commentary: Seek shelter in low-cost index funds or ETFs

Year after year, decade after decade, evidence has piled up that neither individual nor professional investors can outperform broad market indexes consistently over long periods of time.

Studies of fund managers, active traders, and other institutional investors have failed to find persistent outperformance that wasn't caused by either luck or being in the right part of the market at the right time.

Eugene Fama of the University of Chicago, who won a Nobel Prize in economics last week, pioneered the efficient market theory that said stock prices incorporated all relevant information available to investors.

I always thought that theory went too far — individual stocks and whole asset classes can remain "mispriced" for years, as Fama's fellow Nobel winner Robert Shiller of Yale University has shown.

But over the very long run, Fama was right: Almost no one who is operating honestly can maintain a persistent information edge over the millions of other smart investors who comprise "the market."

Some research I've recently come upon clinches it: Fewer than 1% of mutual fund managers persistently beat the market based on superior market-timing or stock-picking skills. That's down dramatically since the mid-1990s, suggesting either a decline in managers' skills or a great leveling of performance because of technology, high-frequency trading, what have you.

That's the conclusion of a 2010 study by professors Laurent Barras, O. Scaillet, and Russ Wermers recently featured in a thoughtful, extended piece on this subject by Julie Segal in Institutional Investor , which I recommend highly.

And it's in line with research by Brad Barber of UC Davis and Terrance Odean of UC Berkeley who found that only about 1% of active traders outperformed the market. The more frequently people trade, the worse they do, Barber and Odean concluded.

It's not just that true stock-picking ability is as rare as, say, being a violin virtuoso or throwing a 95-mile-an-hour fastball; it's that the profits from such talent are eaten up by trading costs or management fees.

That means superior fund managers and their firms keep the fruits of their outperformance, leaving investors with a market return at best. And many actively managed mutual funds trail the market, even before you subtract their management fees. So, individual fund investors just can't win.

The study documents that in painful detail . Barras, Scaillet and Wermers tracked 2,076 actively managed U.S. domestic equity mutual funds between 1976 and 2006. They found that after fees, three-quarters of the funds exhibited zero "alpha," a fund's excess return over a benchmark index. And 24% of the funds were run by unskilled managers (who had negative alpha, or value subtraction).

And — are you sitting down? Only 0.6% — you read that right, 0.6% — showed any true skill at beating the market consistently, "statistically indistinguishable from zero," the three researchers concluded.

Fund managers' performance has even deteriorated over time. "Skilled managers…have become exceedingly rare," the authors wrote.

So rare as to be almost extinct, it seems.

In an interview, Barras, a professor at McGill University in Montreal, explained that in the early 1990s, 15% of active fund managers were able to produce alpha. Still not much, but surely better than nothing.

But "if you take the last decade,.. there is very little or no skill at all through the end of 2006," he told me. Imagine what they would have found had they included the market crash and financial crisis of 2008-9.

Why the big change? Barras cited several factors. Mutual fund fees may have come down, but not enough to produce excess returns for investors. And though "the cost of trading has gone down significantly over the last few years,….managers trade more."

Paradoxically, Barras observed, “the sharp decrease in performance also correlates with a high growth in the mutual fund industry.” So, there are more funds with worse results.

Then there is the lure of greener grass. “Perhaps the skilled guys just moved away from the mutual fund industry,” Barras said. Hedge funds, with their lower transparency and much richer fees, may have attracted talented managers who might have run mutual funds a generation ago.

Not that hedge funds are shooting the lights out, either, despite all the fawning media coverage they get. Some hedge funds have produced considerable alpha, Barras acknowledged, but they’re “almost too good to be true.”

“For hedge funds, the jury’s still out,” he said.

Not so for active mutual fund managers, who might as well have been tried, convicted, and sentenced to oblivion. The only bright spot in this otherwise gloomy study is aggressive growth funds. “We do find that 40% of them are able to generate positive alpha,” Barras said.

Growth and income funds, on the other hand, are worse than useless, the researchers found. Some 30% were classified as “unskilled,” while none manifested superior stock picking ability.

So, what should you do? I would cut the actively managed funds you still own to those that actually have produced alpha over the last five to 10 years, particularly aggressive-growth funds with proven track records. The rest of your equity position should be in low-cost index funds or ETFs.

“I wouldn’t spend a lot of time trying to pick the manager who’s going to give me a stellar performance,” said Barras. “Investors do not participate in the party.”

Because whatever party the very best money managers are throwing, you and I are not invited.

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