Beware of Paying Active Management Fees to a Passive Manager

Indexed mutual funds (passively managed funds) aim to track an index or some segment of the market with low fees. Anyone who has heard of John Bogle knows that runaway fees can eat into your portfolio performance over the long run. However, a recent post at **AlphaBetaWorks Insights** warns of “closet indexing”: the practice of charging active fees for passive management.

The post discusses two measures of a fund’s activity or lack thereof. The first is **Active Share**, which is the percentage difference between portfolio and benchmark holdings. The authors from AlphaBetaWorks feel that this measure is flawed. For example, if an S&P 500 benchmark fund buys SPXL (S&P 500 Bull 3x ETF), this passive position increases Active Share. If a fund with S&P 500 benchmark indexes Russell 2000, this passive strategy has 100% Active Share. The authors cite **research** that indicates that high Active Share funds that outperform merely track higher-risk benchmarks.

Another measure the article discusses is the **Information Ratio** (IR), which is the measure of active return a fund generates relative to its active risk, or tracking error. AlphaBetaWorks estimated each fund’s IR relative to its factor benchmark. The top 10% of U.S. equity mutual funds achieved IRs above 0.36. If a fund outperforms 90% of the group and achieves 0.36 IR, then it needs tracking error above 1% / 0.36 = 2.79% to generate active return above 1%. So assuming a typical 1% fee, if a fund were able to consistently achieve IR in the 90th percentile, it would need annual tracking error above 2.79% to generate a net active return. However, their research shows that much of the industry is far less active: half of U.S. “active” equity mutual fund assets do not even appear to be trying to earn a 1% active management fee.

AlphaBetaWorks has conducted a study covering 10-year portfolio histories of approximately three thousand U.S. equity mutual funds that are analyzable from regulatory filings.

Based on their research, AlphaBetaWorks arrived at the following conclusions:

- Over a third of U.S. equity mutual funds are currently so passive that they fail to merit a typical fee.
- Half of U.S. equity mutual fund capital will fail to merit a typical fee, even when its managers are highly skilled.
- As skilled managers accumulate assets, they are more likely to closet index.
- A typical investor can re-allocate half of their active equity mutual fund capital to cheap passive vehicles or truly active skilled managers to improve performance.

Index funds play a major role in many investment portfolios. At AAII, we publish a wealth of information to help fund investors minimize their costs while maximizing their returns:

- **Achieving Greater Long-Term Wealth Through Index Funds**
- **Common Mistakes and Other Investing Insights**
- **Active Versus Passive: Which Do You Choose?**
- **How to Measure the Skills of Your Fund Manager**

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