

# COMPASS FEATURE ARTICLE

## Actively Managed Funds and Bear Markets

One rationale sometimes used to justify investment in actively managed mutual funds is that the active management approach will protect investors during bear markets by using market-timing techniques.

We can see why it is easy to believe that active managers should outperform during bear markets because such funds can maintain cash reserves to meet redemption requests, or increase allocation to cash to ensure funds are available for the “next great stock purchase.”

Cash is a poorly performing asset class in bull markets, and cash reserve is one of the reasons why active managers tend to underperform in bull markets. In bear markets, however, cash is king. If they were able to anticipate bear markets, active managers could beef up their cash reserves, reduce exposure to equities, and protect their investors from the type of losses index funds experience (since index funds are by definition virtually 100 percent invested at all times). However, we suggest that the historical evidence does not support claims that active managers are actually able to offer such protection. Let’s look at some of the evidence.

A good test of the hypothesis came with the severe bear market we entered in Spring 2000. For the 12 months ended March 31, 2001, the Wilshire 5000 Index fell 24.7 percent. Morningstar reported that the 50 largest U.S. stock mutual funds (which account for 45 percent of U.S. stock

assets) lost an average 27.4 percent. Despite the perceived advantages discussed above, these professional funds underperformed the Wilshire benchmark by almost 3 percent.

Note also that when the bear market began there was no indication that the average fund predicted its arrival and was prepared with cash reserves; at the time, the average fund held just 4 percent of its assets in cash. By the end of February 2001, after prices had fallen dramatically, cash reserves approached 6 percent.<sup>1</sup> This is not an unusual phenomenon. Just prior to the worst bear market in the post-war era (1973–1974), mutual fund cash reserves stood at just 4 percent. They reached about 12 percent at the ensuing low. In mid-1998, when the “Asian Contagion” bear market arrived, cash reserves were less than 5 percent. Compare this to the 13 percent level reached at the market low in 1990, just prior to beginning the longest bull market in history.<sup>2</sup> It seems fund managers are very good at executing a buy high and sell low strategy.

A Lipper Analytical Services study provided further evidence on the failure of active managers to outperform in bear markets, despite their aforementioned advantages. Lipper studied six periods during which the markets dropped at least 10 percent from August 31, 1978 to Oct. 11, 1990. They found that, while the average loss for the S&P 500 was 15.12 percent, the average loss for large-cap growth funds was 17.04 percent.<sup>3</sup>

The subsequent bull market did not help the case for active management either. John Bogle, founder and former chairman of the Vanguard Group, comments that fund investors have not “shared adequately in the rewards of the great bull market” that ended in March 2000. Compared to the 17.5 percent annual return of the S&P 500 during the past 15 years, the average (active) equity fund returned only 14.1 percent per annum during the same period.<sup>4</sup>

As they say in the commercial, where’s the beef? Susan Dziubinski, editor of Morningstar’s *FundInvestor* newsletter, put it this way: “The average fund can’t keep up with its index when it’s sunny or rainy.”<sup>5</sup> The tendency for actively managed funds to underperform during bear markets despite their advantages in such an environment is evidence that investors can avoid making strategic errors by always checking the data before choosing between fact and fiction.

<sup>1</sup> Jonathan Clements, **Investors Stay Cool as Stocks Turn Cold**. Wall Street Journal, April 17, 2001.

<sup>2</sup> John Bogle, **John Bogle on Investing**. McGraw-Hill, copyright 2001.

<sup>3</sup> Richard E. Evans and Burton G. Malkiel, **The Index Fund Solution**. Simon & Schuster, copyright 1999.

<sup>4</sup> **John Bogle on Investing**.

<sup>5</sup> **Who Needs a Money Manager?** *Business Week*, February 22, 1999.

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