

# CAPITAL IDEAS

April 2005

## Indexing Incognito

**Overview:** Investors in actively managed funds may not be aware of it, but many of them have become victims of “closet indexing,” which means they typically end up paying premium fees to achieve the same returns one could expect from a lower-cost index fund. Since we last visited the topic in 2000, it appears that even more equity funds have changed into closet index funds. In February 2005, *Investment News* estimated, “the number of actively managed equity funds that are ‘closet’ index funds has tripled in the past four years.”<sup>1</sup> This article defines closet indexing and discusses why (after expenses, taxes and fees) investors are typically better off steering clear of such funds by taking the most direct route — buying shares in a true passively managed fund.

### Introduction

Fund managers don’t normally advertise the fact that their actively managed funds<sup>2</sup> might have become closet index funds. These funds are still actively managed, but because the funds’ holdings so closely resemble those of an index fund, investors are paying extra for minimal differentiation. In addition, active managers have many costs to overcome as they strive to outperform their respective benchmarks, including the following:

- Operating expenses
- Applicable marketing and distribution fees
- Trading costs, including market impact costs
- Taxes
- The cost of cash, which has a lower expected return over time than equities (Active managers typically hold cash reserves of 5–10 percent of the total asset value of each mutual fund to manage cash inflows and outflows, such as the need for immediate cash to accommodate investors who sell their shares.)

### Determining Whether a Fund is a Closet Index Fund

How do we measure how closely a fund resembles the index it tracks? The amount of similarity between a fund and its benchmark (such as the S&P 500 Index) is measured by the fund’s coefficient of determination (also called “r-squared”), which measures how much of the fund’s variation of returns over time can be attributed to returns on the index.

For example, if Fund A has an r-squared of 0.90 and Fund B has an r-squared of 0.81, this means that for Fund A, 90 percent of its return variations are explained by the returns of the S&P 500. Fund B has a lower r-squared of 0.81, or 81 percent, which tells us that Fund B does not follow its benchmark’s market movements as closely as Fund A. We consider funds with r-squareds of greater than 0.90 to be closet index funds.

## **Expenses Reduce a Closet Index Fund's Chances of Outperformance**

If a large percentage of an actively managed fund follows an index, then the fees charged by the fund should reflect management costs consistent with a low-cost index fund. When higher management fees are added to the other expenses that actively-managed closet index funds incur (including taxes and turnover), the overall hurdle to outperform the benchmark can become overwhelming.

In 1999, *The New York Times* reported that eight of Fidelity's 11 largest actively managed funds had three-year r-squared measurements of 94 percent or higher.<sup>3</sup> In February 2005, *Investment News* noted that one of Fidelity's most popular actively managed funds, the Magellan Fund, had an r-squared that "stood at 98.83 in December [2004]. While that's down from 99.09 a year earlier, it is up from 96.04 in 2000."<sup>4</sup>

In 2004, seven of the 10 largest large-cap funds had r-squareds of 91 percent or higher.<sup>5</sup> Remember that, the larger the fund, the more diversified it tends to become. The more it diversifies, the more closely it will become correlated with its index. In addition, as a fund grows larger, it will incur higher market impact costs, which means the manager will need to overcome a greater hurdle to outperform.

## **Conclusion**

It is often difficult for funds to overcome a high correlation to the benchmark, taking into account the greater fees and other expenses incurred by active managers. Funds that passively track particular indexes are an improvement over closet index funds, in that they typically have lower costs than actively managed funds. Better yet are funds that are structured to capture more of the risk factors of the asset classes themselves. We would suggest that building a globally diversified portfolio of passively managed asset class funds is a prudent decision — and the preferred alternative to trying to determine whether an actively managed equity fund is an index fund in disguise.

<sup>1</sup> Frederick P. Gabriel, Jr., **Active Managers Slip Into Closet**. *Investment News*, February 21, 2005.

<sup>2</sup> Active management attempts to uncover securities the market has either under- or overvalued, and/or time investment decisions to be more heavily invested when the market is rising and less so when the market is falling. Passive management is a buy-and-hold investment strategy, specifically contrary to active management. Characteristics of the passive management approach include: lower portfolio turnover, lower operating expenses and transactions costs, greater tax efficiency and a long-term perspective.

<sup>3</sup> Richard A. Oppel, Jr., **The Indexing Monster in Your Closet**. *The New York Times*, October 10, 1999.

<sup>4</sup> Frederick P. Gabriel, Jr.

<sup>5</sup> *Ibid.*

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