

Top Mutual Funds: Luck or Skill? New Study Questions 'Active' Managers

By [SAM MAMUDI](#)

It's impossible to tell whether actively managed funds that beat the market do so out of luck or skill, according to a new study by the professors who've championed index investing for years.

The claim means that investors can't know for sure how good their active manager is, say the professors, Eugene Fama and Kenneth French.

"People don't understand the effects of chance [on returns]," said Mr. Fama, professor of finance at the University of Chicago Booth School of Business. "And it's impossible to tell how big an element chance is in [good performance]."

Blast at 'Actives'

The latest Fama-French study is another piece of ammunition to support their view that most active managers can't consistently beat index funds, which track the market. Underpinning that is the efficient-market hypothesis, developed by Mr. Fama in the 1960s, that states that assets are appropriately priced since the market has all available information.

Active managers, of course, disagree. "There is clearly a difference between luck and skill," said John Osterweis, manager of Osterweis Fund. "There are investors who, over many, many decades have proven they have skill."

Mr. Osterweis, whose fund is rated five stars by research firm Morningstar Inc. and has 10-year annualized returns of 5.8%, said one of the best ways to determine whether a manager has skill is their performance across a variety of different types of market. He also suggested that sophisticated investors look at a manager's investment process "to see if it's consistent with his results and repeatable over time."

Mr. Fama and Mr. French, professor of finance at Dartmouth College's Tuck School of Business, ran 10,000 simulations of what investors could expect from actively managed funds.

This was based on data for 3,156 stock funds from January 1984 to September 2006. They found that outside the top 3% of funds, active management lags behind results that would be delivered due simply to chance.

The study, "Luck Versus Skill in the Cross Section of Mutual Fund Returns," included mutual funds that were liquidated and any fund launched before September 2001 that reached more than \$5 million in assets. (Find a copy of the report at the Social Science Research Network.)

"The simulations tell us that for the vast majority of actively managed funds, true [abnormal expected return] is probably negative; that is, the fund managers do not have enough skill to produce risk-adjusted expected returns that cover their costs," wrote the professors.

While many studies have shown that the vast majority of active funds can't beat the S&P 500 index, lately active and index funds have been in a dead heat: This year, actives beat indexes, 28.6% to 27.6%, and last year, actives were slightly behind, negative 39% versus negative 37.7%, says Morningstar.

The fact that some funds in the professors' study beat the simulations does suggest that by picking the right funds investors can consistently outperform the market. But there's just one problem, according to the professors: The "good funds are indistinguishable from the lucky bad funds that land in the top percentiles."

Guesswork?

That leaves picking the right fund a matter of guesswork. So even if investors stick with the top performers, they're running a risk because the manager's good results could be based on luck.

The presence of both good funds and lucky bad funds means it's likely that investors focused on top performers will end up with returns close to the market.

In an interview, Mr. Fama cautioned that this doesn't mean all index funds are viable options—there are index funds that charge high fees, for example. Investors should stick to low-cost and efficiently managed index funds, he said, naming Vanguard Group's offerings as among the best.