PRIVATE ASSET MANAGEMENT, INC.
WEALTH STRATEGY ADVISORS
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This month, we delve deeper into actively managed mutual funds. There are three main takeaways from this Paradigm. First, actively managed funds can add value. Second, the ability of actively managed funds to add value appears to be more difficult now than a decade ago. Third, longer holding periods for actively managed funds is likely to improve the value they can add.

Background

The June 2017 Paradigm reviewed our mutual fund selection process. An excerpt from that Paradigm is worth reprinting: *The process for choosing funds must support how we manage portfolios: forward looking, personalized, broadly diversified, and with a long-term focus.*

Recently, Morningstar (a firm that provides mutual fund research) published its semi-annual list of best mutual fund firms. Interestingly, we use actively managed funds from two of the top three fund families: Dodge & Cox plus American Funds.

The overlap is not surprising. We focus on the long term and Morningstar says its "Analysts' long view encourages stability". Both approaches also look at more than performance. Attention is paid to perceived corporate culture and structure, plus mutual fund fees.

Fund Company Data

What follows is, admittedly, a small sample, but we believe it is useful.

Dodge & Cox only has six funds. We looked at the longest reported period of performance for each fund. Five out of the six funds performed better than their index. The sixth fund trailed by 0.3% per year.

Three thoughts about this fund company's performance. First, by only offering six funds, the company focuses on what it thinks it does best. Second, fees are below average. For example, the fund that is the closest in holdings to the S&P 500 has fees of 0.52%—more than an index fund but less than the 1.0% average for comparable funds. Third, you should plan to own their funds long term because over any five-year period, their funds may underperform the index.

American Funds just published a paper on their equity-focused mutual funds. Their two main points were:

1. "17 of our 18 equity-focused mutual funds have index-beating lifetime results."
2. "Our U.S. equity-focused mutual funds have delivered better results than the S&P 500 since 1976."

The data suggests that these fund companies have provided value in the past.

Adding Value Appears More Difficult

In general, it appears that markets have become more efficient over time, meaning that providing superior returns has become harder. Data from the companies suggest this is so. For example, the Dodge & Cox Stock Fund has excellent 20-year performance relative to its peers and index. However, the outperformance is all in the first decade of the two-decade period. Also, the American Funds Growth Fund of America has excellent long-term results, though it has been an average performer over the past decade.

The above data need not imply average performance in the next decade. It does mean, though, that for many asset classes, especially stocks, adding value appears to be getting harder.

The other area where active funds struggle is tax efficiency. Performance data is pre-tax. In the past decade, especially in small cap funds, material gains have been paid out along the way. Some research suggests placing actively managed small cap funds in tax deferred accounts to avoid triggering taxes before the money is needed.

Longer Holding Periods Can Be Helpful

Active managers will have good and bad periods that can last for several years. Owning funds long term might allow you to weather periods of below average performance. The approach to picking the right fund and fund family is integral to this process.

Also, almost by definition, a fund cannot beat its index if it invests exactly like the index. Therefore, a fund's investments will not mimic the index in the near term. For example, as of June 30, 2019, the Dodge & Cox International Funds was 21% invested in emerging markets though its index was 0% in emerging markets. Investors have to be able to trust the fund company for extended periods of time, especially when the fund is under performing its index.

Investing in actively managed funds still appears to have merits. However, the investment process, excess return expectations, and holding periods need to be thoroughly thought out for the outcome to be advantageous to investors.

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