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Fund Fiend

In a Down Market, Many Fund Managers Were Down Even More

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In theory, mutual funds run by stock pickers should beat index funds in a down market. The reasoning is that savvy managers, combing through financial statements, can avoid the worst performers and bulk up on the winners. An index fund, meanwhile, has its hands tied.

Unfortunately for investors, in this past year's bear market, most mutual-fund managers have fallen short.

In some parts of the mutual-fund world, the performance of actively managed funds compared with indexes has been nothing short of abysmal. In the 12 months ended Sept. 30, roughly nine of every 10 actively managed midcap stock funds failed to beat the Standard & Poor's MidCap 400 Index, according to fund tracker Morningstar. During that time, the average midcap fund returned a negative 23.2%, versus the index's 16.7% decline.

Among small-cap funds, fewer than one in five has done better than the Russell 2000 Index. In past years, small stocks had been an area where managers fared well; during the bear-market years of 2000-02, roughly 60% of small-cap funds beat the index.

Steven DeSanctis, who covers small-cap stocks at Merrill Lynch, says a variety of factors are conspiring against fund managers this time around. In early September, financial stocks rebounded a bit from their depths, while energy names were hit hard. Many managers, however, had given up on financials and were heavy on energy. In addition, very small, low-priced stocks have been doing better than stocks at the upper end of the small-cap range, but managers tend not to focus on these generally lower-quality companies.

Ironically, a big reason for the underperformance may be the rise of exchange-traded funds, says Mr. DeSanctis. The [iShares Russell 2000 Index](#) ETF today totals about \$15 billion, roughly seven times its size during the prior bear market. When the Russell bounces sharply, as it did in January, March and again during the summer, money pouring into the ETF pushes the thinly traded stocks in the index much higher, while the kinds of stocks owned by fund managers don't move as much.

The takeaway is that market forces, which have nothing to do with stock-picking skills, can be affecting how your managers stack up against the indexes. In a recent report, Vanguard Group says the winner in the active-vs.-index debate varies, depending on which rolling 10-year period you examine.

Roughly 39% of large-cap stock funds beat the S&P 500 over the past 12 months. On average, 47% of these funds beat the index from 1998 to 2007, according to Morningstar. Investors have most of their money in large-cap funds, so that is a meaningful statistic. But if it isn't even a coin toss as to whether your manager does better than a robot, it bolsters the argument in favor of indexing and ETFs.

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