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Fundamentals of Investing

Active or Index Funds for '09?

The downturn has been rough on stock-picking managers. Now, professionals debate which type of fund will do better when stocks eventually bounce back.

By KAREN HUBE

As return-hungry investors prepare for a stock-market rebound -- yes, analysts say the market will rise again they face some difficult questions about what types of mutual funds will help put their portfolios back on track the fastest.

During a market comeback, is it best to be invested in actively managed funds that aim to beat their benchmarks? Or is it better to stick to index funds that simply rise with the tides?

While some investors may feel it is premature to be thinking about a recovery -- the market may remain in the doldrums for months, after all -- financial advisers say it is better to prepare for a rebound than to react to it. With that in mind, some advisers are making decisive moves now into either index funds or actively managed funds on their clients' behalf.

"We recently replaced any actively managed funds with passive or index funds to ensure a full participation in an eventual recovery," says Steven Condon, director of investment advisory services at Truepoint Capital LLC in Cincinnati, a firm that typically recommends a mix of actively managed and index funds.

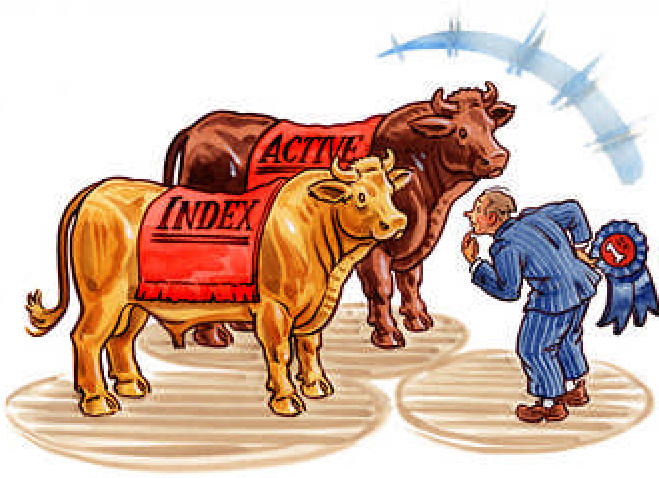
Mr. Condon says that in an index fund, your money is fully invested and will fully benefit from gains as soon as the market turns around. In contrast, many actively managed funds have built up large cash positions in recent months -- in some cases as much as 40% or more -- to try to cushion losses. Since no one can predict when the bottom of the market will occur, active managers sitting on piles of cash are likely to miss out on the early stages of a recovery, Mr. Condon says, pointing out that the early stages of a recovery are critical.

Indeed, a look at bull markets since 1929 shows that an average 48% of the overall gain occurred in the first one-third of the bull-market time period, according to Ned Davis Research, a financial-research firm in Venice, Fla.

Using Cash Wisely

But some investors argue that by investing in a fund that mirrors an index you are holding not only the fastest-rising sectors but also the laggards. An active manager may be able to avoid the low performers and use cash to nimbly pick up shares of companies that are growing ahead of the market.

Fairholme Fund is notorious for holding large stores of cash -- but it uses the cash to buy when investors are fearful, says Wenli Tan, a Morningstar Inc. mutual-fund analyst. "The fund's stock selection has been so strong that it has been able to be at the top of its class even with a big cash stake," Ms. Tan says.



Douglas B. Jones

Managers such as Fairholme's Bruce Berkowitz could be particularly effective if the stock market's recovery is long and slow, as some analysts predict it will be. "In the environment we're going to have going forward, I don't think you're going to be able to make a lot of money just buying and holding an index," says Richard Winer, president of Winer Wealth Management Inc. in Woodland Hills, Calif.

In the recoveries from the past three bear markets, index funds have come out ahead of managed funds on average, according to data from researchers Lipper Inc. and Morningstar.

Over the 12-month period following the most recent bear market that ended in March 2002, less than 30% of actively managed funds beat their benchmarks, according to Morningstar.

But don't assume history will repeat itself, cautions Christopher Cordaro, an investment adviser at RegentAtlantic Capital LLC in Morristown, N.J. He believes the rebound following the current bear market will be different -- and that active managers will have an edge -- largely because of the character of the recent market drop.

"In the type of selloff we've just had, everything got sold because liquidity had to be raised, so there was no looking at whether to sell stock A or B -- it was an indiscriminate selloff," Mr. Cordaro says. "That has created huge price anomalies. You would expect that an active manager would be able to exploit these price anomalies and produce better returns than you'd get just buying an index."

Actively managed funds certainly didn't shine versus index funds last year, with some 58% of actively managed U.S. stock funds failing to beat their benchmark indexes in 2008, according to Morningstar.

But Erik Ristuben, chief investment strategist at Russell Investments in Tacoma, Wash., agrees with Mr. Cordaro that things will be different for stock pickers going forward.

He says that active managers tend to struggle significantly when sentiment is driving the markets -- as has been the case recently. When the market is pricing companies "based on fear -- or euphoria -- you are in an environment where managers may have a hard time keeping up," Mr. Ristuben says. Recently, "stock prices have had not a great deal to do with the actual likely economic value of the corporations."

He believes a rebound will be driven by a recognition of strong fundamentals at individual companies, which will benefit active managers.

A Balanced Approach

So what is the average investor to do? Unless you are wedded to an all-index or all-active management approach, your best bet is to take advantage of both types of funds, says Peggy Ruhlin, an investment adviser at Budros, Ruhlin & Roe Inc. in Columbus, Ohio.

As a rule of thumb, use an index mutual fund or exchange-traded fund to get exposure to a broad segment of the stock market, and go with an actively managed fund for exposure to a particular segment of the market, Ms. Ruhlin says.

"Certain managers can add value with an expertise in either a certain region or segment -- foreign tech stocks, for example," Ms. Ruhlin says. "But if we're just trying to make a play on China, then we use an index fund or an ETF."

Mr. Winer says actively managed funds shouldn't "be painted with a broad stroke." Some are designed to cushion a market decline, but will lag behind the overall market during upswings. Others have only a handful of holdings, and this highly aggressive position results in massive gains in some years and huge declines in others. The important thing is to understand what part an actively managed fund should play in your portfolio, he says.

With a blend of index and managed funds, you eliminate the chance of being left out of a market comeback -- and add the possibility of rising ahead of the tide.

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