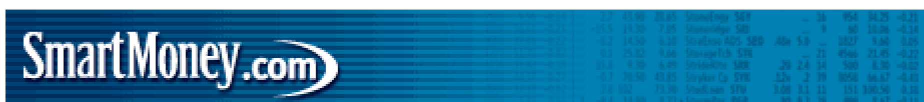

Is Your Fund a Closet Indexer?

By Rob Wherry
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AS THE LEGENDARY Fidelity Magellan fund (FMAGX[1]) was tanking earlier this decade, many complained about its underperformance and its bloated size, which, at one point, soared over $100 billion. But the most disparaging words uttered about the fund were these: It was a "closet indexer."

There isn't a more derogatory remark to say to a fund manager. That's because he is supposed to spend his time picking stocks that will outperform a benchmark like the S&P 500. Shareholders pay hefty fees for those skills. But if he is at the helm of a closet index fund it means he's essentially just buying the same 500 stocks that are in the S&P index. In other words, he so closely hugs his target it will be almost impossible to beat it. Meanwhile, investors are paying three, four, and even fives times the fees of a low-cost index fund. Needless to say, investors in a closet index fund should head for the exits. (After a manager change Magellan is anything but one these days.)

However, it isn't always easy to spot one of these funds. That could be changing, though, thanks to two professors at Yale School of Management, Antti Petajisto and Martijn Cremers. They have developed a theory called "active share." This concept tries to gauge the impact a manager's stock picks that veer from his benchmark will have on the overall portfolio. What they found by looking at performance data between 1980 and 2003 was that funds with significant active shares outdid the broad market while those with small ones lagged behind. "It had a sizable impact," says Petajisto, an assistant professor of finance at Yale. Morningstar, says Petajisto, is currently considering including active share as a screening tool.

Traditionally, spotting a closet indexer meant looking at something called R-squared. This metric measures the percentage of a fund's returns that are directly tied to movements — up or down — in the corresponding index that it tracks. So if your fund has an R-squared of 100 it moves in lock-step with that index. Any actively managed fund with an R-squared above a 95 is probably a closet indexer. Morningstar tracks around 800 equity funds that fit that bill.

Active share takes a different approach by looking at a fund's positions — not only individual stocks but their weightings, too — and the degree to which they deviate from a given benchmark. Let's say your fund holds 500 stocks but 50 of them differ from the constituents of the corresponding index. That means your fund's active share is 10%. The study found that the average large-cap equity fund typically has an active share around 60%. Anything under that, says Petajisto, is a sign that the fund is closely hugging its index. The researchers say that in 2003 almost 30% of all mutual-fund assets were tied up in funds that had low active shares. Some investors are obviously paying too much in fees.

The study also found correlations between active share and fund size and performance. Small funds — those under $500 million — had the highest active shares, while funds that took in over $2 billion tended to have lower ones. No doubt some of those findings can be attributed to the pressures of running big funds that the smaller guys don't feel. Indeed, a manager running a $50 billion fund may not want the scrutiny that comes with picking stocks that go wrong so he just settles for matching the results of the index by purchasing the same companies. "Somebody is usually telling these guys not to stray too far," says Neil Donahoe, chief investment officer of SYM Financial Advisors in Warsaw, Ind.

Active share also tends to be a good predictor of returns. Funds that had high active shares outperformed their benchmarks on average by as much as 1.6 percentage points. Conversely, funds with small active shares fell behind their bogeys by as much as 1.8 percentage points.

Unless you are a mathematician it's a good bet you won't be able to duplicate Petajisto's research — at least until Morningstar puts it up on its site. (The company didn't immediately return our call for comment.) But there are some simple tricks you can do on your own until then. First, you can find your fund's R-squared on SmartMoney.com by going to the "risk" page listed in its profile. Or print out the fund's complete holdings — the breakdown will be in the reports that are mailed to you — and compare them to the fund's benchmark. Cross out the stocks that are the same in both places, not only in name but in weighting too. What you will be left with are the components that make

up the active part of the portfolio. Ultimately, you should think about jettisoning any fund that sits between a truly active fund and an index offering. "You don't want to be in the middle," says Petajisto. "[Those funds] claim to do active management and they will charge you high fees for it."

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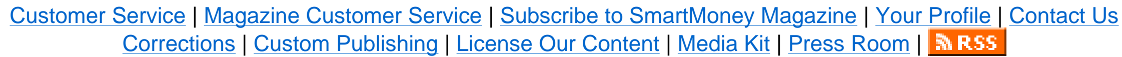

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