

Closest Indexing and Active Management Expense

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Is Your Cost More Than It Seems?

Large cap managed mutual funds are coming out of the closet. Yes, they aren't all what they seem. Instead of all being actively managed, which is part and parcel of the definition of managed funds, many are largely mirrors of their indexes.

These closet index funds masquerade as managed funds and charge their clients as though they are actively managed, but instead are following their relevant index. This means that the client is paying a super-charged fee for active management, but what he/she gets is an index fund with only a smattering of active management.

This is how Ross M. Miller, PhD, approached the problem in his paper entitled Measuring the True Cost of Active Management by Mutual Funds that was published in the a 2007 issue of the Journal of Investment Management. He composed a formula to determine the proportion of passive and active mutual fund management in large cap managed mutual funds in 2004. This required deconstructing the fund assets into those that were passive (following the relevant index) and those that were active (not a reflection of the relevant index). Then, he composed another formula for determining the cost of active management.

Dr. Miller, a Clinical Professor of Finance in the School of Business at the University at Albany (SUNY), and a partner in Miller Risk Advisors, found that that 90% of the variance of the average large cap mutual fund in 2004 was explained by its benchmark index, not by active management. He also found that the mean expense ratio for the active portion of Morningstar's 2004 large-cap equity funds was 7%. The published expense ratio was 1.15%. This means that the cost of active management was six times the published expense ratio.

From Dr. Miller's study we can conclude that investors are being charged for active management in large cap managed mutual funds, but are receiving mostly passive management. The same may be true for some mid and small cap funds. If this same investor went to a store and bought a generic suit off the rack, he would expect to pay for what he got—about \$200. If he were instead charged as though the suit were designer (but really was generic), he wouldn't buy it. Should managed mutual funds be treated any differently?

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