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Investment Update

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Points of interest:

- The majority of active mutual fund managers have failed to beat their benchmark indexes over 10 years.
- Municipal bond fund managers had the worst average showing.
- The indexes even beat most managers during bear markets, which is when active investors are supposed to do best.

Passive investors beat active managers in ten-year Scorecard

Indexed and passive investing have gotten a bad rap from active managers out to protect their turf and the high fees they earn from buying and selling securities.

Passive managers buy a portfolio that matches a market index or that covers an entire asset class. Plenty of academic research suggests that they will do better than the average active investor who tries to beat the market by either selecting the "right" investments or by timing when to buy and sell.

The passive investment managers now have a 10-year real world test to back up their theory: the Standard & Poor's Indices Versus Active scorecard, known as "SPIVA."

For a decade S&P has tracked the performance of its stock and bond market indexes compared to the performance of active mutual fund managers. The results have given strong backing to passive management proponents.

In the race for investment performance, passive stock and bond indexes have outpaced the average active mutual fund manager in recent years.

Bear market myth

Active managers have long argued that they do better during bear markets, because they have flexibility. Unlike passive managers, who must continue to be fully invested, active managers can buy and sell and play defense.

But in the two bear markets covered by the SPIVA scorecard, the majority of active fund managers failed to beat their index benchmarks. For instance, in the 2008 bear market almost 84 percent of small-cap stock funds failed to beat their index, while 53 percent of large cap managers were bested by their relevant index.

Muni funds fail

Municipal bond funds turned in the worst performance: Just 9 percent of national muni bond funds outperformed their indexes, while not one New York or California muni fund did so.

This points out one of the arguments for passive investing: it is cheaper than active investing because trading and management fees are low. Active muni bond funds may not have done so bad vs. their indexes on a gross return basis, but since returns on munis are modest, after subtracting fees they ended up trailing the indexes.

Passive small cap

The SPIVA scorecard demolishes another myth: that managers investing in stocks of small companies are more likely to outperform their relevant indexes. This myth is based on the claim that while large company stocks are priced efficiently because they are so widely

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Indexes have been winners over funds in five-year periods

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followed, small company stocks are less well known and therefore provide an opportunity for savvy managers to select the best stocks.

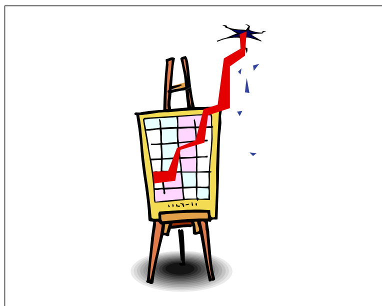
Over the decade covered by the scorecard the majority of small stock funds were beaten by their indexes.

Five-year advantage

During particular years or short periods active managers sometimes do beat their indexes. However, on average, given a five year period, it appears that the majority of active managers fail to beat their indexes, SPIVA shows.

For instance, from June 2006 through June 2011, 63 percent of large stock funds were beaten by the S&P 500 Stocks Index. During the previous five years, almost 70 percent of the big company managers lagged behind the index.

Finally, the scorecard may make active managers look even better than they really are. Each year during the study up to 20 percent of active funds went out of business. If they were included in the study, active management would have looked worse.



Investment indexes win over five years.

Avoid taxes by delaying Social Security

The benefits of delaying Social Security are indisputable: each month of delay after age 62 adds to the lifetime benefit, and a larger lifetime benefit gets a bigger boost each year from inflation adjustments.

For middle-income retirees there is a bonus: a potential lower overall tax bite.

For most workers, full retirement age ranges from age 66 to 67, depending on when the worker was born. Anyone can claim a reduced benefit as early as age 62, and anyone can delay their benefit to as late as age 70.

The 8 percent bump

Any worker born after 1943 who reaches full retirement age but delays taking benefits gets an 8 percent increase for each year of delay until reaching age 70.

So a retiree who is entitled to $2,000 a month in benefits at her full retirement age of 66 can delay until age 70 and instead get $2,640 per month, a difference of $7,680 per year. However, if that same retiree took Social Security at age 62, it would be reduced by 25 percent to $1,500 per month.

Delaying benefits may have another advantage for middle-income retirees: it will help them avoid some of the tax bump that subjects large amounts of Social Security to income taxation.

Social Security benefits are tax free for a couple who has "provisional income" of less than $32,000. The trick here is the definition of income: it includes the usual taxable amounts, such as pension benefits, withdrawals from IRAs, capital gains and interest, but also one-half of the retiree's Social Security benefit. As soon as provisional income exceeds $32,000, then 50 percent of the Social Security benefit is taxed. Once it exceeds $44,000, then 85 percent of Social Security is taxed.

Social Security benefits get bigger if delayed past early retirement age, and a strategy of delaying benefits could save you taxes.

Use IRA earlier

A retiree who takes larger distributions from retirement savings early in retirement while delaying taking Social Security potentially could save taxes: once the retiree collects Social Security it may be big enough that smaller withdrawals will need to be taken from tax-deferred accounts. That would allow the retiree to reduce or avoid altogether any taxes on the Social Security benefits.

A lesser-earning spouse whose benefit is determined by the level of the higher earning spouse also comes out ahead if the spouse delays benefits.

"For middle income retirees there is a bonus: a potential lower overall tax bite."

Global bonds and stocks are the answers for 401k savers

Employees who contribute to their 401k and other retirement plans are missing the boat when it comes to worldwide investment diversification, says OppenheimerFunds.

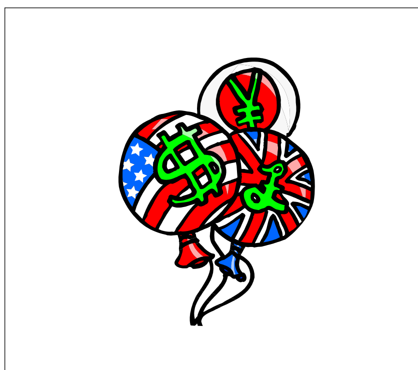
Its recent survey of 1,000 investors found a distinct "home market" bias among employees investing for retirement.

It says employees routinely misunderstood the risks and rewards of investing overseas in international stocks and bonds. Many thought the U.S. stock market had consistently been among the world's top performers.

Top markets

For instance, the survey found that "96 percent of them did not know that Peruvian equities outperformed U.S. equities in 2010," OppenheimerFunds said.

Others did not understand how to best diversify among investment choices. Many did not know that "global" investment funds usually include significant U.S. stock holdings. By combining a global fund with a U.S. stock fund they were not getting the degree of international diversification they may have desired.



Employees saving for retirement should go global in order to build wealth.

OppenheimerFunds says future retirees will be faced with high medical inflation, generally rising prices, and reduced yields on U.S. bonds. That means it is critical for them to seek the highest returns possible.

"Exposure to global equities could potentially mean the difference between accumulating enough assets for retirement or falling short," it said. "Likewise, we believe that investments in global fixed income could help make the difference between generating sufficient income during retirement or not."

It says foreign countries now account for almost two-thirds of world gross domestic product, while two-thirds of the largest publicly-traded companies are located outside the United States.

Emerging growth

Emerging economies are "poised to grow four times faster than developed economies over the next 20 years," it said.

Despite that, a 2008 survey by consultant AON Hewitt found that just 7 percent of 401k plan assets were invested internationally while domestic stock funds garnered almost 27 percent of participants' money, OppenheimerFunds said.

"Exposure to global equities could potentially mean the difference between accumulating enough assets for retirement or falling short."

Savings grow, optimism is up, & more

Americans boosted their retirement savings by 5 percent in the last quarter of 2011 as the values of IRAs, 401k plans, government and private pension plans and other savings reached $17.9 trillion, said the Investment Company Institute, the mutual fund industry's trade group.

More than half of that was held in Individual Retirement Accounts and employer savings accounts such as 401k and 403b plans. Most 401k owners are still in the savings phase of their lives; only 3.4 percent of participants took withdrawals during 2011, the ICI said.

Optimism grows

More Americans think it is possible for a typical middle-income family to save for a secure retirement than in recent years, according to the latest survey by Illinois-based insurer Country Financial.

It said 35 percent responding to its survey were optimistic, up six percentage points from last year and the first increase in five years.

About 57 percent of the 3,000 respondents have maintained or increased their retirement contributions.

IRA confusion

Younger retirement savers are confused over the relative advantages of tax-deductible traditional IRAs and tax-free Roth IRAs, says mutual fund company T. Rowe Price.

Many were not sure which IRA offers tax deductions for contributions (traditional IRAs) and which allows for tax-free withdrawals of principal at any age (Roth IRAs), the Baltimore-based company said.

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A race against hedge funds puts Warren Buffett ahead

Billionaire investor Warren Buffett is running ahead on a bet with two hedge fund managers that the Standard & Poor's 500 Index would beat an index of hedge funds.

Buffett, whose flagship Berkshire Hathaway was added to the S&P index in 2010, contends that the active money management and high fees associated with hedge funds cannot beat the market. His proxy in the bet is the Vanguard S&P 500 Index fund, which, like most index funds, has low management expenses.

Warren Buffett thinks the S&P 500 Index will beat most hedge fund managers.

The hedge fund managers, Jeffrey Tarrant and Ted Seides of Protégé Partners in New York, contend that hedge funds have an advantage over the market because they can bet on rising and falling prices of all types of assets, including currencies, commodities, stocks, and bonds. In a statement they said hedge fund managers "with the ability to sort the wheat from the chaff" will reap big enough profits to outweigh their extra expense.

Hedge funds typically charge 2 percent annual management fees plus take 20 percent of the profit.

They constructed an index of five hedge funds of funds—essentially funds that pick and choose from among all hedge funds. That added additional fees, because hedge funds of funds tend to add a second layer of annual fees and also share in the profits.

The bet began Jan. 1, 2008 as a major financial crisis was breaking. In the first year, the hedge funds outpaced the market, losing 24 percent compared to a loss of 37 percent on the S&P 500 fund.

But in subsequent years, as both hedge funds and the U.S. stock market gained, the market pulled ahead. As of late March the S&P 500 fund was up 2.2 percent for the whole period, compared to a loss of 4.5 percent for the hedge funds.

The bet lasts for 10 years. The loser will make a $1 million contribution to the charity of the winner's choice.