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Burton G. Malkiel: You're Paying Too Much for Investment Help

Index funds have far outperformed the average active manager, and at a far lower cost to the investor.

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From 1980 to 2006, the U.S. financial services sector grew from 4.9% to 8.3% of GDP. A substantial share of that increase represented increases in asset-management fees.

Excluding index funds (which make market returns available even to small investors at close to zero expense), fees have risen substantially as a percentage of assets managed. In my judgment, investors have received no benefit from this increase in expense ratios.

The increase in fees could be justified if it reflected increasing returns for investors from active management, or if it improved the efficiency of the market. Neither of these arguments holds. Actively managed funds of publicly traded securities have consistently underperformed index funds—by roughly the differential in fees charged.

Passive portfolios that held all the stocks in a broad-based market index have substantially outperformed the average active manager since 1980. Therefore, the increase in fees likely represents a deadweight loss for investors.

There are substantial economies of scale in asset management. It is no more costly to place an order for 20,000 shares of stock than for 10,000 shares. The same annual report and similar filings to the Securities and Exchange Commission are required whether an investment fund has $100 million or $500 million in assets. The due diligence required for the investment manager is no different for a large mutual fund than for a small one. Modern technology has fully automated such tasks as dividend collection, tax reporting and client statements. Academic research has documented substantial economies of scale in mutual-fund administration.

In 1980, the equity mutual-fund industry managed less than $26 billion of assets. By 2010 the equity assets of the mutual-fund industry totaled almost $3.5 trillion. Substantial economies of scale could have been passed on to individual investors, resulting in lower expense ratios. But those economies appear to have been entirely captured by asset managers. The same finding holds for asset managers who cater to institutional investors.

In 1980, the annual expense ratio for all mutual funds (as measured by Lipper Analytic Services) was 66 basis points. In 2010, the equivalent (asset weighted) ratio was 69.2 basis points. But in 2010 almost 30% of mutual-fund assets were invested in low-cost index funds, which represented an insignificant share of assets in 1980. Thus the annual expense ratios for actively managed funds rose to 91 basis points from 66 basis points. While expense ratios paid by institutional investors are considerably lower than those paid by individual investors—by about 40%—these fees have not fallen over time as a percentage of assets managed.

However, index funds and their exchange-traded counterparts have allowed the individual investor to benefit from scale economies. Exchange-traded funds that track the Standard & Poor's 500 Stock Index or the Wilshire 5,000 Total Stock-Market Index are available to individual investors at expense ratios of five basis points or less.

There is another way of looking at these asset-management fees. Total fund assets increased 135 times since 1980, but the total expenses paid to equity mutual-fund managers increased 141 times (to $24,143 billion from $170.8 million).

Of course, when stated as a percentage of assets, these fees do look low—close to 1% of assets. But compare them with returns produced. If overall stock market returns average, say, 7% a year, fees of 1% point are actually about 14% of stock-market returns. Mutual-fund fees take up well over 50% of dividend distributions.

Even these recalculations may substantially understate the real cost of active investment management. A more reasonable way to assess the benefits of active management is to measure fees as a percentage of the "excess" returns produced by active managers over the returns available from low-cost index funds. Overall, these excess returns seem nonexistent.

Why do investors continue to pay such high fees for financial services of such questionable value? Many may incorrectly judge the quality of investment advice by the price charged. Individual and institutional investors may suffer from

overconfidence and truly believe that they can select the best investment managers and earn excess returns, despite historical evidence to the contrary.

Outperforming the consensus of hundreds of thousands of professionals at the world's major financial institutions is next to impossible. It has been for decades. Over long periods, about two-thirds of active managers are outperformed by the benchmark indexes. The one-third that may outperform the passive index in one period are generally not the same as in the next period. But investors can benefit from low-cost index funds and their exchange-traded cousins.

The lesson for investors is very clear: You can't control what markets can do, but you can control the costs you pay. The less you pay to the purveyors of investment services, the more there will be for you. The quintessential low-cost investment vehicles are index funds, which should comprise the core of every investment portfolio. The high fees charged for active management cannot be justified.

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