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Mutual Fund Investors Should Crack Down on Closet Indexers: View

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In the world of investing, a label can mean a lot. The mere designation of a country as “emerging”can be worth billions of dollars in capital inflows.

As Bloomberg Markets magazine reports in its March issue, investors have plowed more than $750 billion into funds benchmarked to emerging-market indexes. No wonder Israel, whose per capita economic output exceeds Italy’s, doesn’t want to be labeled “developed” for the purposes of bond investors.

The power of the emerging label to move money also serves as an indictment of the way many so-called active fund managers do their jobs. By abdicating to index administrators the responsibility for defining what is emerging, and by allowing such designations to dictate investment decisions, active fund managers are essentially running passive funds while charging fees as if they were managing something.

The phenomenon is pervasive. Research by Antti Petajisto, a former New York University economist who now works for the investment firm BlackRock, shows that as of 2009, nearly a third of all the money in actively managed U.S.-focused mutual funds was run by “closet indexers,” whose investments tend to mimic the composition of a benchmark index. That adds up to about $520 billion, far surpassing the amount invested in stock index funds.

Closet indexing is great for managers, as it guarantees their performance won’t fall too far behind the benchmarks by which they are judged. Unfortunately, it’s very costly for investors. The average closet indexer had an expense ratio of 1.05 percent of assets. That compares with roughly 0.29 percent for the largest U.S. equity index funds. Over 10 years on an investment of $100,000 earning 10 percent a year, that difference would add up to almost $19,000.

A quick look at 253 funds benchmarked to the MSCI Emerging Markets Index (MXEF) suggests many of them are not as active as they purport to be. As of late January, the performance of 75 actively managed funds was strikingly similar to that of theVanguard Emerging Markets Stock Index Fund (VEIEX), which tracks the index. (Over the previous year, their monthly tracking error was equal to or less than that of the index fund.) For those that reported an expense ratio, the average was 1.53 percent, according to data compiled by Bloomberg. The Vanguard fund, by comparison, charged just 0.35 percent.

What to do? Laziness can’t be outlawed. Dumping active managers in favor of index funds isn’t necessarily the solution, either. Petajisto’s research shows that, on average, managers who went to the trouble of building portfolios that differed from the benchmark indexes performed well enough to justify the fees they charged.

Hence, it’s up to investors to make sure they’re getting their money’s worth. Funds that charge fees for nothing shouldn’t have any assets to manage. What’s amazing is that so many still do.

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