INTRODUCTION

New research examining how successful actively managed mutual funds in Europe have been in out-performing indices over the past twenty years. This reveals that typically 40% of equity funds out-perform their benchmarks, although this figure varies widely over time and for funds investing in different regions.

Active fund managers’ ability to out-perform their benchmarks sits near the heart of any discussion on the relative merits of active versus passive investing. In broad terms the argument against investing in an actively managed fund is that one takes on the additional risk that the fund will significantly under-perform the index, a risk that is exacerbated over time by the additional costs associated with such a fund.

The argument against investing in a passively managed fund is that one not only misses out on the possibility of superior returns that an active manager can offer, but also that, in principle, one is guaranteed to under-perform the index.

The success of the argument for active fund management can be seen in the size of the industry. Actively managed equity funds in Europe stand at just under €1.5trn, while index trackers have €160bn and ETFs €139bn. In other words, of the equity funds pot, passively managed products make up less than 17%.

Clearly the case for active fund management goes hand-in-hand with the case for prudent fund selection. Indeed an industry has grown up trying to deliver the latter for investors, with professional fund selectors choosing funds to invest in and packaging this up as a product of itself: funds of funds. Assets invested in funds of funds in Europe stand at around €370bn – noticeably greater than the assets invested in passively managed funds.

An interesting postscript to this is that funds of funds investing solely in passive products have also begun to develop, with assets standing at €4bn (mostly in the UK). The reasons for such a development will be looked at in future research.

This report will examine how successful actively managed mutual funds in Europe have been in out-performing their benchmark indices over the past twenty years. Needless to say this will not end the active versus passive debate, but it should make a useful contribution to better understanding how successful active fund managers have been in delivering on their objectives.
CURRENTLY ACTIVE FUNDS

The most straightforward means to assess actively managed funds’ success in beating their benchmarks is to look at their latest performance figures. To this end all actively managed equity and bond funds’ performance relative to their benchmarks was assessed over 1, 3 and 10 years to the end of December 2011.

For equities, the proportion of funds that out-performed varied from 26.7% in 2011, 40.0% over 3 years and 34.9% over the past 10 years. While bond funds fared better over 3 years (45.4% out-performed), the proportion tailed off dramatically over the 10-year period, falling to 16.2%. The latest year was similar to that for equities, with 23.7% of bond funds out-performing their benchmarks.

Of course these initial figures do not provide insights into any variations between funds investing in different markets. Figure 1 takes the same approach as above (i.e. actively managed funds’ performance relative to their benchmark indices over 1, 3 and 10 years) but groups funds by six of the largest equity sectors (defined by Lipper Global Classifications).

Funds investing in North American equities have consistently fewer managers that have out-performed their benchmarks than for other classifications. Another pattern that is consistent across the three time periods is that more funds investing in UK and European stocks have beaten their benchmarks than those funds investing globally. Apart from these two points, there is little consistency between the three time periods: different products out-perform more commonly over different periods.

While the primary focus of the current research is equities, similar analysis was also carried out for €, US$, Global and Emerging Market bond funds. Each classification broadly follows the pattern established above for bond funds as a whole. Again the most striking finding is the low proportion of funds that have out-performed their benchmarks over a 10-year period. Of the four classifications, the highest was the 23.1% of global emerging market funds that out-performed their benchmarks. The other three classifications were around 10%, with € bonds the lowest and just 8.3% out-performed.

The figures for these three bond classifications were all lower over 10 years than over both 1- and 3-year periods. For 3-year returns, the proportions exceeded the asset class total of 45.4%, with the highest being global bonds, where 55.7% of the funds out-performed their benchmarks.
FIGURE 1  PROPORTION OF EQUITY FUNDS OUTPERFORMING BENCHMARKS, BY SECTOR

FIGURE 2  ANNUAL PROPORTION OF EQUITY FUNDS OUTPERFORMING BENCHMARKS
SURVIVORSHIP BIAS AND ROLLING RETURNS

Of course these initial findings cannot help but partly reflect much of the recent market turmoil and so a longer term view (beyond the most recent 10 years) would be invaluable of itself. More than this, the issue of survivorship bias must be grasped, i.e. average out-performance figures might be inflated - or deflated - due to funds being closed mid-way through a time period. To do this, the current analysis looks in greater detail at rolling periods over the past 20 years and includes funds that have since closed or been merged.

Having said this, investors in Europe cannot escape the fact that fund closures and launches are a significant feature of the industry landscape and that this may impact on the funds in which they choose to invest. It is therefore useful for a long-term investor to at least have a sense that the funds available change each and every year.

In Europe over the past 10 years, 3,400 funds have been launched every year, on average, and 2,400 have been closed or merged. In other words, there has been a net increase of 1,000 funds each year (across all asset classes and for both actively and passively managed funds). The current universe stands at around 35,000 funds, so there is certainly not a shortage of products to choose from!

Funds’ rolling returns have been assessed over 1, 3 and 10-year periods every year from 1992 to the end of 2011. The first of these, as the shortest period, is most useful in tackling survivorship bias and figure 2 reflects the number of equity funds that out-performed their benchmarks each year over this 20-year period. (The MSCI World index has been included to provide broad context in the chart, although obviously only a relatively small proportion of the funds assessed will be benchmarked against this index).

The proportion of equity funds that have out-performed their benchmarks has varied between 59.1% and 26.7%, coincidentally the first and last years in this analysis. The annual average is 42.8%. This last figure is at the higher end of the spectrum found in the initial analysis presented above, suggesting that the difficult recent market conditions have indeed had a negative impact on the proportion of active managers that have been able to out-perform their benchmarks.

The 26.7% of actively managed equity funds that out-performed their benchmarks in 2011 can be further scrutinised by seeing how many also out-performed in 2010. The number of funds achieving this falls by 40%, with 16.4% of funds out-performing in both years. This process can be extended further, with 8.6% out-performing in 2011 and 2010 and 2009; 5.2% out-performing in each year back through 2008; 2.6% through 2007; 1.6% through 2006; 1.3% through 2005; 1.0% through 2004; 0.8% through 2003. Finally, 0.5% (13 funds) have out-performed in each of the ten years from 2002 to 2011.
LONGER-TERM PERIODS

For long-term investors the fact that an active manager does not out-perform in every calendar year is likely to be less significant than whether he/she can out-perform over a longer time period. To examine this, the data has been expanded to look at rolling 3-year and 10-year periods.

For all three sets of data the rolling period used is 1 year. For example, for 3-year performance the periods begin from December 1991 to December 1994, then December 1992 to December 1995, then December 1993 to December 1996, and so on. This means that for 3- and 10-year rolling returns, a proportion of many funds’ performance will be accounted for in more than one period. This helps to account for any survivorship bias.

The average proportion of 42.8% of equity funds out-performing their benchmarks over the past 20 years is a figure referred to above. Figure 3 now puts this into a wider context. The equivalent figure for 3-year rolling periods is 41.4% and for 10-year rolling periods it is 39.7%. In other words, the proportion of funds out-performing over longer periods may have dropped very slightly, but it remains largely stable. For 10-year returns in particular it is unavoidable that there will have been funds that closed before they reached their tenth year, and more likely these funds will have been performing less well.

A more noticeable decline as the periods lengthen can be seen when one turns to fixed income. The figure for the asset class as a whole is consistently lower than for equity funds and drops to just 17.4% over rolling 10-year periods.

This latter finding bears out that it is also crucial to drill down and identify any variations for funds investing in different regions. For bond funds one can clearly see that for emerging market and global products for 1- and 3-year rolling periods the proportion of funds out-performing is fairly similar to that for equity funds. But for €-denominated and US$-denominated bond funds, the proportion of funds is not only smaller than equities for 1-year returns, but it then declines as the periods assessed are lengthened, so that just over 6% of funds in these two classifications have out-performed their benchmarks when looking at 10-year rolling returns.

On the equity side, while funds investing in Asia and the UK maintain or improve on the proportion of funds out-performing as the time periods lengthen, the opposite is the case for the four other classifications assessed. These two diverging trends mean that for 10-year periods, 20.8% of North American equity funds out-performed their benchmarks on average, while the equivalent proportion for Asia Pacific (ex-Japan) funds is 54.4%.
### FIGURE 3
AVERAGE PROPORTION OF FUNDS' ROLLING RETURNS OUTPERFORMING BENCHMARKS, 31/12/1991 TO 31/12/2011

<table>
<thead>
<tr>
<th></th>
<th>1 YEAR PERIODS</th>
<th>3 YEAR PERIODS</th>
<th>10 YEAR PERIODS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ALL EQUITY FUNDS</strong></td>
<td>42.8%</td>
<td>41.4%</td>
<td>39.7%</td>
</tr>
<tr>
<td><strong>ALL BOND FUNDS</strong></td>
<td>31.6%</td>
<td>24.7%</td>
<td>17.4%</td>
</tr>
<tr>
<td><strong>EQUITY ASIA PAC EX-JAPAN</strong></td>
<td>48.4%</td>
<td>48.9%</td>
<td>54.4%</td>
</tr>
<tr>
<td><strong>EQUITY EMG MKTS GLOBAL</strong></td>
<td>38.5%</td>
<td>31.1%</td>
<td>24.6%</td>
</tr>
<tr>
<td><strong>EQUITY EUROPE</strong></td>
<td>37.7%</td>
<td>35.9%</td>
<td>27.0%</td>
</tr>
<tr>
<td><strong>EQUITY GLOBAL</strong></td>
<td>42.2%</td>
<td>38.4%</td>
<td>32.5%</td>
</tr>
<tr>
<td><strong>EQUITY NORTH AMERICA</strong></td>
<td>36.2%</td>
<td>30.3%</td>
<td>20.8%</td>
</tr>
<tr>
<td><strong>EQUITY UK</strong></td>
<td>46.4%</td>
<td>47.6%</td>
<td>47.4%</td>
</tr>
<tr>
<td><strong>BOND EMG MKTS GLOBAL</strong></td>
<td>45.8%</td>
<td>45.4%</td>
<td>--</td>
</tr>
<tr>
<td><strong>BOND EUR</strong></td>
<td>25.8%</td>
<td>18.5%</td>
<td>6.3%</td>
</tr>
<tr>
<td><strong>BOND GLOBAL</strong></td>
<td>34.4%</td>
<td>30.4%</td>
<td>23.1%</td>
</tr>
<tr>
<td><strong>BOND USD</strong></td>
<td>25.9%</td>
<td>16.8%</td>
<td>6.4%</td>
</tr>
</tbody>
</table>

### FIGURE 4
PROPORTION OF EQUITY FUNDS OUTPERFORMING BENCHMARKS — ROLLING 1 YEAR PERIODS

[Graph showing percentage of funds outperforming benchmarks over time for various regions and asset classes.]
CLASSIFICATION DIFFERENCES

Looking at 1-year rolling periods by classification of equity funds (using Lipper Global Classifications, figure 4), the proportion of funds out-performing their respective indices move broadly – but not always – in the same direction in any given year. Secondly, the range of proportions of out-performance have generally narrowed in the most recent 10 years (from 2002 to the end of 2011) compared to the earlier decade (1992 to the end of 2001).

Having said this, some fund classifications have stayed in a narrower range of out-performance proportions than others. Picking up on funds investing in Asia and the UK once more, while the former has ranged from 8.3% (2004) to 83.8% (1999) of funds out-performing their benchmarks, for the latter the range has been much narrower, ranging from 23.1% (2011) to 64.5% (2000).

The narrowing of the range of funds out-performing between the first and second 10-year periods is even more pronounced when one looks at 3-year rolling returns (figure 5). On the downside this means that no classification has a proportion of funds out-performing in excess of 60% that could be seen in the early 1990s or late 1990s. But on the upside, this means that classifications with a proportion of out-performing funds below 30% has virtually disappeared in the three most recent rolling periods.

Figure 5 also draws out the fact that a greater proportion of UK equity managers generally outperform than for other classifications, while US equity managers sit at the foot of the table. While the average proportion of Asia Pacific funds out-performing is actually higher than that for the UK (see figure 3), this is clearly the result of results posted over the first 10 years, while the more recent period has seen a dramatic change for the worse.

Differences between equity classifications are most clear with the 10-year rolling periods (figure 6), although the broad picture painted above (for 3-year periods) holds true. 10-year periods also reduce the variation in the proportions for each classification. This is most notable for UK equity funds (ranging from a low point of 37.6% to a high of 52.9%), while yet again there is considerable volatility for Asian equity funds (ranging from 31.3% to 66.7%) and, unfortunately, on a downward trajectory.
FIGURE 5  PROPORTION OF EQUITY FUNDS OUTPERFORMING BENCHMARKS — ROLLING 3 YEAR PERIODS

FIGURE 6  PROPORTION OF EQUITY FUNDS OUTPERFORMING BENCHMARKS — ROLLING 10 YEAR PERIODS
CONCLUDING REMARKS

This research has revealed that typically 40% of actively managed equity funds out-perform their benchmark indices. While clearly this figure has varied over time, it not only represents the proportion of equity funds that have out-performed in the most recent 3 years, but also approximates the average proportion of equity funds that have out-performed for 1-, 3- and 10-year rolling periods over the past 20 years.

While those selecting actively managed funds to invest in may well like their chances of finding the 4 in every 10 funds that can out-perform an index, this proportion does vary each year (broadly between 30% and 60% of funds, see figure 2), as well as varying for funds investing in different regions (which can be between 20% and over 50% over different periods, see figure 3).

The findings presented here will clearly not settle the active versus passive debate one way or the other, but they do provide robust statistical research into actively managed funds’ relative performance across Europe. Such insights can better inform this ongoing discussion.

METHODOLOGY

Finally, some comments on the methodology used. The universe of funds analysed included all open-ended mutual funds domiciled in Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, Liechtenstein, Ireland, Italy, Netherlands, Norway, Spain, Sweden, Switzerland and the UK. Only actively managed equity and bond funds were included, so index tracking funds and ETFs were specifically excluded, as were absolute return funds and funds with other alternative strategies that tend to use cash-type benchmarks. Funds of funds were also excluded to enable more consistent comparisons. For any fund with multiple share classes, only the one identified as the ‘primary’ class was included.

Analysis of a fund’s out-performance was measured using its own benchmark index, so where this could not be identified the fund was excluded from the study. Performance was calculated using total returns, with dividends re-invested on ex-dividend date, in each fund’s local currency. Data points including fewer than twenty funds were excluded. Last, but by no means least, thanks are due to Ran Vispap-Rich and Noora Vainio for their invaluable help in preparing this research.

A version of this paper will appear in Institutional Investor’s ‘Guide to European Indexing’ (http://www.euromoneyplc.com)