



## Letters to the Editor

May 5, 2009

*The following letters are in reference to our article, [Active versus Passive Management in Bear Markets](#), which was published last week. Our response follows these two letters.*

Gentlemen,

I found this article at once misleading and amusing and clearly not what it pretends to be in any way.

Allow me to elaborate; Mr. Huebscher's statement in the body of his article, "we take no position in the active versus passive debate" is utterly ludicrous. His entire premise is one of attacking passive management in general and the Standard and Poor's SPIVA Report specifically. He clearly contends that there is hope that active management is the answer, which simply serves to indict his alleged neutrality on the entire topic. Clearly he has an axe to grind and does so to no avail. In order to successfully refute an argument, he would, by necessity, have to pose an equally compelling argument supported both by evidence and methodology. In this context he offers neither.

In order for his thesis to be respected, it would be best to clearly state that he supports active management, doesn't mind paying the extra fees along the way and can identify which managers will succeed in advance. Good luck on all fronts!

Further, he should break down the number of shareholders by fund as well as assets to truly deem who benefits and who is harmed by underperformance. For example, perhaps he could make a case for one of the largest and best known actively managed funds: the Fidelity Magellan Fund. This noteworthy stalwart of the "no-load" industry has woefully underperformed the S&P 500 for over a decade, yet it charges its shareholders 73 basis points for the privilege of the possibility of beating the market, which it consistently fails to accomplish. Or better yet, perhaps he could craft a similar defense for the esteemed member of the American Funds family known as The Washington Mutual fund, which is so admired by wirehouse brokers, charges an up front commission and holds nearly \$40 billion in assets. The fund, by its prospectus, dines only on stocks in the S&P 500 that are dividend payers and yet somehow delivered less return than the S&P over the last ten years.

Is it truly possible the SPIVA report is somehow accurate or is harpooning two of the largest funds just anecdotally easy and also a matter of luck? I suggest Mr. Huebscher



do a bit more research and he will quickly discover that the facts do indeed support both the SPIVA report as well as the aforementioned anecdotal evidence. Nobel laureates across the globe agree on this topic.

At the center of this debate is the question of whether or not markets are indeed efficient. Picking funds is little different than picking stocks when one gets down to the nuts and bolts of how both are accomplished. Funds are picked on the track records of their managers, superior performance and expected returns that are perceived as likely to recur. Unfortunately, the graveyard of failed expectations is filled with the likes of John Ballen, former manager of the high flying MFS Emerging Growth Fund, Gary Pilgrim of the PBHG Growth Fund, and more recently Bill Miller of the Legg Mason Value Trust, the gang at Dodge and Cox, and others.

If you please, I would also make one more request; Tell us all how to pick active managers, in advance, who outperform with consistency on an after-tax basis. That would indeed be greatly appreciated.

Sincerely,

Brian Murphy  
Pathways Financial Partners  
Tucson, AZ

PS--- I still admire and respect your newsletter as the best open forum of ideas for independent advisors!

---

Dear Editor:

Your article on Active vs. Passive was really weak. Mr. Huebscher's arguments don't hold much water. If those are the best rebuttals that you can provide to a very compelling research piece, then I am even more convinced that passive index funds are a better investment tool than active funds.

Let me respond to Mr. Huebscher's three bullet point critiques:

1. S&P's equal-weighting methodology is fairer than a cap-weighted methodology. It allows every active manager to display their acumen equally. Mr. Huebscher's argument is weak, but S&P could silence it by showing results both equal- and cap-weighted. I suspect indices would still outperform regardless of the weighting.
2. It does not matter whether S&P's indices outperform those of other vendors. If that is so, then it is perfectly fine to compare active funds to S&P index based funds.



3. Cash should have had a positive impact in either the index fund (which doesn't hold much cash) or the active fund (which I am presuming Mr. Huebscher thinks would hold more cash because the manager is smart). But if the manager is making cognitive valuation errors with the securities he holds, then the negative effect of securities can/may more than offset the stable cash position.

It would be fun to see S&P issue a rebuttal to these weak critiques.

Regards,

Jeffrey B. Broadhurst, MBA, CFA, CFP  
Broadhurst Financial Advisors, Inc.  
Lansdale, PA

---

*I thank Mr. Murphy and Mr. Broadhurst for their comments.*

*I do not take a position in the active versus passive debate. For example, I wrote an article last August, [Luck versus Skill in Active Mutual Funds](#), that highlights new research in support of the passive side of the debate. You can also read the interviews I have done with [John Bogle](#), [Burton Malkiel](#), [William Sharpe](#) and [Ken French](#), all of whom advocate passive investing.*

*SPIVA does not attempt to answer the question of whether skillful active managers can be identified in advance. Personally, I believe the percentage of skillful active managers is less than the SPIVA study might lead one to believe.*

*I would like nothing more than to publish the results of a carefully researched, methodologically precise defense of either passive or active management. When S&P published its SPIVA study with claims of the superiority of its own index products, it called for scrutiny. My conclusion remains that S&P's methodology is insufficiently rigorous to justify its conclusions.*

*The third bullet point referenced in Mr. Broadhurst's letter is very important. S&P claims all US equity active managers underperformed its passive index by 221 basis points. If the index and the active investors were fully invested (no cash), this difference should equal fees and costs, as dictated by William Sharpe's "The Arithmetic of Active Management." In this article, Sharpe states "Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement."*

*The average mutual fund expense ratio is 80 basis points, leaving 141 basis points unexplained. Active managers hold more cash than passive indices, so the real*



*difference in a bear market is more than 141 basis points (holding cash improved the performance of active managers). S&P needs to account for this inconsistency before I can accept their results.*

*The SPIVA study's primary conclusion was that passive management beats active management to a greater degree in bear markets. Even if I were to accept S&P's equal-weighting methodology, the use of its own index products as the benchmark, and the impurities in its data, this primary conclusion would remain unsupported. The broad-based market data clearly show a weak and statistically insignificant inverse relationship between market and passive index performance.*

*Robert Huebscher*

[www.advisorperspectives.com](http://www.advisorperspectives.com)

For a free subscription to the Advisor Perspectives newsletter, visit:  
<http://www.advisorperspectives.com/subscribers/subscribe.php>