On Course Financial Planning

Facing the Future with Optimism and Courage

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Active Managers' Report Card

S&P's Indexes Versus Active (SPIVA) Scorecard is a semiannual report that compares the performance of actively managed mutual funds to their S&P benchmark index. The latest SPIVA Scorecard, covering the 20 years ending December 2024, notes that 2024 was the 15th consecutive year in which the majority of actively managed large-cap domestic stock funds underperformed the S&P 500 Index. Additionally, 79% of actively managed domestic stock funds underperformed the S&P 1500 Total Market Index last year.

Fund Asset Class	1 YR	3 YRS	5 YRS	10 YRS	15 YRS	%
Large-Cap Growth	F	F	F	F	F	3%
Large-Cap Value	P	F	F	F	F	12%
Mid-Cap Growth	F	F	F	F	F	12%
Mid-Cap Value	F	F	F	F	F	6%
Small-Cap Growth	P	F	F	F	F	9%
Small-Cap Value	P	P	P	F	F	7%
Domestic REITs	F	F	F	F	F	10%
Int'l Large Stocks	F	F	F	F	F	N/A
Int'l Small Stocks	P	F	F	F	F	27%
Emerging Market Stocks	F	F	F	F	F	5%

Data as of December 31, 2024
N/A = Benchmark index data does not go back 20 years

This is the year-end 2024 SPIVA report card for active fund managers. The far-left column lists ten popular stock asset classes. The next five columns give a pass or fail grade to active managers in each asset class for the past 1, 3, 5, 10 and 15 years. If more than 50% of actively managed funds in an asset class outperformed their benchmark index, they get a passing grade of **P** for that period. If more than 50% underperformed, they get a failing grade of **F**. The last column shows the percentage of funds in each asset class that survived and outperformed their benchmark index for the past 20 years. Note that this does not mean that these funds outperformed for each of the past 20 years.

Active fund management is a high-pressure occupation, and those who undertake it are subject to the same emotions as individual investors. They seek to generate good long-term returns for their shareholders, but they also must produce good short-term performance to keep current investors happy and attract new ones. Unfortunately, trying to generate short-term performance from long-term assets involves active trading that is likely to harm their shareholders' long-term interests. Stuart Rhodes, the director of global equities at the British firm M&G, has been managing the firm's flagship Global Dividend Fund since 2008. At a recent M&G event, Rhodes discussed the emotional challenges of managing a large active fund, *"I am not particularly proud of it, but I have punched a wall and broken an electrical device at home…It's not that easy to cope with prolonged periods of underperformance, when you're behind the market, and you're just not where the market wants to be. It takes over your body, almost takes over your mind. You're a long way behind, and no matter how many good days you have in the immediate future, it's still going to be difficult to get back."* It's easy to understand why prolonged underperformance can be emotionally devastating to an active fund manager. It harms self-esteem, professional reputation and can lead to unemployment.

Times of stock market volatility provide active managers with a great opportunity to provide value for their shareholders, or so they say. But what does the historical data reveal? An analysis of active fund performance in bear markets was conducted by Anu Ganti at S&P Dow Jones Indices. In the 24-year history of the SPIVA US Scorecard, the S&P 500 produced negative annual returns five times – in 2001,2002,2008,2018, and 2022 – and you'd expect that it is easier to outperform in down years than in up years. In the five down years, Ganti notes that an average of 39% of large-cap funds outperformed the S&P 500 Index each year, barely more than the average of 35% of funds that outperformed the S&P 500 in the 19 up years. The reason for the similar disappointing success rates is simple. Active funds managers aren't competing against an index; they're competing against other active managers in the quest to find stocks that the market has mispriced. In order to outperform their benchmark index, not only must they find these mispriced stocks, but they must find and exploit these mispricings before the competition. And that isn't any easier in down markets than in up markets.

I am thankful for active fund managers. May they be fruitful and multiply. By devouring all available information about companies and the economy and relentlessly trading among one another, they create an efficient market. In other words, their frenetic trading activity leads to pricing efficiency that incorporates all currently known facts. The only thing that will change stock prices is new information, which by definition is unknowable in advance (for example Trump's next social media post). The stock market is not 100% efficient at pricing stocks, but it is efficient enough to make beating the market an incredibly difficult task for even the most talented fund managers. If this weren't so, more active funds would be outperforming their benchmark index, and no one would be buying index funds.

Fortunately, the degree of the stock market's pricing efficiency isn't something you need to worry about. Although there are mispriced stocks, they are hard to find, and the best strategy is to assume that current prices reflect actual value. Index investors believe that attempts to find mispriced securities generate additional costs that are not compensated for by higher returns. We are content to buy and sell at current prices and take advantage of the market's pricing efficiency that is freely provided to us by the hard work and trading activity of active managers.

The Scorecard also tracks the longevity of mutual funds. Of the 2,376 domestic stock funds available to investors on January 1, 2005, only 865 (36%) were still in business on January 1, 2025. Typically, poor performing funds are merged into other funds or liquidated. If we assume that the surviving funds have the most talented managers, the removal of less talented competitors will make it even harder for active managers to outperform in the future. The SPIVA Scorecard provides a periodic reminder of how difficult it is to beat the market, especially over longer time horizons - a fact that active managers hope will remain hidden from their shareholders.

Today, unnoticed and unknown, a lonely fund manager sits at his desk peering at a computer monitor through bloodshot eyes. Soon, he will make a few correct buy/sell decisions (by luck or skill) that will yield performance worthy of the cover of finance magazines and fawning interviews in the financial media. He will be named "Fund Manager of the Year" and comparisons to Warren Buffett will abound. The financial media will proclaim that its new hero possesses rare investing skills, although no evidence except past performance will be offered to support this claim. Like snowbirds flocking to Arizona in December, investors will flock to his fund and make him richer than you or I can imagine. But alas, his Midas Touch will not last. Late to the party investors will be bludgeoned by reversion to the mean and become discouraged, dismayed, depressed, downcast, demoralized, dejected, dispirited and flee in droves. But this will not, in any way, diminish the now shunned manager's newly acquired lifestyle or require him to sell his yacht, private jet or winter home anytime soon.

Charlie Munger, Warren Buffett's business partner, noted - *"If I had to name one factor that dominates human bad decisions, it would be what I call denial… Take the world of investment management. How many managers are going to beat the indexes? All costs considered; I would say maybe 5%… Everybody else is living in a state of extreme denial. "They're used to charging big fees for stuff that isn't doing their clients any good. It's a deep moral depravity."*

Random Thoughts About Retirement

Retirees today must fund their retirement differently than in the past when defined benefit pensions were common. My parents spent pension income, Social Security, and interest from savings but never touched their savings and investments. Today, few retirees can adopt this strategy. Instead, they need to calculate how much principal they can safely withdraw and spend each year. Unfortunately, few know their maximum "safe" withdrawal rate or how to calculate it.

There have been numerous academic studies that seek to determine the maximum annual "safe" withdrawal percentage for retirees. These studies use a detailed analysis of past investment returns, inflation data and Monte Carlo simulations of future returns. Most recommend a maximum annual withdrawal percentage in the neighborhood of 4%. All such studies assume a 40% - 60% equity allocation and make assumptions about the "Big Three" unknowns –

- How long you (and your spouse if you're married) are going to live.
- The rate of inflation during your retirement years.
- Your portfolio's rate of return during your retirement years.

Typically, financial advisors deal with the Big Three by making conservative assumptions. First, a healthy 65-year-old couple will need to finance a 30-year retirement. Second, retiree expenses and Social Security benefits will increase annually at the rate of inflation, usually in the 2% - 3% range. Most advisors will use conservative assumptions of future asset returns during retirement. Unfortunately, you can't just "set it and forget it" the day you retire. You'll need annual reviews with your financial advisor to track and update these Big Three crucial, unpredictable factors.

A traditional retirement age is becoming a relic of the past. Our model of retirement is often attributed to Chancellor Otto von Bismarck who set a mandatory retirement age of 70 in late 19th century Germany. This didn't cause any social upheaval because the average German worker didn't make it to age 50. A mandatory retirement age might have made sense in the industrial age when a worker's value was proportional to his physical strength – which inevitably declined with age. But in today's economy, a worker's value is more related to intellectual capital than physical strength. Many employees find it difficult to replace the intellectual capital of a retired 60-something employee with that of a 20-something new hire (young skulls full of mush being a phrase that comes to mind).

The primary factor that will determine the financial quality of your retirement isn't the stock market's performance during your working years, it's how much you saved and invested during those years. Retirees who are most likely to be free from money worries are those who practiced deferred gratification and lived within their means during their working years. Retirees with more than enough assets to fund their retirement can afford to splurge a bit. But it's easy to let deferred gratification become denied gratification if you're uncomfortable withdrawing principal each year. Some clients feel uneasy when I tell them that they can spend more than their needs require. May you have this problem someday.

Most Americans don't understand the intricacies of Social Security. Consequently, with 10,000 baby boomers turning 65 each day, we've seen many articles in the financial media explaining these benefits. Most focus on maximizing lifetime Social Security income by delaying claiming benefits until age 70. But should maximizing lifetime Social Security income be everyone's goal? I don't think so. First of all, you can't know how to maximize your lifetime Social Security income if you don't know how long you're going to live. Perhaps you believe that it's more important to get a check at age 67 than a larger check at age 85. Like so many other financial issues, Social Security claiming is an individual decision that should be based on your unique circumstances.

Many financial advisors calculate a new retiree's withdrawal requirements by inflating first year expenses annually throughout retirement. But is this a realistic assumption? If you've dealt with aging parents, you know that retirees spend more in their 60s than in their 80s. Are advisors overestimating retiree expenses by planning for an inflation adjustment in spending each year? Morningstar published a report, *Estimating the True Cost of Retirement* that addressed this issue. Using data collected by the US Census Bureau, the report concluded that real (inflation-adjusted) spending tends to decline approximately 1% annually during retirement. Even though healthcare expenses increase significantly at older ages (from 10% of total expenditures for a 65-year-old to 20% by age 85) this increase is offset by a decline in spending in other areas such as travel and leisure activities. The report concludes that typical expense models may be overestimating the cost of retirement by up to 20%. These results are highly personalized based on each retiree's unique circumstances. But it seems that retirees can safely spend a bit more than previously believed early in their retirement on activities that they might not be able to enjoy later in life.

Many retirees prefer to own dividend paying stocks for the ongoing cash flow. But this is a flawed strategy because it fails to account for the source of the dividends. When a company pays a dividend, its stock price must drop by the amount of that dividend. For example, if a $20/share stock pays a $1 dividend, it must send a dollar from its bank account to the owner of every share. Instantly, the stock's price falls to $19. If this weren't so, someone could buy one million shares before the ex-dividend date, collect the $1 million dividend, and then sell the shares for $20. Never going to happen! Many retirees prefer dividends because they view them as extra income instead of what they actually are - a return of their own capital. This creates the illusion that dividends are a free bonus, rather than just a transfer of value from the stock's share price to shareholders. Investors who would rather receive dividends than sell shares to generate the same income don't realize that receiving a $100 dividend from 100 shares of a $20 stock is no different than selling 5 shares of the stock. Either way, they are left with $100 in cash and $1,900 in stock.

During our working years we enjoy leisure because we need a break from work. But leisure is a poor permanent substitute for work. Perpetual self-indulgence and a life void of significance do not lead to happiness and fulfillment. Today, about 25% of retirees engage in part-time work, while 73% of pre-retirees expect to work after officially retiring, according to the Greenwald Research 2023 Retirement Confidence Survey. Retirement is an attractive option for many. Others would prefer a hybrid option: partial retirement while keeping one foot in the workforce. Perhaps we should think about retirement as the time in life that begins when we have achieved financial independence; a time that provides new opportunities for service and other gratifying activities that we have had no time for during our working years.