Chapter 1

Mutual Funds: The Evidence

There are many studies on the performance of actively managed equity mutual funds. They provide evidence that is both consistent and overwhelming. For example, a 2002 study by Mark Carhart and three colleagues analyzed the performance of 2,071 equity funds for the period 1962–1995. They found that the average actively managed fund underperformed its appropriate passive benchmark on a pretax basis by about 1.8 percent per annum.[1] This study built on the work of an earlier Carhart paper, "On Persistence in Mutual Fund Performance." Among its conclusions were:

- There was no persistence in performance beyond what would be randomly expected—the past performance of active managers is a poor predictor of their future performance.

- Expenses both reduce returns on a one-for-one basis and explain much of the persistent long-term underperformance of mutual funds.
- Turnover reduces pretax returns by almost 1 percent of the value of the trade.

Carhart's conclusion: "While the popular press will no doubt continue to glamorize the best-performing mutual-fund managers, the mundane explanations of strategy [asset-class allocation, not individual stock selection] and investment costs account for almost all of the important predictability in mutual fund returns."[2]

Keep in mind that Carhart's findings are all pretax. After taxes, the results would have been worse because of the greater turnover incurred by actively managed funds.

When You Wish upon a Morningstar

One of the most common investment strategies employed by individual investors is to buy the mutual funds that are highly rated by Morningstar. Morningstar itself provided us with evidence on how successful a strategy that is.

The November 2009 issue of Morningstar's *FundInvestor* provided the following evidence on its five-star funds:

- The 2004 class of five-star domestic funds had a five-year rating of just 3.2, just slightly above average. And, as we have seen, the average fund has underperformed its risk-adjusted benchmark by close to 2 percent.
- The 2005 group of five-star funds had a three-year rating of just 3.1.
- The 2006 group had a three-year rating of just 2.9.

The paper "Mutual Fund Ratings and Future Performance" from the Vanguard Institute provides further evidence on the ability of star ratings to predict the future.[3]

Authors Christopher B. Philips and Francis M. Kinniry Jr. examined the excess returns over the three-year period following a given rating. They chose the three-year period because Morningstar requires at least three years of performance data to generate a rating and investment committees typically use a three-year window to evaluate the performance of their portfolio managers. The period covered was June 30, 1992 through August 31, 2009. The following is a summary of their findings:

- Thirty-nine percent of funds with five-star ratings outperformed their style benchmarks for the 36 months following the rating, while 46 percent of one-star funds did so.
- Most of the star-rating groups produced negative excess returns in the succeeding three years. Even worse, the four- and five-star figures were more negative than those of lower-rated groups.

Philips and Kinniry concluded: "Higher ratings in no way ensured that an investor would increase his or her odds of outperforming a style benchmark in subsequent years."

In fact, they found that "5-star funds showed the lowest probability of maintaining their rating, confirming that sustainable outperformance is difficult. This means that investors who focus on investing only in highly rated funds may find themselves continuously buying and selling funds as ratings change. Such turnover could lead to higher costs and lower returns as investors are continuously chasing yesterday's winner."

The bottom line is that using Morningstar's ratings system is like driving forward while looking through the rearview mirror. The system does a great job of "predicting" the past.

The Vanguard Institute paper also addressed one of the questions I am frequently asked: "If index funds are so good, why do many of them carry three-star (average) ratings?" The authors explain that "the natural distribution of the actively managed fund universe around a benchmark (the index) dictates that an appropriately constructed and managed index fund should fall somewhere near the center of that distribution." (It is important to note that it will fall to the right of the center of distribution due to lower costs.)

Think of it this way: A sprinter in a 100-yard dash might be able to overcome wearing a two-pound weight on each ankle, but the odds of doing so decrease with the length of the race. And the odds of winning a marathon with that handicap are close to zero. Thus, it is over longer periods that cost advantages of passively managed funds have a greater influence on the distribution of relative performance.

Focus Funds

One often-heard excuse for the failure of the typical mutual fund is they are "overdiversified"—by owning so many stocks, the value of the manager's best ideas are diluted. Warren Buffett seems to agree with that hypothesis. Here is what he had to say about diversification: "Wide diversification is only required when investors do not understand what they are doing."[4]

The mutual fund industry's solution (or sales pitch) to what Buffett called "di-worse-si-fying" portfolios is to create "focus" funds—funds that concentrate holdings in the manager's best ideas. While most mutual funds hold well over 100 stocks, the typical focus fund will hold 40 or less. There are even funds that hire several submanagers for just their single best pick.

The question for investors is: does concentration of risk improve returns? Travis Sapp (associate professor of finance, Iowa State University) and Xuemin (Sterling) Yan (associate professor of finance, University of Missouri, Columbia) sought the answer to that question in their 2008 study "Security

Concentrations and Active Fund Management: Do Focused Funds Offer Superior Performance?"[5] Their database covered the period from 1984 through 2002 and contained 2,278 funds comprising 16,399 fund-years. The study excluded funds with less than 12 holdings, as well as those with less than $1 million in assets. The following summarizes their findings:

- There was no evidence that focus funds outperform diversified funds. In fact, after controlling for other fund characteristics, funds with a large number of holdings significantly outperformed funds with a small number of holdings both before and after expenses—fund performance was positively, not negatively, correlated to the number of securities in the portfolio.
- The quintile of funds with the fewest holdings realized an economically and statistically significant annual three-factor alpha of negative 1.44 percent.
- At the one-year horizon, the buys of focus funds *underperformed* their sells by 0.3 percent.
- Focus funds have significantly higher return volatility and tracking error to benchmarks. Thus, investors were taking greater risk while earning lower returns.
- Focus funds held considerably larger cash positions: 12.8 percent versus 7.8 percent for diversified funds. Cash acts as a drag on returns for equity funds.
- The attrition rate of focus funds is higher than for diversified funds.

One explanation for the underperformance of focus funds is that the larger the ownership stake in a stock becomes, the greater the trading costs—the fund cannot react quickly to new information without incurring significant trading costs. As the authors noted, "Even if managers of focused funds have better stock-picking ability, their funds might not perform better than diversified funds because of liquidity problems." Once trading costs are added to the burden of their relatively high operating expense ratios, achieving a positive risk-adjusted alpha becomes difficult. This issue is discussed further in Chapter 7.

Another explanation for the failure of focus funds is that while the market may not be perfectly efficient, it is sufficiently efficient that *after expenses* it is difficult to exploit any pricing errors.

The evidence on bond mutual funds is just as compelling.

Active Management of Bond Funds

The following are the results of just two of the many studies that could be cited on the attempts of active management to exploit market inefficiencies in the fixed income markets. Christopher R. Blake (professor of finance, Fordham University, Graduate School of Business Administration), Edwin J. Elton (professor of finance, NYU, Stern School of Business,), and Martin J. Gruber's (professor of finance, NYU, Stern School of Business) 1993 study, "The Performance of Bond Mutual Funds," covered as many as 361 bond funds and showed that the average actively managed bond fund underperformed its benchmark index by 0.75 percent to 0.95 percent per annum.[6] A 1994 article in *Fortune* magazine reported that only 16 percent of 800 fixed income funds beat their relevant benchmark over the 10-year period covered.[7]

Of course, being a loser's game does not mean there are not some winners. The fact that there are winners allows investors to hope that they can identify the few winners ahead of time. The evidence from a study by Marlena I. Lee of Dimensional Fund Advisors suggests otherwise.

Lee studied the performance of 2,353 bond funds over the period 1991–2008, which included investment-grade, high-yield, and government bond funds. The following is a summary of her findings:[8]

- Actively managed bond funds underperformed by an amount roughly equal to fees.
- Expense ratios were a good predictor of performance.
- Good past performance did not predict good future performance. There was no evidence of positive after-cost expected alphas, even in the top percentile of funds.
- Underperformance of loser funds persisted for several years. Most of the persistence in loser returns could be attributed to fees.
- Collectively, investors in active bond funds lose about 90 basis points per year, or about $1.4 billion in 2008, in underperformance.

Lee concluded: "Although some investors may believe that the higher fees associated with active management are compensation for return-enhancing abilities, the data do not show this."

She added: "These results indicate the unlikelihood that investors can profit from investing in funds with good past performance, but they may be able to shield themselves from poor risk-adjusted returns by avoiding funds with poor past performance."

Other studies on the subject, including those on municipal bond funds, all reach the same conclusions:

- Past performance cannot be used to predict future performance.
- Actively managed funds do not, on average, provide value added in terms of returns.
- The major cause of underperformance is expenses—there is a consistent one-for-one negative relationship between expense ratios and net returns.

The results of a 2004 study by Morningstar demonstrated both the importance of costs and that past performance of actively managed funds is a poor predictor of future performance.

It tested funds with strong performance and high costs against those with poor past performance with low costs. "Sure enough, those with low costs outperformed in the following period."[9]

Why did all these studies come to the conclusion that bond fund managers charge Georgia O'Keeffe prices and deliver paint-by-numbers results? The Efficient Market Hypothesis (EMH) provides the answer: the market's efficiency prevents active managers from persistently exploiting any mispricing. And as difficult as it is for active managers to add value when it comes to equity investing, it is much harder for them to add value in fixed income investing. Let's see why this is true.

First, with U.S. Treasury debt, all bonds of the same maturity will provide the same return—there is no ability to add value via security selection. If we restrict holdings to the highest investment grades, there is an extremely limited ability to add value via security selection—while the stocks of two companies with AAA bond ratings can perform quite differently, their bonds of similar maturity will likely produce very similar results (because credit risk is low). The higher the credit rating, the more likely it is that bonds of the same rating will produce similar returns.

That leaves interest rate forecasting as the only way an active manager might add value in any significant way. And there is no evidence of any persistent ability to forecast interest rates. (The value of economic forecasts in general is discussed in Chapter 7.)

We turn now to one reason why past performance of active managers should not be relied on as a predictor of future performance.

Skill versus Luck

Trying to discern the lucky from the skilled can be very difficult in many walks of life. For example, every time there is a professional sports draft, the debate flares up whether the evaluation of college (or even high school) athletes is an exercise in skill or luck.

For example, the Houston Rockets had the first pick in the 1984 NBA draft. They chose Hakeem Olajuwon. With the second pick, the Portland Trail Blazers selected Sam Bowie instead of Michael Jordan. While Bowie went on to an uneventful and injury-plagued career, Jordan led the Chicago Bulls to six championships and is considered by many to be the greatest player ever. Were the Blazers unskilled or just unlucky? The point is that sometimes it is very difficult to discern luck from skill. This difficulty extends to the evaluation of active mutual fund managers.

Bradford Cornell, professor of financial economics at the California Institute of Technology, contributed to the literature with his 2009 study, "Luck, Skill and Investment Performance."[10] Cornell noted: "Successful investing, like most activities in life, is based on a combination of skill and serendipity. Distinguishing between the two is critical for forward-looking decision-making because skill is relatively permanent while serendipity, or luck, by definition is not. An investment manager who is skillful this year presumably will be skillful next year. An investment manager who was lucky this year is no more likely to be lucky next year than any other manager. The problem is that skill and luck are not independently observable."

Since skill and luck are not directly observable, we are left with observing performance. However, we can apply standard statistical analysis to help differentiate the two—which is what Cornell did.

He used Morningstar's 2004 database of mutual fund performance to analyze a homogeneous sample of 1,034 funds that invest in large-cap value stocks. Cornell's findings are consistent with the previous research. The great majority (92 percent) of the cross-sectional variation in fund performance is due to random noise. This result demonstrates that "most of the annual variation in performance is due to luck, not skill." He concluded: "The analysis also provides further support for the view that annual rankings of fund performance provide almost no information regarding management skill."

Professors Eugene F. Fama (professor of finance, University of Chicago, Booth School of Business) and Kenneth R. French (professor of finance, Dartmouth College, Tuck School of Business) also studied this issue in their March 2009 paper, "Luck versus Skill in the Cross Section of Mutual Fund Alpha Estimates." The two academics looked at mutual fund data from the Center for Research in Security Prices. Using statistical analysis, Fama and French found that active managers as a group have not added any value over appropriate passive benchmarks. They concluded: "For (active) fund investors the simulation results are disheartening."

They did concede that the results looked better when looking at gross returns—the returns without the expense ratio included. However, gross returns are irrelevant to investors unless they can find an active manager willing to work for free. The bottom line is that Fama and French found no evidence of fund managers with skill sufficient to cover costs.[11]

It is important to note that the evidence on both the aggregate underperformance and the lack of persistent outperformance beyond the randomly expected has been found regardless of the asset class. So the argument that active management wins in "inefficient" asset classes like small caps or emerging markets is simply a myth. As you will see, the same underperformance has been found whether the markets are rising or falling.

The 2009 Spring/Summer issue of *Vanguard Investment Perspectives* provides us with evidence on the performance of actively managed equity funds during bear markets. Vanguard's study covered the period 1970–2008 and examined the returns of active funds during the seven periods when the Dow Jones Wilshire 5000 Index fell at least 10 percent and the six periods when the MSCI EAFE Index fell by at least that amount. Despite acknowledging survivorship bias (poorly performing funds disappear and are not accounted for), Vanguard found:

- It didn't matter whether an active manager was operating in a bear market, a bull market that precedes or follows it, or across longer-term cycles, the costs of security selection and market timing proved a difficult hurdle to overcome.
- "Success" can be explained at least in part by style exposures. For example, during the bear market of September 2000–March 2003, the Russell 1000 Value Index fell just 21 percent, while the U.S. total market lost more than 42 percent. Once active funds were compared to their style benchmarks, there was no consistent pattern of outperformance. Past success in overcoming this hurdle didn't ensure future success. "The degree of attrition among winners from one period to the next indicates that successfully navigating one or even two bear markets might be more strongly linked to simple luck than to skill."

Vanguard concluded: "We find little evidence to support the purported benefits of active management during periods of market stress."

Vanguard's conclusion is confirmed by Standard & Poor's finding in its *2008 Indices vs. Active Scorecard*. S&P concluded: "The belief that bear markets favor active management is a myth. A majority of active funds in eight of the nine domestic equity style boxes were outperformed by indices in the negative markets of 2008. The bear market of 2000 to 2002 showed similar outcomes."

As the evidence demonstrates, the belief that active managers are likely to protect you from bear markets is just another myth perpetuated by Wall Street.

Who Cares about the Average Fund?

Whenever I present this type of evidence, the typical response from skeptics goes something like: "Who cares about the average fund? I invest only in the best funds, the ones with great track records." The problem with this line of thinking is that all the studies on this subject have found no persistent outperformance beyond the randomly expected—the past is not prologue when it comes to mutual fund returns. And, as you will see, even a long record of persistent outperformance has little value.

With Active Managers, How Long Is Long Enough?

Streaks randomly occur with much greater frequency than people believe. For example, the odds of flipping a coin 20 times and getting either four heads or four tails in a row are 50 percent. Because people underestimate the frequency of streaks, they tend to assign far too much meaning to events that are highly likely to be random occurrences. One study even demonstrated that a "hot hand" in basketball was likely to be nothing more than a random event. A statistician following a basketball team around for an entire season found that the odds of a career 50 percent shooter hitting the next shot were 50 percent, even if this player had just hit five shots in a row. The hot hand, at least for basketball, is a myth.[12]

Erroneously overreacting to what are random events can lead to not only poor coaching decisions but poor investment decisions as well. Hopefully, the following evidence will convince you that the Securities and Exchange Commission's (SEC's) required disclaimer that past performance doesn't guarantee future results is far too weak. It should read: *Past performance* *is not indicative of future results.* We begin with perhaps the best example of why past is not prologue when it comes to the performance of active managers.

The 44 Wall Street Fund

Most investors would be surprised to learn that Peter Lynch's Magellan Fund was not the top-ranked fund of the 1970s. Thanks to its now long-forgotten manager David Baker, the 44 Wall Street Fund generated even greater returns than Peter Lynch's Magellan Fund in the 1970s and ranked as the top-performing diversified U.S. stock fund of the decade. Surely, 10 years of the best performance in an entire industry could not be the result of luck. Or could it? How were investors rewarded for believing that past performance of active managers is prologue?

While the S&P 500 Index returned 17.6 percent per year—each $1 invested grew to over $5—the 44 Wall Street Fund ranked as the single worst-performing fund in the 1980s, losing 73 percent—turning each $1 invested into just 27 cents. The fund did so poorly that it was merged into the Cumberland Growth Fund in April 1993, which was then merged into the Matterhorn Growth Fund in April 1996.

We next consider the case of a fund that accomplished what even Lynch never did—beating the S&P 500 11 years in a row.

The Lindner Large-Cap Fund

For each of the 11 years 1974–1984, the Lindner Large-Cap Fund outperformed the S&P 500 Index. However, over the next 18 years, the S&P 500 Index returned 12.6 percent per annum. Believers in past performance as a prologue to future performance were rewarded for their faith in the Lindner Large-Cap Fund with returns of just 4.1 percent, an underperformance of 8.5 percent per year for 18 years. The Lindner fund was finally put out of its misery when it was purchased by the Hennessy Funds in October 2003 and eventually merged into the Hennessy Total Return Fund.

Then there is the case of Bill Miller, who managed to beat the S&P 500 Index 15 years in a row. Surely that long a streak of excellence could be relied on. Clearly, it could not have been the result of luck. Or could it?

The Legg Mason Value Trust Fund

By the end of 2005, Bill Miller's streak of outperforming the S&P 500 Index had reached 15 years. Unfortunately for investors, that streak was broken in 2006 when the fund underperformed the S&P 500 Index by about 10 percent. His 2007 performance was even worse, underperforming the S&P 500 Index by 12 percent. And 2008 was even more miserable, as the fund underperformed that benchmark by 18 percent. Miller finally reversed that performance in 2009, as his fund beat the S&P 500 Index by 14 percent.

There is one last case to present. Although it is not about a mutual fund, it is a tale about relying on the past performance of active managers.

The Tiger Fund

The Tiger Fund was a hedge fund formed in 1980 by the legendary Julian Robertson with $10 million in capital. The fund had a remarkable run, averaging more than 30 percent a year for the first 18 years. By 1998, it had in excess of $22 billion under management—the vast majority coming from new investments. And it is from this height that it began its fall into oblivion, generating losses of some $10 billion from peak to closing. The irony is that while the fund still showed a return of 25 percent per year over its life, it is estimated that investors in the fund may have actually lost money. The reason is that most of the money came in late, after the great returns had already been earned.

These tales demonstrate that 10, 11, 15, or even 18 years of outperformance are not sufficient to draw reliable conclusions.

What always surprises me is that while people concerned about their personal health will heed the surgeon general's warning about the dangers of cigarettes, they will ignore the SEC warning that relying on past performance of money managers is dangerous to your financial health.

The body of evidence on past performance being a reliable predictor of future performance of money managers has led many to the conclusion that investing in actively managed funds is a loser's game. Pay close attention to the conclusions drawn by some of our most respected investment managers and financial economists.

Advice from Professional Investors and Academics

Burton Malkiel is a professor of economics at Princeton University. He has also served as a member of the Council of Economic Advisors, president of the American Finance Association, and dean of the Yale School of Management. He was also on the board of the Vanguard Group for 28 years. Malkiel is probably best known as the author of the book *A Random Walk Down Wall Street,* in which he had this to say about past performance of mutual fund managers:

> I have become increasingly convinced that the past records of mutual fund managers are essentially worthless in predicting future success. The few examples of consistently superior performance occur no more frequently than can be expected by chance.[13]

David F. Swensen has been the chief investment officer of the Yale Endowment Fund since 1985. He is one of the most respected investment managers in the world. He is also the author of *Pioneering Portfolio Management* and *Unconventional Success*. Swensen had this to say about mutual funds fees and performance:

> Overwhelmingly, mutual funds extract enormous sums from investors in exchange for providing a shocking disservice. That is, mutual funds charge their investors big fees and usually fail to deliver returns that beat the market.[14]

In his book *Unconventional Success*, Swensen provided this advice for investors:

> Compelling data show that nearly certain disappointment awaits the mutual-fund shareholder who hopes to generate market-beating returns.[15]

John Bogle is the founder and former chairman of the Vanguard Group. In 1999, *Fortune* named him one of the investment industry's four "Giants of the 20th Century." In 2004, *Time* named him one of the world's 100 most powerful and influential people. The same year, he also received *Institutional Investor*'s Lifetime Achievement Award.

He is the author of seven books on investing. "Saint Jack," as he is known because of his tireless crusading efforts on behalf of individual investors, is one of the most respected people in the world of finance. In his book *Common Sense on Mutual Funds*, Bogle had this to say on the ability of investment advisors to identify the money managers that *will* deliver alpha:

> I do not believe that they can identify, *in advance*, the top-performing managers—no one can!—and, I'd avoid those who claim they can do so.[16]

In his keynote speech at the Personal Finance Conference on January 30, 1999, Bogle advised:

> Make no mistake about it, the record is clear that top-performing funds inevitably lose their edge.

If asked to name the investment professionals they respect the most, it is safe to say that most people would have Warren Buffett at, or near, the top of their list. In the 1993 Berkshire Hathaway Annual Report, Buffett provided this advice:

> By periodically investing in an index fund the know-nothing investor can actually outperform most investment professionals.

Given the sources, the cumulative weight of the advice should be sufficient to convince most people of the futility of trying to identify future outperformers by reviewing past performance. However, we are not yet done. Given the sources, careful attention should be paid to the quotations that follow.

Admissions from Industry Practitioners and the Financial Media

Ralph Wanger was the highly regarded lead manager of the Acorn Fund from its inception in 1977 until his retirement in 2003. During this period, the fund returned 16.3 percent per annum versus just 12.1 percent for the S&P 500 Index. Wanger is also the author of the book *A Zebra in Lion Country*. In his book, he made this startling admission:

> For professional investors like myself, a sense of humor is essential for another reason. We are very aware that we are competing not only against the market averages but also against one another. It's an intense rivalry. We are each claiming, "The stocks in my fund

> today will perform better than what you own in your fund." That implies we think we can predict the future, which is the occupation of charlatans. If you believe you or anyone else has a system that can predict the future of the stock market, the joke is on you.[17]

Bill Miller, the highly regarded manager of the Legg Mason Value Trust Fund, said:

> The S&P 500 is a wonderful thing to put your money in. If somebody said, "I've got a fund here with a really low cost, that's tax efficient, with a 15- to 20-year record of beating almost everybody," why wouldn't you own it?[18]

Douglas Dial was the manager of the CREF Stock Account, one of the largest funds in the world, when he commented:

> Indexing is a marvelous technique. I wasn't a true believer. I was just an ignoramus. Now I am a convert. Indexing is an extraordinary sophisticated thing to do. . . . If people want excitement, they should go to the racetrack or play the lottery.[19]

The following is important because it comes from Morningstar, the seller of a service that rates mutual funds:

> For starters, expense ratios are the best predictors of performance—way better than historical returns. It's tempting to look at strong past performance and assume a fund can repeat its success, but there's no guarantee it will. In fact, we've found that you'd be better off randomly picking a fund with expenses in the cheapest quartile and past returns in the worst quartile than a fund with returns in the top quartile and expenses in the highest quartile. In addition, for the investor, there isn't much logic to costs. Higher expenses don't get you better management. If it did you'd expect higher-cost funds to outperform their lower-cost peers—when in fact just the opposite has happened.[20]

The following quotations are important because of their source: the financial media and publications that anoint the latest hot manager as a guru and tout the hot funds you just have to own.

The first is from an article by *BusinessWeek* reporter Robert Barker. In his December 17, 2001, column, "It's Tough to Find Fund Whizzes," Barker observed:

> If picking stocks is a random walk down Wall Street, as Princeton economist Burton Malkiel famously put it, then picking mutual funds is an obstacle course through Hell's Kitchen.

The next quotations are from *Fortune*:

> Despite the solemn import that fund companies attribute to past performance, there is no evidence that the 4 percent who beat the index owe their record to anything other than random statistical variation.[21]

> We have learned that past investment records make lousy crystal balls.[22]

> Despite volumes of research attesting to the meaninglessness of past returns, most investors (and personal finance magazines) seek tomorrow's winners among yesterday's. Forget it.[23]

> That sort of skepticism about past returns is crucial. The truth is, as much as you may wish you could know which funds will be hot, you can't—and neither can the legions of advisers and publications that claim they can. That's why building a portfolio around index funds isn't really settling for average (or a little better). It's just refusing to believe in magic.[24]

John Rekenthaler is the vice president of research and product development at Morningstar, a firm best known for its mutual fund ratings service. Here is what he had to say about the ability to identify future alpha:

> "We should have more answers," he said, while noting there is "surprisingly little" that we can say for sure about how to find top-notch stock funds.[25]

Commenting on whether investors should pay attention to mutual fund advertisements, Rekenthaler had this to say:

> To be fair, I don't think that you'd want to pay much attention to Morningstar's star ratings either.[26]

Don Phillips is managing director of Morningstar. Read carefully his admission in an interview with the *Wall Street Journal*:

> The very likely takeaway may be that it's too hard to pick managers—these great mythic figures don't walk the earth.[27]

Jason Zweig is the personal finance columnist for the *Wall Street Journal*. He is also the author of *Your Money and Your Brain* and the coauthor of the updated version of Benjamin Graham's classic, *The Intelligent Investor*. Here is what Zweig had to say about the chances of identifying future alpha generators:

> Your chances of selecting the top funds of the future are about as high as the odds that Bigfoot and the Abominable Snowman will both show up in pink ballet slippers at your next cocktail party.[28]

Jonathan Clements was the personal finance columnist for the *Wall Street Journal* when he warned investors:

> Santa Claus and the Easter Bunny should take a few pointers from the mutual fund industry [and its fund managers]. All three are trying to pull off elaborate hoaxes. But while Santa and the bunny suffer the derision of eight-year-olds everywhere, actively managed stock funds still have an ardent following among otherwise clear-thinking adults. This continued loyalty amazes me. Reams of statistics prove that most of the fund industry's stock pickers fail to beat the market.[29]

The following "shaggy dog" story is a fitting conclusion to this chapter. Lost on a country road, a man notices a farmer tending his sheep and decides to ask for directions. After thanking the farmer for the directions, he tells the farmer he has an unusual talent. He says: "If I can guess exactly how many sheep you have on that hill, can I take one with me?" Thinking there was no way anyone could guess exactly how many sheep he tended, the farmer agrees. The man scans the hill quickly and says 2,376. Shocked, the farmer says: "That's amazing. I am a man of my word. Go ahead and pick out a sheep." The man marches up the hill and carries back his choice. The farmer says: "Before you leave, I would like a chance to win back my animal. I bet I can guess what you do for a living." Of course, the man accepts this challenge. The farmer says: "You're a manager of an actively managed fund." Stunned, the man says: "How did you know that?" The farmer responded: "Out of 2,376 sheep, only an active manager could pick out the one dog."

We now turn to the evidence on pension plans.