There are a few skeletons lurking in the closets

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The old adage "you get what you pay for" may apply to many goods and services but it does not always apply to investment funds. In theory, if you pay active management fees - for private investors, typically an annual charge of 1.5 per cent of funds under management - then you expect an active fund manager who tries to beat the benchmark by taking educated bets on which stocks will outperform.

Alternatively, you can pay passive management fees - normally a fraction of 1 per cent - for an index, or tracker fund that aims to deliver a return very close to that of a specific benchmark, say the FTSE 100 index.

But many investors who are paying higher active management fees are getting passive performance through "closet" tracker funds. Billions of pounds are invested in such funds and a study has found that their share of the retail funds market has risen dramatically since the mid-1990s so that they now account for around third of all retail funds.

How Active is your Fund Manager?, published last year by two academics at Yale*, concluded that the answer to this question is in many cases "not very". They found that since the mid-1980s, the proportion of index funds has risen from near-zero to more than 10 per cent, while stock-pickers' share of the market has fallen from 70 per cent to 30 per cent. Closet trackers, who they say barely existed 20 years ago, are now as numerous as stockpickers.

Unsurprisingly, closet trackers are the worst-performing type of fund manager. This is because they combine high fees with a lack of "alpha" - the term for investments that beat the benchmark. With a standard tracker, performance is likely to be slightly behind the benchmark because of annual charges. But, with a closet tracker, performance will often be worse because of higher annual fees which can often be more than double those of a tracker fund. The study also found that stockpickers generated better returns on average than managers that take a top-down, asset allocation approach.

The best way of spotting a closet tracker is to compare the stocks in its portfolio with the ones in its benchmark index, according to the study. The bigger the overlap, the lower the fund's "active share". Index trackers aim for an active share of zero - but many other so-called active funds come worryingly close.

The study highlighted Fidelity's gargantuan Magellan fund, widely held by US private investors, saying that the $45bn fund has become a closet tracker. It saw its active share fall from 90 per cent in 1981 to 30 per cent in 2003. And while it beat the S&P 500 benchmark between 1977 and 1990 with an impressive annual return of 29 per cent, it has languished below the index over the past 10 years. Over the past year its return of 5.3 per cent was woefully behind the S&P 500's 14.5 per cent.

In the UK, a prime suspect in the search for closet trackers is Prudential's UK Growth Trust. With £2.4bn under management, it is one of the UK's biggest funds. Comparing its top holdings with the biggest companies in the FTSE 100, you get the impression that the two were separated at birth. The top five are the same, and appear in the same descending order of size with the exception of Royal Dutch Shell. Nine of the Pru fund's top 10 holdings are also in the FTSE 100 top 10, and eight are in the same descending order of size. The fund has underperformed its benchmark for each of the past five years.

Another fund suspected of being a closet tracker is the Axa UK Growth fund but it recently changed its manager, which could trigger a more genuinely active approach.

Another tell-tale sign of a closet tracker is a low tracking error. The term error denotes how much a fund's return diverges from the benchmark's. Ellis reckons a tracking error below 2 per cent should raise suspicions. Interestingly, investment trusts that focus on UK equities have a higher tracking error than their direct rivals among open-ended funds, which suggests that they are more genuinely active managers.

A fund fact sheet should state the fund's tracking error and returns relative to its benchmark - if it does not, you can ask the fund provider or the intermediary through whom you are buying funds. For information online, see www.fundslibrary.co.uk.

James Tew, head of research at the financial ratings group Standard & Poor's, says: "A lot of fund managers move to index tracking for tactical reasons because they don't know what's happening in the marketplace. He's hiding from making a decision because he doesn't know which way to jump."

He says this indecision can last for months, as once fund managers start to bring down tracking error they can get stuck in a rut. He adds that recently many fund managers have seen their tracking error fall to a lower level than they intended owing to low volatility in equity markets, which brings down tracking error across the board.

Simon Ellis, managing director of Fidelity International's multimanager business, says most closet trackers are found in large asset classes where there are many funds at work. Big equity markets such as the US and the UK are good examples.

But Ellis says that, rather than simply comparing a fund with a broad benchmark such as the FTSE 100, it may make sense to compare it with a particular style of investing. For example, a fund manager with a growth style, which favours companies expected to experience rapid earnings growth, might passively invest in all the growth stocks in an index. If he beats the benchmark, it is simply because growth stocks outperformed others, and the manager deserves little credit.

The lesson for private investors is that it can make sense paying the higher fees associated with active management if the aim is to get superior performance.

"Paying for active management is fine," says James Montier, a global equity strategist at Dresdner Kleinwort Wasserstein. "But [if you are paying for it] make sure that is what you are actually getting."

**How active is your fund manager*, by Martin Cremers and Antti Petajisto, available from www.ssrn.com