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What Are You Paying For?

'Closet index funds' have higher fees than true index funds but don't differ enough to justify the higher costs

By SAM MAMUDI

The pact between a mutual-fund investor and the manager of the typical stock mutual fund is, in theory, a simple one: payment in exchange for expert stock selection.

But financial advisers have long complained there are funds that don't fully live up to that exchange. These funds charge high fees but follow a strategy that is very close to simply betting on an index. The supposedly active fund manager, in effect, is being paid for doing close to nothing.

Investing with a "closet indexer" is a double whammy for investors: It lowers their odds of getting results that are far better than the benchmark, which is a key reason to opt for an active stock picker (although, to be fair, their chances of falling far behind are lower, too). And they may be paying substantial annual fees, and sometimes sales commissions, for fairly average returns.

In many cases, investors could benefit by moving some money to a cheap index-tracking fund with fees of less than 0.2% of assets a year or by investing with managers who happily veer from the index—or some combination of both.

"It's hard to make the case for index-huggers" that lag behind the index "and have higher costs," says Russel Kinnel, director of fund research at Morningstar Inc. "While the risks to your portfolio aren't great, investors are needlessly settling for mediocrity."

The Wall Street Journal went looking for closet indexers in one of the largest fund categories—large-cap blend funds, which typically compare their performance to the Standard & Poor's 500-stock index. The Journal asked Morningstar to identify large-cap blend funds with "R-squared" scores of more than 98% over the five years through Oct. 31. A fund's R-squared score, figured by comparing the fund's performance to a benchmark, measures the percentage of a fund's returns that can be explained by the index's movements.

Morningstar excluded from its screen enhanced index funds, which aren't quite index funds but also can't be called closet indexers. These funds, which include Vanguard Growth & Income, track their benchmarks closely, but use some active management to try to beat the index or lower volatility. Unlike closet indexers, however, they openly state their intention to stay close to their benchmark.

The Journal also used an "active share" gauge suggested by two Yale University academics, in a paper published in September, that looks at how much a fund's holdings differ from its benchmark. For instance, if a fund that compares itself to the S&P 500 holds 50 of the index's 500 stocks, its active share is 90%—just 10% of the index is mirrored in the fund. But a fund with an active share below 60%—indicating it holds at least 40% of the stocks in its index—could be a closet indexer, say authors K.J. Martijn Cremers and Antti Petajisto, who provided active-share scores for more than 1,000 funds from 1990 to 2006 in their paper.

Controlling Risk

R-squared scores and active-share data suggest that closet indexers in the large-cap blend category may include Thrivent Large Cap Stock, which has about $1.7 billion in assets; Principal LargeCap Blend I and Principal LargeCap Blend II, which have assets of roughly $900 million and $700 million, respectively; and the $900 million Dreyfus Fund.

Three additional funds that appeared on our screens and have at least $100 million in assets are Dryden Large Cap Core Equity, First Investors Blue Chip and Nationwide Fund.

In response to their funds appearing on our screens, the firms mentioned point to what they say is risk-controlled approaches in their strategies.

Randy Welch, director of investment services at Principal Financial Group Inc., says the LargeCap Blend I and LargeCap Blend II funds don't have to take large bets against the index to outperform peers—an approach that keeps their risk low relative to the S&P 500.

"It's for people on the outside to determine whether these funds are closet indexers," Mr. Welch says. "We consider them to be actively managed; it's just about how much risk we want them to take."

Dreyfus, a unit of Bank of New York Mellon Corp., says in a statement that "good active management is maximizing return per unit of risk." The fund is beating its benchmark this year due "to stock selection and a rigorous investment process for its shareholders," the firm says.

Thrivent Financial for Lutherans says in a statement that "prudent risk management is at the core of Thrivent's investment-management process." R-squared isn't a measure of risk and active share "is not a measurement commonly used by professional money managers," it says.

Matthew Wright, manager of First Investors Corp.'s Blue Chip Fund, says the fund's management team focuses on outperforming its peers in Lipper Inc.'s large-cap core category and doesn't "spend a lot of time figuring out where we are compared to the S&P 500." Correlation to the S&P 500 is mostly coincidental, he says.

JennisonDryden, a unit of Prudential Financial Inc., declined to comment. Nationwide Funds Group, a unit of Nationwide Mutual Insurance Co., didn't return calls seeking comment.

Playing It Safe

There can be various incentives for fund managers to mirror the holdings of a benchmark.

Since a manager's performance is usually judged relative to an index, staying close to the benchmark can be a way of playing it safe, says Graham Spiers, chief investment officer at wealth manager Waypoint Advisors, Norfolk, Va. "There is a framework where if managers make a mistake or are wrong, they can lose their jobs," says Mr. Spiers, who worked at asset-management firms for 10 years.

Managers who take more risks often have periods when they lag behind the benchmark, forcing them to preach patience and point to their long-term records as a reason for investors and employers not to lose faith. That can be harder than staying close to an index and delivering returns that don't stand out, either positively or negatively, Mr. Spiers says.

Messrs. Cremers and Petajisto found that the proportion of assets in closet indexers climbed over the roughly 15 years for which they examined fund data. In 2003, about 30% of all assets in large-cap funds were in funds with active shares of between 20% and 60%; that figure was almost zero in the 1980s.

That increase coincided with dramatic growth in the mutual-fund industry—the number of U.S.-stock funds rose to 3,599 at the end of September from 941 at the end of 1989, according to the Investment Company Institute, a trade group.

Mr. Cremers, an associate professor of finance at Yale University's School of Management, says the growing importance of benchmarks in judging fund performance and determining fund managers' pay, dilution of talent due to the explosion in the number of funds, and a move by talented stock pickers to hedge funds may explain the boom in closet indexers as a proportion of the fund industry

Morningstar's Mr. Kinnel thinks the growth and subsequent specialization of the fund industry contributed to the increase. Rather than having one stock fund with a go-anywhere approach, investors now can choose sector or category funds that by their nature are more disciplined.

Institutional-style money-management approaches also played a role, Mr. Kinnel says. Big pension funds, for instance, have limits on how far they want a manager to veer from an index—if they are hiring a small-cap growth manager, they want the manager to stay in that space. That investing strategy is then adopted in mutual-fund management.

Far From Perfect

It can be tough for investors to spot closet indexers, partly because of the limitations of the measures currently available.

Fund investors can find a fund's R-squared for the past three years on Morningstar.com (look up a fund and then click on the "Ratings & Risk" tab). But R-squared is far from perfect. A fund may have a high R-squared if it has sector exposure very similar to an index or index-like weightings of stocks of different sizes and styles, yet still generate market-beating returns.

Consider, for instance, the JPMorgan U.S. Equity fund, launched in 2001. The fund has a five-year R-squared of 98.8%, but over the five years through November beat the S&P 500 by an average 2.3 percentage points a year. That's because while the fund's portfolio in some ways mirrors the index, it takes big bets that differ from market weightings. On Sept. 30, for example, Hewlett-Packard Co. was the fund's second-largest holding, accounting for 3.1% of the fund. H-P was only 1.2% of the S&P 500 on that same date.

In our examination of R-squared figures, about 40 funds among the 492 funds in Morningstar's large-blend category had scores of 98% or more, 10 of which seemed to have the characteristics of closet indexers.

Closet Index Funds?

These funds closely resemble the Standard & Poor's 500-stock index in performance and composition, according to their R-squared and active-share scores

		Return above or below the S&P 500* (in percentage points, annualized)			
Fund (Share class)	Symbol	3 years	5 years	10 years	Expense ratio (% of assets)
Dreyfus Fund	DREVX	+0.51	+0.26	-0.63	0.75%
Dryden Large Cap Core Equity (Z)	PTEZX	-1.28	-0.83	+0.03	1.06
First Investors Blue Chip (A)	FIBCX	+0.50	-0.37	-1.61	1.40
Nationwide Fund (D)	MUIFX	-1.81	-1.05	-0.20	0.79
Principal LargeCap Blend I (Inst.)	PLIIX	-1.69	-1.24	N.A.	0.45
Principal LargeCap Blend II (Inst.)	PLBIX	+1.06	+0.72	N.A.	0.75
Thrivent Large Cap Stock (A)	AALGX	-0.12	-0.83	-0.80	1.03

Note: Data are for the largest share clas s of each fund, which in most cases is the least expensive. All returns are net of fees. Other share clas ses with higher expenses have lower returns.

*Through Nov. 30

Source: Morningstar

Active share, meanwhile, can't be calculated as often as R-squared scores. That's because doing so requires full disclosure from funds about their holdings—and funds are required to reveal their portfolios only every three months. While active-share scores are available in the paper published by Messrs. Cremers and Petajisto, with additional information on Mr. Petajisto's Web site at Petajisto.net, they generally are unavailable elsewhere.

For instance, while the Web site MutualDecision.com ranks roughly 400 funds based on active-share data, it doesn't reveal their actual scores, making it difficult to determine if those at the bottom are, indeed, closet indexers.

There also is a quirk in the active-share approach in that the numbers aren't completely consistent across types of funds, with small-cap funds typically scoring higher.

That's because small-cap funds, which often compare themselves to the Russell 2000 index, have far more stocks in their universe. So a small-cap fund with 400 of the index's stocks would still have an active-share score of 80%.

Morningstar's Mr. Kinnel says investors who are trying to determine if they are invested in a closet indexer could start by looking at the fund's R-squared score. While 98% is a flashing red light, even 95% or above is a high score.

Next, check the fund's prospectus to see if management states clearly that it is constrained in ways that keep the fund close to its benchmark. For instance, T. Rowe Price Capital Opportunity, with an R-squared of 99.5%, states clearly that its sector weightings will be "approximately the same as the S&P 500 Index."

If a fund with a high R-squared score doesn't make clear that it is constrained, investors should next look at annual performance—specifically since the current management team took over—and then check its fees, says Mr. Kinnel.

"If the expense ratio is at 0.4% I'd be much happier than if it's at 1.4%," he says. "If you're a closet indexer but only charging slightly more [than typical index funds], then maybe that's okay."

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