Magellan's Problem: Closet Indexing

November 15, 2005

The recent departure of Robert Stansky from Fidelity's flagship Magellan Fund highlights a broader issue: many investors are growing concerned about whether their mutual fund is a "closet indexer." Such funds claim to be actively managed while in reality they just passively invest most of their assets in the benchmark index.

The problem with closet indexing is that investors are paying high fees for the alleged benefits of active management, but they still end up getting a mostly passive portfolio with only a small active part. Instead, investors could get the same type of portfolio but pay much less if they invest separately in a low-cost index fund and in a truly active fund.

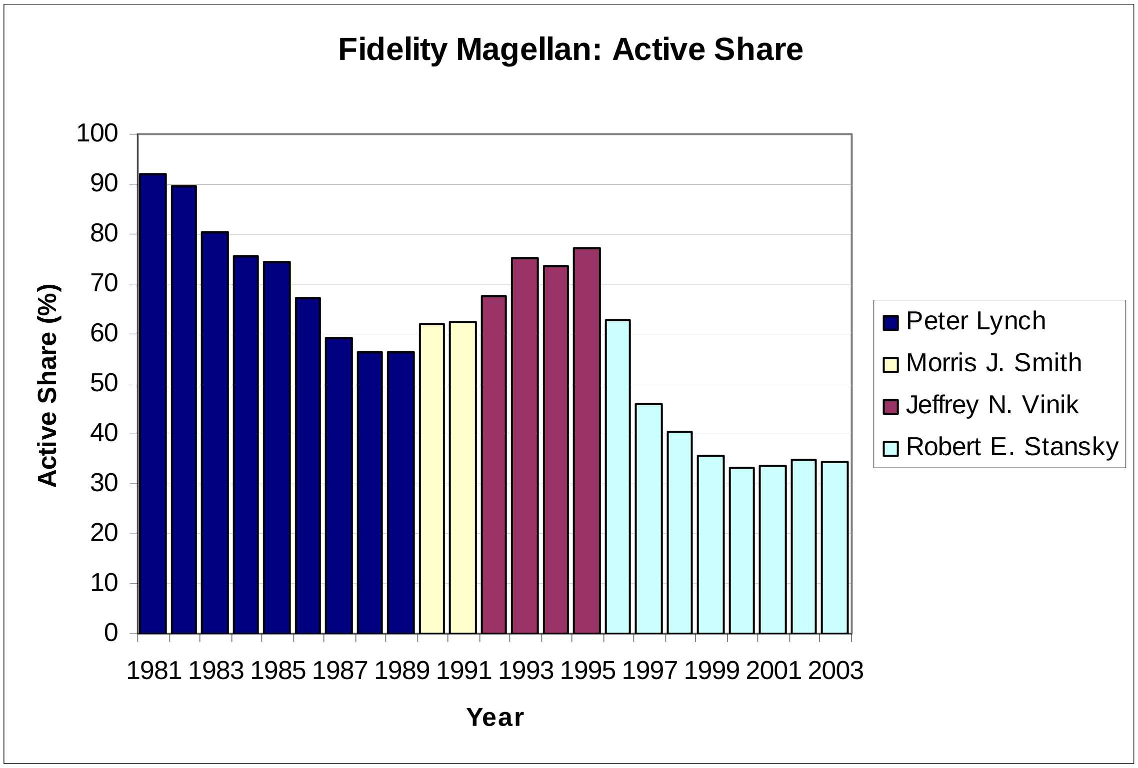
Fidelity Magellan used to be known as an aggressive (and highly successful) fund. But its active management approach experienced a significant change when Stansky took over in June 1996. It became a closet indexer.

We can measure closet indexing by computing the "active share" of Magellan's stock portfolio. This is the fraction of the fund's stock holdings that are different from the holdings of the S&P 500 index.

To illustrate the measure, assume that GE and Exxon Mobil each account for 4% of the index. Further assume that a hypothetical fund holds exactly the index, except that it has 8% of its portfolio in GE and nothing in Exxon Mobil. This implies the fund has an active share of 4% – this is the portfolio weight shifted away from the index. More generally, the active share of a mutual fund ranges from zero (pure index fund) to 100% (zero overlap with the benchmark index).

Magellan's active share in 1995 under the previous manager Jeffrey Vinik was about 77%, which is a rather typical value for an actively managed fund. But by 1997, only one year after Stansky took over, active share had fallen to 46% and then continued to decline to as low as 33%. In other words, two-thirds of the assets in the Magellan portfolio are simply invested in the S&P 500 index. This is one of the lowest numbers for any non-index stock fund.

Larger funds do tend to be less actively managed in general, but for Magellan the shift to closet indexing clearly cannot be explained by fund size. Magellan's year-end total net assets grew from $22 billion in 1992 to $54 billion in 1995 under Vinik, yet he simultaneously *increased* active share from 68% to 77%. Under Stansky, total net assets did keep growing but only *after* he had significantly tilted toward the index.



Stansky's departure has been credited to Magellan's unimpressive returns under his management. This is not unrelated to closet indexing. One can only beat the benchmark by deviating from it, so given the fund's modest active bets, it was virtually impossible to obtain stellar returns. Instead, Magellan's performance was just what we would expect from a closet indexer: always very close to the benchmark, minus a drag of about 1% per year for management fees and other expenses.

The lesson for mutual fund investors is clear: if you want active management, make sure you get what you pay for. There are many other funds still in the closet, charging fees for very little active management.

Antti Petajisto
Assistant Professor of Finance
Yale School of Management
135 Prospect St.
PO Box 208200
New Haven, CT 06520-8200
Tel: 203-436-0666
Fax: 203-436-0630
Email: antti.petajisto@yale.edu