



Letter to the Editor re:FundQuest

The following letter is in response to our [article](#) last week on FundQuest's study of active and passive management strategies.

Dear Editor:

I read the original study by Jane Li, CFA, and Ruhan Inanoglu of FundQuest, and I have very serious concerns regarding their methodology.

First, they did not make an apples to apples comparison – they used Morningstar to categorize the funds, and then used a hodgepodge of index providers for comparison. The problem is twofold:

1. Investors do not receive the average of monthly returns for a year, they receive annualized returns...analyzing the 'mean' returns of the funds proves nothing. For example, from January 2000 to Sept 2007, the average monthly return of the Growth Fund of America was .6%. By using the mean return, then multiplying by 12 over the 7 ¾ year period, leads one to expect a 7.21% annual return. The reality is investors in this fund over the period only achieved a .49% return...barely breaking even! (Source: Steele Mutual Fund Expert Data)

This problem can be best illustrated comparing the Growth Fund of America against the 90 Day Treasury Index (which most money markets are compared) for the above period. The average monthly return of the index was a mere .25%; however, since every return was positive, the result was an investor in the money market fund would have achieved a 3.06% annualized rate of return for the period. Averages prove nothing.

2. Li and Inanoglu calculated the "real alphas" of funds by comparing each fund to its best fit benchmark, after determining the best fit from 56 possible indexes. However, the indexes they used will cause a problem known as multi-collinearity because securities are held in more than one index used for comparison (e.g., the Russell, Wilshire, and S&P indexes used in the study all have overlapping constituents). The Pension Research Institute provides more [information](#) about multi-collinearity, as it relates to index selection and performance measurement.



Advisors need to understand styles and indices in order to make better asset allocation decisions. The assumption that all indices are homogenous is leading the industry to focus too much on manager selection instead of asset allocation strategies.

FundQuest sells 'due diligence,' so we can expect a bias against passive investing. However, RIAs acting as fiduciaries need to understand the problems. Too many RIAs are 'selling' advice and due diligence as a product. They are distributing someone else's knowledge as their own.

I believe it must be done in-house, not only to offer the client the best value at the least risk, but as a fiduciary, the RIAs must monitor the TAMPs like FundQuest. Doing so will alleviate the need to use external providers. Once you are capable of monitoring your due diligence provider, you no longer need them.

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