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Stock-Picking Funds Are Performing as Poorly as Ever

Just 13% of U.S. large-cap funds have outperformed indexes over the past decade, new data show

By Jack Pitcher

Total assets in U.S. equity mutual funds and ETFs



Source: Investment Company Institute

Investment pros say AI disruption has created a stock picker's market. They are still struggling to pick the right ones.

Just 27% of actively managed U.S. large-cap equity funds beat their benchmark passive-fund alternatives in the 12 months ended June 30, according to Morningstar data that compares returns after fees. That is actually an improvement over stock-picking funds' long-term track record. In the decade through June, just 13% of active large-cap funds beat their benchmarks.

The fees on actively managed mutual funds have been a cash cow for investment firms for decades, but years of outflows from investors moving to more tax-efficient, and often passive, exchange-traded funds are weighing heavily on the industry.

"If you look at active equity mutual funds, they've had outflows every year consistently since 2015," said Matthew Bartolini, global head of research strategists at State Street Investment Management. "That's a losing trend only compared to the New York Jets."

In recent Wall Street marketing and outlook materials, stock picking is still all the rage. Active managers argue that higher interest rates have ended the cheap-money tide that lifted all boats, just as AI is set to mint huge winners and losers, making security selection crucial.

"Conditions have shifted to favor active investing," T. Rowe Price declared. AI means "active stock selection will be increasingly important," says Janus Henderson. "Finally, active managers can participate and join the passive moneymakers," Jefferies CEO Rich Handler said in a recent letter to clients.



Stock picking is still all the rage in recent Wall Street outlook materials. JEENAH MOON/REUTERS

Those predictions have been correct, to an extent. Stock-market dispersion—or the divergence in performance between individual stocks in the same index—has soared to the highest level in decades this year.

That should theoretically make it an ideal environment to beat low-fee index investing by picking winners. But the S&P 500 and Nasdaq-100 are weighted by market value, and outsize gains from a handful of superstar companies continue to drive returns. The S&P 500's 10 largest companies represent more than 40% of its value, according to Dow Jones Market Data—the highest concentration since the 1960s.

Many active managers are uncomfortable making bets that concentrated, especially since nearly all of the value is tied to the technology sector.

“That amount of concentration is broadly viewed as too deep for most portfolios,” said Holly Framsted, head of product group at Capital Group, one of the largest active-fund managers. “It’s really important to recognize that if you get the direction of travel on that theme wrong, the risk is outsized.”

Investors should consider both diversification and the total portfolio risk in their portfolios when comparing active and passive results, Framsted said.

U.S. index-tracking funds pulled even with active funds in total assets for the first time in 2020, according to the Investment Company Institute, and now hold almost twice as much money. That is a far cry from the pre-financial-crisis landscape: In 2007, assets in active equity funds outnumbered those in passive strategies by more than three to one.

Still, the proliferation of passive funds that track nearly anything, from total-market indexes to small subindustries, means plenty of individuals and institutions use such funds as tools to make their own active decisions, like going overweight on a specific theme.

Low-cost passive ETFs are on pace to hit \$1 trillion in net inflows for the first time this year, underscoring the dominant role they now play in portfolios.

Bonds have been more of a bright spot for fund managers. Active intermediate core bond funds, the largest category, had a 66% success rate beating benchmarks over the past year, and a majority have done so for three years running, according to Morningstar. Active fixed-income ETFs have been growing faster than passive funds.

Investors considering active management would be wise to look beyond large-cap stocks, State Street's Bartolini added.

"You can go get stock-market beta with ETFs in a very fee-efficient and tax-efficient manner, and then use your active budget elsewhere where there might be more opportunities, like fixed income," he said.