

How much should you pay someone to manage your equity portfolio? I think the answer is a resounding, “It depends.”

The dependency rests mainly on how the stocks in your portfolio are managed. And today there is an important first choice; to index or to go active.

Index funds are passive portfolios. They are built to match the structure of a market benchmark. Probably the most common of these is the S&P 500 Index. It is challenging to match because it is capitalization weighted. That means that the largest companies, like Microsoft, GE and Exxon Mobil, carry much more weight in the index than smaller companies. By contrast, the Dow Jones 30 Industrials is a simple arithmetic average of the prices of 30 stocks. The 40 largest companies in the S&P 500 account for 60 percent of index’s weight and the other 460 companies account for only 40%. So, it takes some mathematical skill to match the S&P 500.

There is evidence that the S&P 500 outperforms most active managers. Indexers claim that “outperformance” means the highest quartile of results for active managers. I have looked at this question a couple of times and concluded that over long periods, compared to large cap managers, index funds are above average; not top quartile.

Finding an active manager who outperforms index funds over long periods, net of fees, is no small task. A manager used by my firm was uncovered by our screening. That screen is to look for managers who outperform the S&P 500 over a market cycle; not an arbitrary period like five years. It led us to this manager and its remarkable record.

First, this firm has had negligible people turnover since the ‘70s. It has a well-conceived investment philosophy and has built an excellent staff to carry it out. It is controlled by a family that has its own money in the portfolio, so the interests of the firm and its clients are aligned. Then there’s the track record. In every ten-year period since 1969, they have outperformed the S&P 500, net of fees. They do point out that in three or four years in each of those ten-year periods they lag the S&P. But the overall string of ten-year performance is intact.

The records of indexers and a manager like this give an investor a choice. Experience tells me that some folks will say, “Let’s do the index fund in years when the active manager lags.” Only problem is, no one can tell you how to discern those years before they occur. So, index or active? And, our original question, What should you pay?

If you like the index idea, then you have a clear choice; the cheapest fund is likely to have the best return. These funds are nearly all the same. Their portfolios will perform within a tiny range of each other, so the fee is the deciding factor. Choose the lowest.

Active managers are a different story. Index funds are your benchmark and the key question is; Does this manager show an ability to exceed an index fund **Net of Fees**? If the answer is yes, do you really care what that fee is because an exorbitant fee would not allow this performance.