



Active vs. index mutual funds: Which approach is right for you?

If you invest in mutual funds, you may already know how varied the choices are. You can invest in a fund devoted to stocks or a fund devoted to bonds, in a fund that focuses on large caps or one that focuses on small caps, in a fund that concentrates on U.S. equities or stocks from overseas companies. Another consideration when choosing a fund is whether to use an active investment strategy or one that mimics an index.

Most mutual fund assets in the United States today are actively managed, but index funds—which debuted in the 1970s—are gaining ground. By 2012, 17.4% of all assets invested in equity mutual funds were invested in index funds, compared with 11.8% in 2007, according to the Investment Company Institute.

Two distinct approaches

Actively managed mutual funds

In an **actively managed** fund, a professional fund manager uses analytical research and his or her own experience and judgment to build a portfolio of individual stocks or bonds. Generally the manager is attempting to achieve a long-term return that exceeds a particular benchmark. The benchmark could be the well-known Standard & Poor's 500 Index, or it could be something less familiar, such as an international stock index or small-company stock index. Other characteristics of an actively managed fund include:

- Typically has fewer stock or bond holdings than the benchmark it tracks, with the portfolio's allocation to underlying sectors (e.g., healthcare, financials, technology, etc.) likely being different than the benchmark
- May have holdings that are not contained in the benchmark. The difference is deliberate in that the manager is trying to generate returns for the fund that are above the benchmark return

You might choose to use an active investment strategy if you found a manager who you believe could produce market-beating returns. You also might choose an actively managed fund if you are a long-term investor who believes that the returns delivered by an active manager over time will more than offset the often higher expenses associated with running an actively managed fund versus an index fund.





Passively managed – or index – mutual funds

In an **index** or **passive** strategy, the manager sets out to track the performance of a particular benchmark, minus the expenses associated with the fund. More specifically:

- A fund company offering an index fund that invests in small capitalization stocks may build a fund that holds most or all of the same stocks as the Russell 2000 Index, a widely used small-cap benchmark, and hold the shares in the same proportions.
- One measure of the fund's success would be how closely it replicates the performance of the underlying benchmark. If the Russell 2000 rises 7.3% in a one-year period, the index fund should also rise 7.3% before the fund's expenses are taken into consideration. If the benchmark declines by a few percentage points, the fund, ideally, should go down by the same amount, again, before the fund's expenses are taken into account.
- Thus, managers of index funds aren't attempting to beat the market, but rather to keep pace with it.

Active or passive investing isn't an either-or proposition. In fact, many mutual fund companies offer both types of funds to their clients. Likewise, many investors find uses for both indexed and actively managed products within their portfolios.

Some key differences

Funds that use an active approach generally have higher expenses than index funds. This is because active portfolio management is a relatively labor-intensive process that requires portfolio managers and analysts supporting the fund to conduct daily research to gain a competitive advantage.

How much more might you spend? The cost of operating a mutual fund is measured through an expense ratio, which is calculated by dividing a fund's operating expenses by the dollar value of its assets under management. The average expense ratio for an actively managed equity fund was 92 basis points (or .92%) in 2012, according to the Investment Company Institute and fund rating company Lipper, compared with 13 basis points for equity index funds. As the fees you pay will cut into your investment return, it can pay to look for managers charging below average fees. According to Morningstar Direct, TIAA-CREF fees are generally less than half of the mutual fund industry average.¹

¹ Based on Morningstar data, the expense ratio on all mutual fund products and variable annuity accounts managed by TIAA-CREF is generally less than half the mutual fund industry average. (70% are less than half their respective Morningstar Universe average and 60% are less than half their respective Morningstar Universe median.)

Key points to consider:

In an **actively managed** mutual fund, a professional fund manager uses analytical research and his or her own experience to build a portfolio of individual stocks or bonds.

In an **index** or **passive** strategy, the manager sets out to track the performance of a particular benchmark, minus the expenses associated with the fund.

Both mutual fund approaches are viable. Which you use depends on your investment goals and risk tolerance.

Though expenses can be higher, active mutual fund investing offers the chance of an above-market return. Whether in rising markets or declining markets, active fund managers who make the right choices can produce returns that are better than the benchmark. However, with the chance of outperformance comes the risk of underperformance—getting a return that is worse than the benchmark. Here are points to consider when investing in an actively managed fund:

- **Past performance.** Has the manager exceeded his benchmark for the past three to five years? Keep in mind, though, that past outperformance isn't a guarantee of future success.
- **How long has the manager led the fund, and/or worked in asset management?**
- **What is the fund's Lipper or Morningstar rating?** These are independent companies which rate mutual funds.

On the other hand, by investing in index funds, you tie your returns to the performance of the underlying index that the fund tracks. Whether the market rises or declines, the index investor can expect a return that is in-line with the market—no less, and no more. In addition, you will typically pay a lower management fee for most index funds than you would for actively managed funds. For those investors who want to minimize management fees as well as the risk of underperforming the market, index funds can be an attractive choice.

Whether the market rises or declines, the index investor can expect a return that is in-line with the market—no less, and no more.

Making your decision

Both mutual fund approaches—active and passive—are viable. Which you use depends on your investment goals and risk tolerance. Consider working with an advisor who can help you select the best mutual funds for your portfolio. TIAA-CREF Advisors can help you determine which approach or combination of approaches may be right for your portfolio.

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