

THE EXPENSIVE ACTIVE MANAGERS' DILEMMA: HURDLING IN THE SAND

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It's not easy managing a big-fee mutual fund. Last August, in *Active Share: Measuring Stock Picking among Your Strategies*, we discussed the [interrelationship between the uniqueness of a fund's holdings and its expense ratio](#). Unlike "closet indexers," who hug their benchmarks while claiming to implement great investment ideas, truly [active managers](#)¹ have the courage of their convictions. They have high active share, which measures the proportion of the fund that is different from what is in the benchmark.

Many fund managers, having witnessed years of flows into [passive, cap-weighted](#) indexes, realize that the jig is up on charging lucrative fees for mirroring the benchmark, so they are making bolder calls out of business necessity. A problem is that, for many, bold investing still can't overcome the obstacle of fee structures stuck in a time warp. Even high-[tracking-error](#) funds are left sprinting on sand while the competition laces up for solid-surface running.

Our 500

Our answer to the [S&P](#), the [WisdomTree U.S. Earnings 500 Index \(WTEPS\)](#), modifies capitalization weighting by focusing on each company's proportional piece of society's total earnings. If corporate America earns \$500 billion in aggregate, and XYZ Corp. earns \$10 billion of that pie, the company is 2% of our Index. As investors learn that [cap weighting is our industry's accident of history](#), active fund managers find themselves going head-to-head with [modern alpha](#) ETFs like the [WisdomTree U.S. Earnings 500 Fund \(EPS\)](#), which tracks WTEPS.

Sand Runner Screens

Using the Zacks Investment Research fund screener, we find 378 U.S. [large-cap](#) blend funds with an expense ratio of 1% or more. Of those, 10 have more than \$2 billion under management. Figure 1 shows the difference in holdings, measured by active share, between those funds and EPS, our 500 stock ETF.

The funds have median AUM of \$3.3 billion and high active share to EPS of 78%, so only 22% of their exposures are the same as what is inside our ETF. In fact, their active share to the ETF ranges from 67% to 94%, meaning that every single one of them is materially different from EPS.

Figure 1: Active Share & Hurdle Rate, Expensive Mutual Funds

Fund Name	Median AUM (\$mil)	Median Expense Ratio	WisdomTree Expense Ratio	Funds Excess Expense Ratio	Active Share to EPS	Annual Hurdle Rate
Ten Fund Median	\$3,277	1.06%	0.28%	0.78%	78.0%	1.00%

Sources: WisdomTree, Zacks Investment Research, Bloomberg. Active shares as of 7/27/2018 from Bloomberg, with a screen for large-cap blend mutual funds with >\$2bn under management and expense ratios above 1%. Active share concepts by Martijn Cremers and Antti Petajisto. Hurdle rate equals median fund expense ratio less WisdomTree ETF (ticker: EPS) expense ratio, divided by the active share to that ETF. In this case, hurdle rate = $(1.06\% - 0.28\%) / 78\% = 1.00\%$. Past performance is not indicative of future results.

A problem, of course, is that many of these funds are stuck in a prior era's fee paradigm. With expense ratios 78 [basis points \(bps\)](#) higher than that of EPS, the 78% of holdings that are different from the holdings of EPS need to really shoot the moon. Doing the division, those positions have a "hurdle rate" of 100 bps, the amount they need to outperform just so the fund's return can equal that of EPS, after fees.

Their 10,000 Friends

These 10 funds are not alone. There are another 368 large-cap core funds that are charging that kind of expense ratio; they just have smaller asset bases. In fact, open the Zacks database to all fund managers across all asset classes—stocks, bonds, commodities, and the rest—and you will find more than 10,000 funds that are charging 1% or more. Some will overcome that hurdle with skill, or luck. But many others are sprinting on beach sand.

For investors that understand these hurdles, a modern alpha ETF like EPS may be the angle for entire U.S. large-cap allocations. The choice is beach sand or a solid surface, and the fee is the decision maker.

¹Martijn Cremers, "Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity," 12/18/2016.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of EPS please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/eps>

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

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You cannot invest directly in an index.

DEFINITIONS

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Modern Alpha : Modern Alpha® combines the outperformance potential of active with the benefits of passive—to offer investor strategies that are built for performance.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Basis point : 1/100th of 1 percent.