

CHALLENGING CONVENTIONAL WISDOM

DO ACTIVE MANAGERS PERFORM BETTER IN INEFFICIENT MARKETS?





“Investments in emerging market small-cap stocks are consistent with (our) timetested philosophy of investing in overlooked and under-researched companies...We believe this greatly unexplored asset class provides a substantial opportunity for us to apply our vast global research capabilities.”¹

—GLOBAL INVESTMENT MANAGER

“Our in-depth, bottom-up stock selection process is designed to exploit inefficiencies inherent in the small-cap market.”²

—FINANCIAL SERVICES COMPANY

1. www.franklin-templeton.com, Fund Fact Sheet 12/31/08, accessed on 3/31/09.

2. www.oppenheimerfunds.com, “An Investor’s Guide to Oppenheimer Funds,” 12/31/08, pg 8, accessed on 3/31/09 .

Why challenge conventional wisdom?

The statements prior are examples of ones frequently made by investment managers. In fact, they illustrate an often-stated claim in the financial services industry: active (as opposed to index) mutual fund managers investing in so-called “inefficient” markets have an easier time outperforming an index.

Conventional wisdom states that these managers have special insight into these markets, which allows them to pick winning stocks over and over again. That translates into higher returns in their funds—and justifies the high fees they charge.

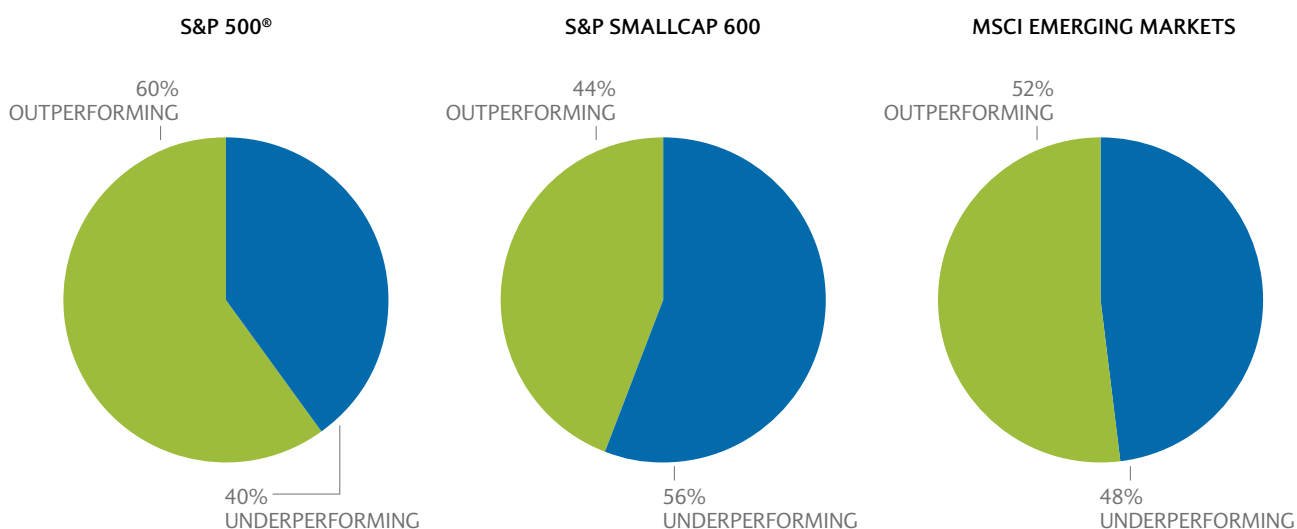
Problem is, the data doesn't support the claim. In fact, beating an index is just as difficult in an “inefficient” market as it is in any kind of market. There certainly are skilled mutual fund managers who perform better than an index, but not simply because they happen to be invested in any particular asset class.

What is market “inefficiency”? And what does that mean for fund managers?

What exactly are “inefficient” markets? Finance experts use the term to describe markets where basic information about companies may not be available to investors. For example, many small-cap, international, and emerging market companies are not widely followed by analysts or other investment professionals in the United States (in contrast to most large-cap U.S. companies).

This means stocks that are over- or undervalued can go unnoticed for some time, which translates into more opportunities for active managers to outperform the index. But because less efficient markets have greater volatility—they have higher highs and lower lows—it also means larger consequences if the manager is wrong.

FIGURE 1
10-Year Annualized Return Comparison for Active Managers vs. Category Benchmark



Sources: BGI, Morningstar, MSCI Inc., S&P, as of 12/31/08. Data is based on the oldest share class of active open-end mutual funds to avoid double counting of multiple share classes.

Past performance is no guarantee of future results.

» Large numbers of active managers have underperformed their respective indexes across a number of asset classes.

And it's not enough for such "mispricings" to simply exist. Investment managers still need to find them before others do. While some truly skilled managers can take advantage of more opportunities in these markets to beat an index, not all of them can.

Looking at the record

The fact that there is no magic wand in inefficient markets when it comes to stock selection, and thus manager selection, is supported by the actual record of active mutual fund managers investing in those markets.

Figure 1 shows the percentages of active managers—in both efficient (S&P 500) and less efficient (S&P Small-Cap 600, MSCI Emerging Markets) markets—out- or underperforming their respective indexes for the last 10 years.

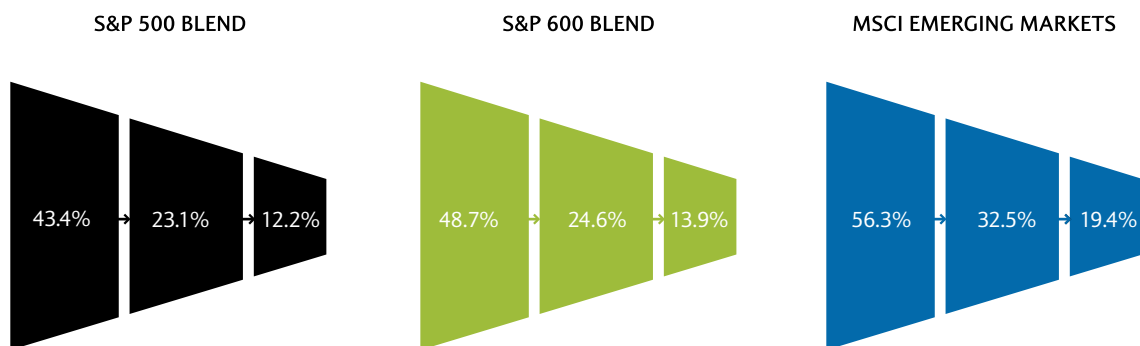
Clearly, some managers may have skill in identifying mispriced securities in less efficient—or efficient—markets, but most do not. And it is important to remember that fees in less efficient markets are generally higher, making it even more challenging for an active manager to outperform an index in this environment.

Even if a manager beat an index in a particular year, how do we know if he or she was truly skillful, or simply lucky? Perhaps they made the right stock picks, but for the wrong reasons. If so, it is doubtful their luck will last for very long.

Indeed, as Figure 2 illustrates, the chance of a manager's continued outperformance falls dramatically for each subsequent year across all three asset classes.

FIGURE 2

Persistence of Skill—active managers outperforming their respective benchmarks in consecutive years.*



Sources: BGI, Morningstar, MSCI Inc., S&P, as of 12/31/08. Data is based on the oldest share class of active open-end mutual funds to avoid double counting of multiple share classes.

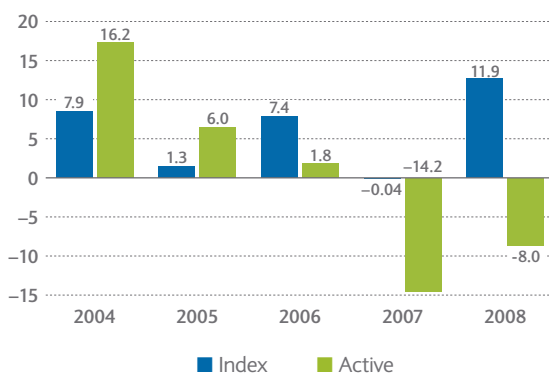
Past performance is no guarantee of future results.

* Average for the period 12/31/93-12/31/08.

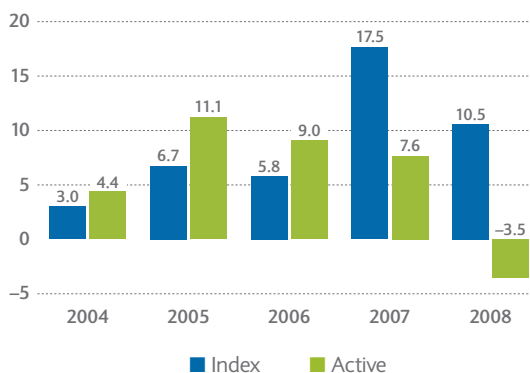
» The chance of continued active manager outperformance falls dramatically each subsequent year across all three asset classes.

FIGURE 3
Index and Active Funds: Net New Assets (\$B) per Calendar Year

U.S. SMALL-CAP FUNDS



EMERGING MARKET FUNDS



Sources: BGI, *Strategic Insight*, as of 12/31/08.

The indexing solution

An index is intended to represent a given market or market segment. It can be as broad as the entire U.S. stock market, or as narrow as a single country or industry. And numerous indexes exist for inefficient markets.

Index-based investing offers several benefits, including typically lower costs than most active management strategies and benchmark tracking performance. In addition, index funds are broadly diversified since they typically hold all or almost all of the securities within the index. This “instant” diversification helps reduce portfolio risk.

As Figure 3 illustrates, more and more investors are turning to indexing as a more precise, less expensive way to access particular asset classes, including “inefficient” ones.

Conclusion

Although good active managers exist, identifying them in advance is challenging. More importantly, given the uncertainty that will always surround performance of even the best active managers, it makes sense to use them in combination with index funds to more effectively manage risk within a portfolio.

But finding the right balance of index and active funds for your particular investment needs and goals can be very difficult. That’s why it is smart to seek the help of a financial professional. A financial professional can help you navigate the investment process by focusing on the right blend of investments for your needs—while steering clear of the conventional wisdom.

For more information:

WWW.ISHARES.COM

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In addition to the normal risks associated with investing, international investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Investments in smaller companies typically exhibit higher volatility. Diversification may not protect against market risk.

The strategies discussed are strictly for illustrative and educational purposes and should not be construed as a recommendation to purchase or sell, or an offer to sell or a solicitation of an offer to buy any security. The information provided is not intended to be a complete analysis of every

material fact respecting any strategy. The examples presented do not take into consideration commissions, tax implications, or other transactions costs, which may significantly affect the economic consequences of a given strategy.

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