Morgan Stanley: It's Tough To Beat The S&P 500 And This Is Why

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It's no secret that active managers have struggled to outperform in the past five years while the S&P 500 and other benchmark indexes have seen big gains.

According to a Bloomberg report earlier this year citing Morningstar data, **just 20 percent of mutual funds that pick U.S. stocks beat their main benchmarks in 2014, while 21 percent topped the indexes in the five years ended December 31.** (If you widen the time frame out to 10 and 15 years, the winners do rise to 34 percent and 58 percent, respectively.) Unsurprisingly, investors have thus moved money to low-cost funds that mimic indexes.

So why is beating the benchmark seemingly so hard for the people who are paid to do so?

Morgan Stanley released a note this morning from a team led by Adam Parker with a few possible explanations.

One of the main reasons is that when the S&P 500 removes a company and adds another, the new firm tends to be an outperformer:

The median stock removed from the S&P 500 has negative earnings growth in the preceding three- and five-year periods. The earnings growth of the companies added to the index was not only much superior to the companies removed but also much higher than those companies already in the index.

The note goes on to say that this causes a very important bias in the overall index.

This causes a substantial, structural upward bias to the earnings growth of the S&P 500 index. We decided to compare the earnings growth of companies in the S&P 500 that were in the index the previous year, each year – the so-called "apples to apples" growth rate – to just the index level growth rate. We looked at the difference in the year-on-year earnings growth rate of the S&P 500 using all the stocks in the index vs. the growth rate of the index excluding the new entrants. The median annual gap is 1.2%, and the index has beaten the "apples to apples" companies for eight straight years.

This leads to the question of why the firms added were outperformers. Parker and his team have this reasoning:

Why is there an almost permanent gap in earnings growth between the overall index and apples to apples companies? Because the new companies that are added to the index typically have much higher margins than both the companies removed and the surviving constituents … with faster prior revenue and earnings growth, and higher margins, the stocks added to the index typically have performed much better over the few years before their inclusion.

Thus, Morgan Stanley's advice to active managers is to avoid firms in the S&P 500 that have "poor [earnings per share] growth, very low margins and negative price momentum" like Apollo Education and Energizer Holdings.

Instead, you should look at firms outside of the index with the exact opposite features. Morgan Stanley says these include Sonic, Madison Square Garden and Illumina.