

HIGH COUNTRY Business Review

EAGLE & SUMMIT COUNTIES' SOURCE FOR ALL THINGS BUSINESS

MARCH 2006, PGS. 21–22

Passive Asset Class Investing Points to Success for Investors

Publication title: **Active or passive? The path to success for investors**

Investors are inundated by Wall Street and the financial press with exhortations over what will be the next hot stock or who is the best fund manager. With much to gain, Wall Street marketers appeal to “active” investors. At the same time, much quieter voices from the academic community support a “passive” approach. Where does the evidence point?

Active investors, through security selection and market timing, try to “beat the market” to achieve a rate of return greater than the benchmark for the particular category of investment, such as large-cap domestic stocks, where the standard is the familiar S&P 500 index.

Passive investors, on the other hand, believe it is difficult—if not impossible—to beat their benchmarks by an amount greater than the costs of engaging in the active strategy. Costs of research and commissions can subtract from 1–3% annually from returns, imposing a daunting headwind against the possibility of achieving success as an active investor.

Passive investors also do not believe they can identify, in advance, managers who are likely to outperform. So passive investors engage in “indexing” or other low-cost passive strategies, being satisfied to earn benchmark returns.

The decision—to index or not—is a threshold question and all investors must answer it as part of an overall strategy and must be made prior to committing funds to strategy execution.

Summary: Passive vs. Active

Based on the nobel-prize-winning development of modern portfolio theory, passive investing strategies may give investors the edge. Some academic research backs this approach, but investors must diligently diversify and rebalance as a part of their strategy.

Investment managers are not beating the market; the market is beating them.

—Charles Ellis
Winning the Loser's Game, McGraw Hill, 2002



Steven R. Smith, JD, CFP® is the principal of RightPath Investments & Financial Planning, Inc., a “fee-only” Registered Investment Advisory firm in Frisco, Colorado. Steve may be contacted at 970-668-5525 or steve@rightpathinvestments.com.

Specific firms mentioned are illustrations only and are not recommendations. Past performance does not guarantee future results.

This article was published by the *High Country Business Review*.

877.481.7110 • www.rightpathinvestments.com
Your Way to Prosperity

Nobel Prize Winning Theory

Passive investing claims its origins in the “efficient market hypothesis” (EMH), a component of the academic disciplines which make up modern portfolio theory (MPT). In 1990, the founding fathers of MPT, Harry Markowitz and William Sharpe, earned a Nobel Prize in Economics for their efforts, which began in the early 50’s.

EMH suggests that securities pricing information is disseminated and absorbed by the market virtually instantaneously, making it nearly impossible for investors to consistently exploit such information in their security selection.

According to EMH, your broker’s recommendation that Microsoft is “undervalued” at \$27 per share is unfounded because the millions of shares exchanging hands at that price on a given day reflect all the information that is currently available. The market’s determination that MSFT is worth the established price is the very best approximation of its value.

Accordingly, it is inherently risky and costly to attempt to beat the market by assembling portfolios of a selection of stocks.

Research Backs Passive Investing

Following the early academic work, subsequent research has supported EMH by demonstrating that most active portfolio managers—whether of pension funds, mutual funds or individual investors—have consistently failed to outperform their benchmark indexes. In a recent study, “Chasing Top Quartile Performance,” the Center for Fiduciary Studies (www.fi360.com) determined that from 2000 to 2004, only 57 out of 5,080 surviving mutual funds (1.1%) remained in the top quartile.

Occasionally, we learn of hot managers, but always after the fact. Such managers create the seeds of their own destruction by attracting assets and diluting their best ideas. And contrary to popular belief, indexing works as well in small cap and emerging markets asset classes—the “inefficient” markets—because trading in these markets carries even higher costs to surmount.

The Virtues of Asset Allocation

Passive investing permits investors to use the winning strategy of globally broad diversification among and within asset classes, such as domestic stocks, international stocks, real estate and bonds.

Wall Street marketing suggests that proper diversification can come from a few dozen or a perhaps a hundred securities in your portfolio. The research maintains that a genuine asset allocation strategy, however, can only be accomplished by using low cost, passive mutual funds, each containing hundreds, if not thousands, of securities.

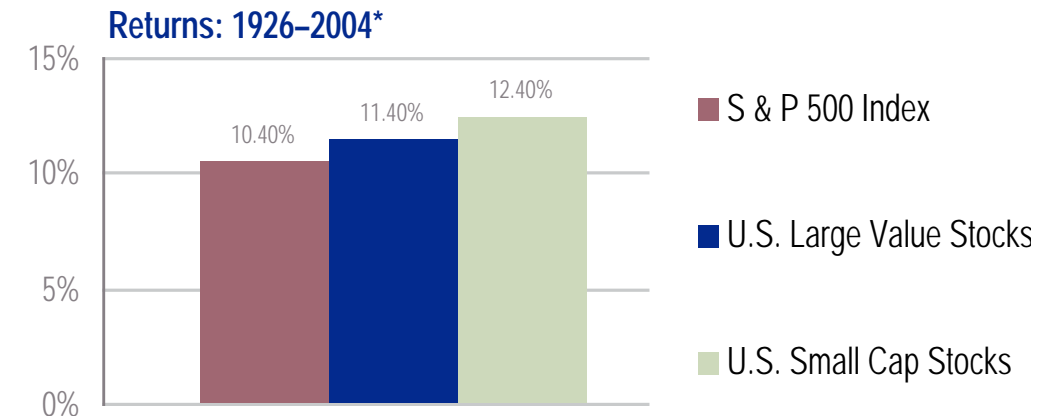
The academic research has also shown that by tilting your portfolio toward value stocks—those that the market disfavors—and small stocks, returns can be increased on a risk adjusted basis (see chart below).

Implementing a Passive Strategy

Investors have a number of tools at their disposal for implementation of a passive asset class investment strategy. Vanguard Group (www.vanguard.com), one of the leading providers of index funds, sponsors such funds in a multitude of asset classes. Dimensional Funds Advisors (DFA, www.dfaus.com), who practice a refined form of passive investing with distinct advantages over indexing, is another highly re-

spected shop. And, the emerging world of Exchange Traded Funds (ETF's) gives investors an increasing number of good, low cost choices.

Investors should also be mindful of the critical importance of rebalancing their portfolio, which forces a "buy low, sell high" discipline.



*** Source: Dimensional Funds Advisors, Fama-French Three Factor Model.**

Results

Longer term data strongly support the benefits of passive asset class investing. Ironically, index funds have consistently outperformed the average mutual fund over the long term. While data from only one year is merely anecdotal, 2005 was a good example of the value of global diversification. The S&P 500 Index—with dividends reinvested—rose 4.91%. By contrast, the Dow Jones Aggressive Global Portfolio Index—which, with some effort, can be largely replicated by ordinary investors using index funds—rose 12.09%.

As Rex Sinquefeld, the inventor of the index fund and co-founder of DFA, once said, the only people who continue to deride the power of efficient markets are active managers and socialists.