Top Ten List: Why Passive Investing Wins

SUMMARY:
Too often the active vs. passive investing debate focuses only on performance. While research shows passive strategies generally outperform their active counterparts, there are additional reasons why passive investing is a more effective approach to managing wealth. We list the top ten.

JULY 2008
Value Added Indexing℠

1: The effective use of leading edge passive investment strategies based on academic research. 2: A wealth management approach offering superior long-term performance, consistency, broad diversification, low cost, and tax efficiency. 3: A disciplined investment experience grounded in research and planning rather than following predictions, emotions or trends. 4: The Rappaport Reiches Capital Management solution.

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Passive investing is an investment approach that looks to match, not beat, the return of a particular area of the capital markets. This is accomplished through buying and holding all (or substantially all) of the securities that comprise the particular market. Indexing, the most common form of passive investing, refers to the strategy of matching a specific market index or benchmark, such as the S&P 500¹.

Active investing is an attempt to outperform the returns of the market through ongoing buying and selling of securities thought to be “mispriced” and/or timing purchases and sales based on predicted market price movements.

Performance is the common reference point in the debate over which approach is superior. After all, it’s the most tangible and easiest to understand. Did your fund “beat” the market?

However, focusing exclusively on performance ignores the larger issue – why taking a passive approach is a more effective solution in meeting long-term goals. So we’ll start with performance, and then expand the debate.

**THE TOP TEN REASONS PASSIVE INVESTING WINS…**

10: **Superior long-term performance**

A preponderance of research into money manager performance shows that most active money managers consistently fail to beat their benchmark index over time. A small and constantly changing percentage of managers will outperform; however, it is very difficult to identify these managers in advance. Furthermore, research shows they are no more likely to outperform again.

Professor Burton Malkiel, author of *A Random Walk Down Wall Street*, recently remarked that for the 20 year period ending 2006, the S&P 500 index beat roughly 90% of active managers. Funds that beat the index during one 10-year period were not the same ones that beat it during the next 10-year period.²

Diversified portfolios hold a variety of asset classes, including municipal and taxable bonds, large and small company stocks (from U.S., international, and emerging markets) and real estate securities. The likelihood of predicting the small number of managers and funds that will outperform – in each asset class – is low. The effort is ultimately unproductive. Passive investing – accepting the “average” return of the market – is the superior performing strategy.

9: **Low costs**

Minimizing costs is crucial to achieving long-term investment success. Costs, unlike market performance, are one of the few areas that investors can control.

Every dollar paid for management fees and trading costs (including commissions, bid/ask spreads and market impact) directly reduces returns.
Studies have shown that a fund’s expense ratio was the most reliable predictor of its future performance, with low-cost funds delivering above-average performance.3

Passively managed funds typically have much lower fees and transaction costs than actively managed mutual funds because they do not need to pay for expensive research and trade much less frequently.

How big is the cost differential? A recent study shows that for U.S. stocks, index funds were about 0.60% (large cap stocks) to 0.80% (small cap stocks) less expensive on an asset-weighted basis. The conclusion: contrary to the typical economic relationship between price and value, higher costs do not lead to higher returns.4

8: Tax efficiency

Taxes can be one of the biggest drains on long-term performance. Most active mutual fund managers do not consider the tax consequences of their trading because they are judged on their pre-tax returns. The annual turnover (the rate of trading activity) of the average actively managed large cap U.S. stock fund is approximately 90%.5 Such high turnover can lead to higher tax liabilities.

Passively managed funds, with their buy and hold philosophy, trade much less frequently. A broad-based index fund’s turnover is about 5% to 10%. The result is modest realization and distribution of capital gains, the bulk of which are taxed at lower long-term rates.

7: Applicability to any asset class

While passive investing is most commonly associated with large-cap indexes such as the S&P 500, the strategy can be easily applied to practically any asset class. Passive and index funds are available for a variety of capital market areas ranging from conservative fixed-income to emerging markets small cap stocks. Even less traditional portfolio components such as real estate, commodities, and inflation-protected bonds can be indexed. The benefits of passive investing apply to these areas as well.

For example, conventional wisdom holds that the market in small cap stocks is “inefficient” and can be consistently exploited by skilled managers. Research shows this traditional thinking is misplaced. The same characteristics that make indexing a powerful strategy among large- and mid-cap stocks (above-average performance, relative predictability of returns) work to investors’ advantage in small-caps as well.6

6: Broad diversification

Passive investing is an ideal strategy to achieve broad diversification, a critical element of long-term success. Passive funds generally hold most or all of the securities in their target indexes. An actively managed fund typically holds a much smaller selection of securities.

According to Morningstar, the average actively managed U.S. large-cap stock fund held 118 securities as of year-end 2006. By comparison, the average U.S. large-cap stock index fund held 664 securities.7 The added diversification provided by passive funds can reduce the risk of a dramatic decline in any one security or economic sector.

5: Predictability

Financial planning is based on modeling the returns and risks inherent in various asset classes and how they perform in combination. The use of passive or index funds allows investors to be more precise in realizing the portfolio characteristics assumed by their plan.

Active fund managers can take on more or less risk than expected, underperform their benchmarks, or drift from their stated style. The returns can then deviate significantly from those predicted by the plan. Passive and index funds are predictable and consistent in delivering the returns of their underlying asset classes.
4: Ease of understanding
Evaluating proposals by various financial advisors and brokers can be overwhelming. While research shows few actually beat the market, every sales presentation seems to offer a combination of market-beating strategies by “best-in-class” managers. The research and portfolio construction process of active management is often complicated and lacks transparency. Attempting to evaluate all the different approaches can be frustrating. Even the salespeople themselves are often not fully knowledgeable about each component in a diversified portfolio.

A passive approach avoids needless complexity and offers a straightforward, understandable solution. Investors know what they own and can make more-informed decisions.

3: Discipline in implementation
Maintaining discipline (sticking to a long-term plan) is extremely challenging for many investors. Average investors do not receive the long-term market rate of return because they are constantly buying at the top and selling at the bottom – moving from funds that are unpopular to those that are in favor.

Chasing prior performance and following trends is not an effective strategy. Implementing a financial plan through passive funds is a disciplined approach that avoids these value destroying behaviors.

2: Meets fiduciary responsibilities
Investors who serve as trustees have added obligations as fiduciaries. The law governing the investment activities of trustees of private trusts in most states is the Uniform Prudent Investor Act. The Act also has a bearing on fiduciaries responsible for retirement plans, foundations and endowments.

The Uniform Prudent Investor Act obligates trustees to carefully consider investment costs, taxes, and

“Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees.”

Warren E. Buffett
Chairman and CEO, Berkshire Hathaway, Inc.
1996 Annual Report, Chairman’s Letter

diversification. Employing a passive approach is often viewed as the default standard in meeting these requirements.

Additional support for passive investing is found in the Third Restatement of Trusts, published by the American Law Institute. The Restatement mandates that trustees consider the efficiencies of passive strategies. “The greater the trustee’s departure from one of the valid passive strategies, the greater is likely to be the [trustee’s] burden of justification [for choosing another strategy].”

AND THE #1 REASON WHY PASSIVE INVESTING WINS...

1: Less stress
Investing, by nature, is stressful. Stocks are volatile and performance is uncertain. Even with a long-term focus, results are still available every day the markets are open for trading.

Active management adds tension. Constantly evaluating performance, hiring and firing managers, buying and selling funds, and listening to excuses or explanations produce unneeded anxiety.

A passive approach cannot eliminate all the stress that comes with investing, just the portion that is unnecessary. Less stress—that’s a return from your investments worth pursuing!
Sources

1 The S&P 500 is an unmanaged market capitalization weighted price index composed of 500 widely held common stocks listed on the New York Stock Exchange, American Stock Exchange, and OTC/NASDAQ markets. The index includes dividend reinvestment.


4 Vanguard Investment Counseling and Research: The Case For Indexing (2007)

5 Morningstar Principia Mutual Fund Database 12/31/03 (excluding Index Funds).

6 Vanguard Investment Counseling and Research: Evaluating Small Cap Active Funds (2007)

7 Vanguard Group: Learn About Indexing (2007)

8 The American Law Institute, Restatement of the Law Third, Trusts – Reporter’s Notes Section 90 (Prudent Investor Rule), comment h (2007)
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