

THE CASE FOR PASSIVE PORTFOLIO MANAGEMENT



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The Case for Passive Portfolio Management

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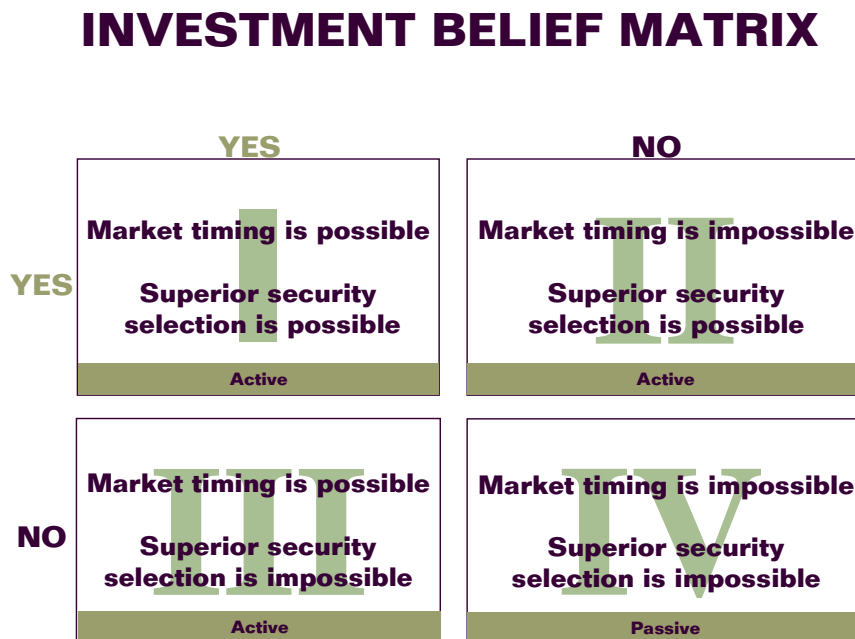
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The Case for Passive Portfolio Management

Introduction

All approaches to investing can be divided into two broad categories – active and passive. The proponents of each have dramatically different beliefs about the way capital markets behave.

All investors must settle on a belief about market timing and security selection. The matrix below shows the four possible beliefs:



Source: Roger Gibson, *Dow Jones Investment Advisor*, March 1996

- I. Both market timing and superior security selection are possible.
- II. Market timing is impossible, but superior security selection is possible.
- III. Market timing is possible, but superior security selection is impossible.
- IV. Both market timing and superior security selection are impossible.

Many individual investors fall into quadrant I. Most professional investment advisors fall into quadrant II. This position paper advocates quadrant IV as the most prudent approach.

Defining Active and Passive Management

Active investors (quadrants I, II and III) believe there is a constantly changing set of investment opportunities that can be captured by skillful investment managers. They buy and sell securities through market timing and stock picking to capitalize on these perceived opportunities.

Passive investors believe there is a relatively constant relationship between risk and reward that can best be harnessed by using a consistent strategy over time. They do not engage in market timing or stock picking. Instead, passive managers seek to own a large basket of securities in pre-defined asset classes. They may be active in controlling costs, controlling taxes and rebalancing. But they are passive with respect to market timing and stock picking.

Active Management is a “Zero-Sum” Game

In active investment management, successes and failures exactly offset each other. For every active investor who wins, there will be one who loses. And, since active management is costly, the average return of all active investors will be less than the average return of all passive investors. There is no debate about this point among knowledgeable investors in either camp. It is a mathematical fact.

The ongoing debate is over whether skill or luck divides the winners from the losers in this “zero-sum” game. Active managers with good performance believe it is due to skill; active managers with bad performance believe they are skilled and they are victims of bad luck. But it doesn't matter whether performance is the result of skill or luck – the real issue is whether the winners can be predicted in advance.

There is no Empirical Evidence that Active Portfolio Management Skill Exists

Clearly, some active managers with good performance can thank luck for that performance. Academic evidence goes beyond that and suggests most - if not all - of the performance results from luck.

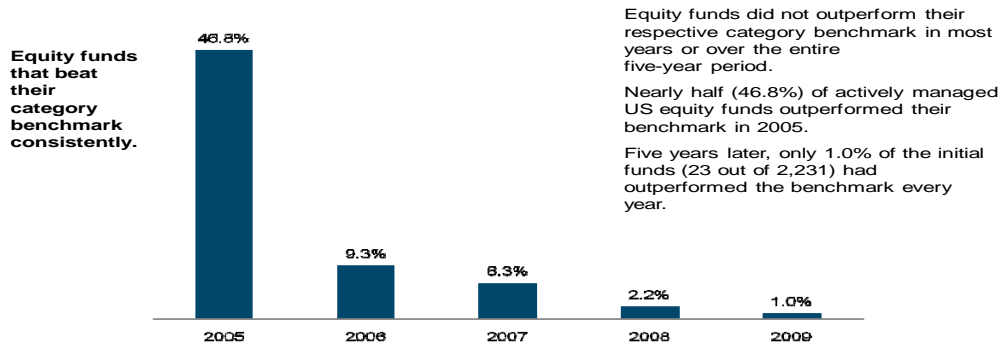
Here is a sampling of the numerous and ongoing studies demonstrating the inability of active managers to beat the market:

- Princeton University economist Burton Malkiel examined the results of an investment strategy based on mutual funds selected in the *Forbes* magazine's annual "Honor Roll" survey. He found it underperformed the S&P 500 index by 1.38% per annum for the sixteen years ending 1991.
- Lipper Analytical Services studied fund results from 1990 - 1994 and determined that performance of funds with five-star ratings from Morningstar, Inc., was not statistically different in the subsequent year from the average equity fund.
- Professor Mark Carhart of the University of Southern California conducted one of the most comprehensive surveys of mutual fund performance. He assembled a database tracking 1,892 funds over a 32-year period ending December 1993. (Roughly one-third of the funds had ceased to exist by 1993, and only 5% existed for the entire period, indicating the magnitude of the problem when researching historical fund performance.) He concluded: "The results do not support the existence of skilled or informed mutual fund portfolio managers."
- Dimensional Fund Advisors prepared this illustration showing that only 1% of active funds outperformed their benchmark every year for five years.

Few Consistent Equity Fund Winners

Actively Managed US Equity Funds
2005-2009

S1165.2



Data provided by CRSP Survivor-Bias-Free US Mutual Fund Database. Sample includes mutual funds existing as of 12/2004. Returns analyzed for the five-year period from 2005-2009. Multiple share classes are aggregated to fund level. Index funds, inverse funds, and leveraged funds are excluded.

A benchmark is a standard against which the performance of an individual security or group of securities is measured. It is usually based on published indexes of securities of the same or similar class. However customized ones may be used to suit a particular investment strategy. Past performance is not a guarantee of future results. Values change frequently, and past performance may not be repeated. There is always the risk that an investor may lose money.

It doesn't matter what causes winners to be winners and losers to be losers if you can't predict results in advance. Winston Churchill said, "The greatest lesson in life is to know that even fools are right sometimes."

Investors, however, have a hard time accepting that active managers can't beat the market - hope springs eternal! It's like Garrison Keillor's characterization of Lake Wobegon, where all the children are "above average." Or automobile drivers, 80% of whom, according to a survey, consider themselves to be "above average" drivers. It can't be so!

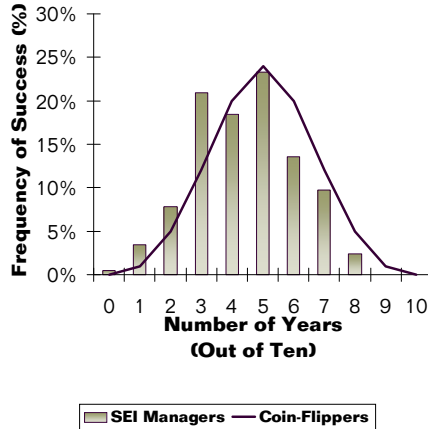
But what about Peter Lynch? He managed the Fidelity Magellan fund and *did* beat the market, even after adjusting for risk factors. Wrong question. The better question to ask: Why aren't there more active managers with a track record like Peter Lynch?

What about Bill Miller who manages Legg Mason Value Trust? From 1991 through 2007 the fund outperformed the broad market every year (a winning streak that no other fund manager has come close to matching). Then, in 2008, it dramatically underperformed the S&P 500, wiping out nearly 20 years of market-beating performance and was one of the worst performing in its asset class for the prior one, three, five and 10-year periods.

The graph on the following page illustrates the percentage of investment managers in a well-respected database that beat a simple benchmark of the S&P 500 plus 1%. (One percent was added to reflect fees charged by the managers because the results were tabulated before fees.) The green bars indicate what percentage of the managers in the database beat the benchmark for the number of years out of ten years. The purple line illustrates what we would expect by coin flipping, i.e., a random outcome.

Note that there are fewer winners and more losers than we might expect by chance. In other words, we would expect to see more managers beat the market (if only by luck), and we actually see fewer!

Active Managers Who Beat S&P 500 +1% compared to Coin Flipping



- ▶ Active managers' performance is worse than expected by chance, once management costs are included.
- ▶ Once costs are included, too few managers consistently outperform the S&P 500 and too many managers consistently underperform the S&P 500.

Source: SEI Corporation

The Results of Passive Portfolio Management are Above Average

Successful people have a hard time letting go of the desire to be among the winners. We hire experts in other areas of our life, so why can't we do it when it comes to investing? Passive investing sounds like accepting mediocre results and seems to eliminate the possibility of spectacular results. However, the cost advantages alone cause passive investors to outperform active investors 75% of the time. Passive investing is not accepting mediocre results – it is a more reliable way of achieving above average results.

The average avid golfer carries about a 20 handicap. If you play golf, ask yourself if you would agree to have a handicap of 2 if you had to accept that you would never again record a hole-in-one or even a birdie. Passive investing is a similar proposition. Perhaps you wouldn't make that deal in golf, but you play golf for fun. Your portfolio strategy may determine whether you can afford to play golf in the future.

Passive Investing is Safer and More Reliable than Active Investing

You must decide whether you invest to achieve future economic objectives or whether you invest for entertainment. Many people invest at least in part for that reason. If that is your purpose, you have

a legitimate motive to pursue active investing for at least a portion of your portfolio. It is much more thrilling entertaining than passive investing. You will have big winners and big losers. You will have interesting reasons for investing in this or that. You will be able to discuss market forecasts and hot stocks and have great stories to tell. Releases of quarterly economic data will be of interest to you.

But if you want to maximize the probability of achieving your financial goals, then passive investing is the clear choice. Not only does passive investing yield a higher return and have significantly lower costs, but it does so at a dramatically lower risk. Active investors will dispute this point. They often cite safety as an advantage of active investing due to the fact that they accumulate cash or take other defensive positions from time to time. Remember, active investing is a “zero-sum” game. For every active investor who accumulates cash or takes a defensive position at the *right* time, there will be one who does it at the *wrong* time.

In order for active investors to offset their trading costs and commissions, they must have higher returns. This can only be achieved by taking concentrated investment positions, which results in additional risk. Concentrations of risk come in several forms:

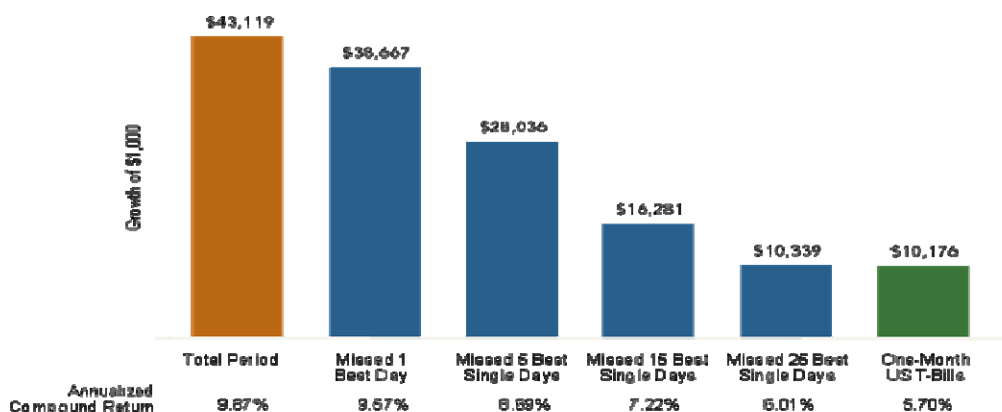
- Heavily weighting dollars to a few purported hot stocks
- Going from equities to cash in advance of a predicted market downturn then from cash to equities in advance of a predicted market upturn
- Weighting dollars to one or two sectors of the market that the active manager predicts will be the next area of the market to boom

Some active investors claim to mitigate their risk through diversification. In doing so they eliminate the possibility of achieving the above average returns they are seeking through active investing. Broadly diversified active investors are simply expensive passive investors. Passive investing is the only reliable approach to broad diversification.

Active investing through market timing is a risky way of increasing returns and has a low probability of success. The following chart illustrates the risk of missing just a few of the “up” market days, leading some to the conclusion that the risk in the stock market does not result from being in the market when it goes down. Rather, the risk is being out of the market when it goes up because the advances are often very extreme.

Performance of the S&P 500 Index
Daily: January 1, 1970-December 31, 2009

01990 0



Performance data for January 1970-August 2008 provided by CRSP; performance data for September 2008-December 2009 provided by Bloomberg. The S&P data are provided by Standard & Poor's Index Services Group. US bonds and bills data © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefeld). Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Dimensional Fund Advisors is an investment advisor registered with the Securities and Exchange Commission. Information contained herein is compiled from sources believed to be reliable and current, but accuracy should be placed in the context of underlying assumptions. This publication is distributed for educational purposes and should not be considered investment advice or an offer of any security for sale. Past performance is not a guarantee of future results. Unauthorized copying, reproducing, duplicating, or transmitting of this material is prohibited.
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Everybody Wins with a Passive Portfolio Strategy

Passive investing in one form gained popularity in the late 1990s. Many actively managed mutual fund families added an S&P 500 stock index fund. This was not due to enlightened thinking about passive investing. It was just chasing returns and money flow because the S&P 500 stock index produced unusually high returns in the mid to late 1990s.

There was a time when you could not achieve a well-diversified portfolio by using mutual funds. But now, every major asset class can be captured passively and portfolios can be engineered to have the desired exposure to various risk factors such as small stocks, value stocks, international stocks, etc. Harnessing the returns of these asset classes efficiently is the key to successful long term investing,

not beating the market. These asset classes produce much higher returns than most investors achieve.

While the record of active managers is not impressive, the record of individual investors is even worse. By chasing the mutual funds with good performance, individual investors achieved results even worse than the average actively managed fund. And, both are worse than the average passive fund.

As an example, CGM Focus was the best performing mutual fund from 2000 through 2009, generating an average return of 18%. Unfortunately, the dollar-weighted investor's experience was negative 10%. This was a fund that had market-beating returns followed by significant troughs. Investors flocked to the fund following a stellar period just in time to experience a devastating loss. They then left the fund at the bottom only to miss the next peak.

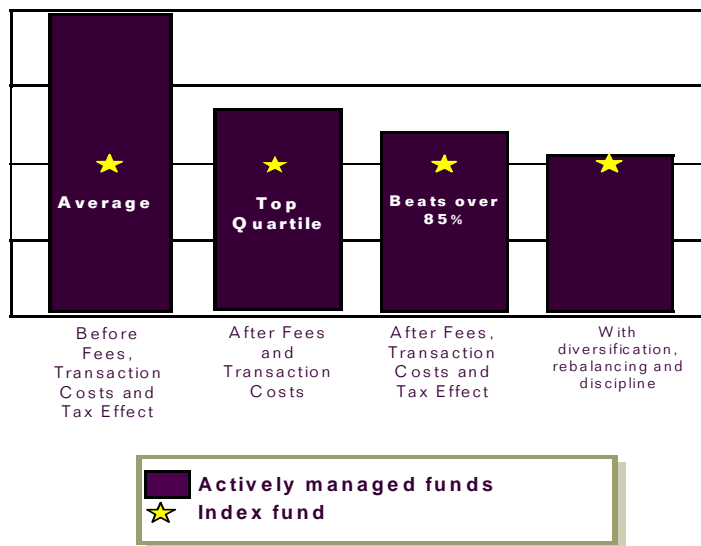
Morningstar® conducted a study of 199 no-load growth mutual funds for the period 1989 to 1994. The average total return for the funds was 12.01%. However, the individual investors during that same time period earned a total return of just 2.02%. Why? The individual investors held onto their funds for only 21 months. They were either trying to time the market or chase a hot fund. A similar study of stock mutual funds from 1984 to 1996 discovered that the average investor's return was 10% less than the average returns for the funds themselves.

DALBAR, Inc. publishes an annual study of investor behavior. For the twenty year period ended December 31, 2008, the study found that while the S&P 500 returned 8.35%, the average equity fund investor would have earned an annualized return of just 1.87%, which was less than the inflation rate of 2.89%. Bond investors fared no better. They earned returns of just 0.77% compared to 7.43% for the index. Part of the reason for this was the underperformance of active managers. The major difference, however, was that the average investor held a mutual fund for under three years. This is further evidence that investors chase the hot funds.

The Power of Passive

The following chart illustrates the power of passive investing after taking into account the fees, transaction costs, and taxes, coupled with diversification, rebalancing and discipline. It does not reflect additional strategies that could enhance returns such as tilts to small cap and value portfolios.

COMPARING AN INDEX FUND TO ACTIVELY MANAGED FUNDS



An index fund should be an average performer when comparing its reported return to the reported return of actively managed funds in the same investment category.

After taking into account the effect of fees and transaction costs on the reported return, the index fund becomes a top quartile performer, beating over 75% of all actively managed funds.

After taking into account the additional impact of income taxes, the index fund should beat over 85% of all actively managed large cap accounts.

Even more value can be added to an individual portfolio through diversification, rebalancing and discipline.

Institutional Investors are Moving to Passive Investing

Institutional investors have the least to gain by passive investing because they can bargain for lower fees from active managers, typically paying up to 2% less per year than individual investors. Despite the fact that institutional investors pay a lower percentage in fees, they pay a huge amount in dollar terms for active management because of their portfolio size. Therefore they are able to hire the best

talent in active management. Even so, institutional investors have been moving toward passive management for more than ten years.

In 1995, Intel fired all five of its active money management firms that had been picking stocks for its corporate retirement plans. They chose instead to invest \$1 billion in passive index funds.

In the summer of 1999, Phillip Morris USA, Inc. (now Altria Group) axed all of its active equity managers. The company had \$8 billion in its defined benefit plan utilized both active and passive strategies for some time. According to the company, the active managers significantly underperformed so they were all dismissed.

If institutional investors are moving to passive management, where the cost advantage is less than 1/2% and they are able to hire the very best of the active investors, why shouldn't individual investors do the same? The cost advantage for individual investors is usually more than 1% and can exceed 2% per year.

Passive Investing is Consistent with The Prudent Investor Act

The Uniform Prudent Investor Act (UPIA) has been adopted by at least 44 states plus the District of Columbia in some version and more states are expected to follow. Although the UPIA could easily be the subject of an entire paper itself, these major points are relevant here:

- A trustee who strays from the basic tenets of Modern Portfolio Theory (MPT) must carry a burden of persuasion as to the reasonableness of that approach. (MPT refers to the process of reducing risk in a portfolio through systematic diversification across asset classes and within a particular asset class. It assumes that all investors desire the highest possible returns while bearing the lowest amount of risk, and that capital markets are generally efficient.)
- The overall investment strategy should be based upon risk and reward objectives suitable for the trust.

- There is a duty to diversify unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify. The UPIA goes beyond prior law in requiring diversification across asset classes, not just within an asset class.
- Asset allocation is the trustee's principal responsibility
- Cost minimization is required

Passive investing fits the bill because it focuses on the factors deemed relevant by the UPIA – Modern Portfolio Theory, asset allocation, broad diversification and cost control. Active management either focuses on factors that are deemed not relevant by the UPIA (market timing and stock picking) or are much more costly than necessary. Trustees are on much firmer ground with passive investing.

Summary

Passive investors who pursue a consistent low-cost strategy over time reliably earn market returns and end up with performance exceeding the vast majority of the average investors. Active investors attempting to “beat the market” are the ones who risk losing in the long run. Certainly, some active investors will win, and some will win big. More, however, will lose and some will lose big. All passive investors win in the long run.

Active management is exciting, expensive and unpredictable. Passive management is boring, cost effective and reliable. Where would you like your financial future to lie?