The debate between active and passive[1] investing has been largely waged in the extreme. Proponents of active investing argue against pure indexing and proponents of passive investing argue against the most extreme active strategies. As in most things, the truth lies somewhere in the middle. Modern passive investing begins with the most valuable elements of indexing, adds practical procedures to convert from the textbook to the real world, uses active strategies to the extent they can be applied cost-effectively, and adds profit from making markets for thinly traded securities. By taking strategies from indexing, active management and trading, passive investing is the most reliably powerful, wealth-building strategy available to investors in the 21st century.

Centuries of Stock Trading

Archeologists excavating the ancient city of Aizanoi in western Turkey have found evidence of a stock market dating back to the second century AD. Some give France credit for developing the first stock market in the 12th century. Others give Antwerp, Belgium credit for creating the first stock exchange in 1490.

The first stock exchange that resembled those that trade securities today was the Amsterdam Stock Exchange, which was founded in 1602 to trade shares of the Dutch East India Company. The New York Stock Exchange was founded in 1792. The first Asian stock exchanges were formed in Bombay and Tokyo in 1875 and 1878, respectively. From these early beginnings, investors have faced the question of how to differentiate the “good” investments from the “bad” investments.

Many early companies, like the Dutch East India Company, raised capital to buy ships and hire crews to trade goods with other parts of the world. Perhaps early investors researched the ship captains to evaluate the risk of loss of ships and cargos at sea. Maybe certain trade routes were viewed as safer than others and investors considered such risks in their investment decisions.

Seeking the Highest Return

For centuries we have wrestled with the question of how to make money in the stock market. Every means of evaluating risk and forecasting return has been tried and retried – researched and debated. As early as the 1900s, the idea of random stock prices was discussed. Gene Fama proposed the idea of market efficiency in a paper published in 1965 and *A Random Walk Down Wall Street* by Burton Malkiel brought this idea to the public in 1973.

Computers and years of stock market data provided Fama and Malkiel the ability to evaluate the results of unmanaged indexes. Up until that time, stock market investors were satisfied with 5 or 6 percent returns when compared to earning 2 or 3 percent in bonds. Early analysis concluded that unmanaged indexes of stocks produced returns of as much as 9 percent. This result shocked investors and managers alike.

©RCG; All rights reserved

Managers were quick to point out that indexes were not real results – no practical means of investing in an index existed at that time. Indexes make no provision for transaction costs or management fees. They assume a perfectly liquid market in which a portfolio could be created, managed and rebalanced with no cost, market impact or friction of any kind. Just as a projectile fired in a vacuum will travel much further unencumbered by wind resistance, so, too, would an index imply unrealistic investment results.

Advocates of index investing were undaunted and the first index funds were created in the 1970s. These funds proved that it was possible to efficiently capture the returns implied by indexes. Still, early critics of indexing made some valid points. Indexes were not created for the purpose of building portfolios. They were created to measure market results.

Since index investing was pioneered in the 1970s, the evidence supporting the case for indexing has become overwhelming. Even Warren Buffett and Peter Lynch, two of the most successful investors of all time, advise individual investors to use index funds to build portfolios. Daniel Kahneman, who earned a Nobel Prize in economics for his work in behavioral finance, also advises investors to use index funds. The criticisms of indexing are not sufficient to offset the enormous efficiency of investing in indexes. However, there is another question. Can these criticisms yield opportunities to improve upon index investing?

Harnessing Technology

Deviating from pure indexing to address the problems of going from a computer model to the real world is passive investing. The next phase of the development of the science of capturing market returns began December 23, 1981, when the DFA Micro Cap Fund[(2)] was launched. This fund was originally based on the CRSP (Center for Research of Securities Prices) 9-10 index – the ninth and tenth deciles (the smallest 20% of companies as measured by market capitalization)[(3)] of the US stock market. However, the objective of this fund was not to mirror the results of this index. The objective of this fund was (and still is) to maximize wealth by investing in micro cap stocks.

From 1926 through 1981, these micro cap stocks returned 3.44% per year more than the S&P 500. The objective of this fund was to capture that return for investors. However, many micro cap stocks are not widely traded. This means that they are costly to buy and sell. The cost of buying and selling these stocks could erase the additional return expected for investing in this asset class. Even proponents of indexing had to concede some genuine barriers to replicating this index. Buying thousands of tiny companies would be much more costly than buying 500 large companies.

The Move from Indexing to Passive

The solution to this problem was the first step in moving from index investing to passive investing. This solution was 1) approximate replication and 2) patient trading. It was neither necessary nor practical to own all micro cap stocks in the exact weighting implied by the index. Instead, ownership ranges were established for each stock in this index. This yielded an important advantage - the flexibility to develop the portfolio opportunistically.

©RCG; All rights reserved

This flexibility allowed a patient trading strategy. Traders could buy the stocks on which they could get the best deal. Allowing up to double the weight in any security allowed DFA to take advantage of block trading opportunities. This patient trading strategy not only kept trading costs down to a reasonable level, but in some cases it yielded a negative trading cost!

Trading cost is an even greater problem for active investors than for passive investors. Active investors decide to sell based on their management process and then need to sell immediately. An institutional investor who wants to sell 100,000 shares of a stock that typically trades only 10,000 shares a day has a problem. DFA turned the active manager's problem into the passive investor's advantage by buying the entire position at a discount to fair market value. This was a good deal for the active manager since the discount was less than they would have suffered by selling these shares on the open market, and it was a good deal for DFA since they were able to build their portfolio at discounted prices.

This same philosophy was applied when stocks moved out of the index. Rather than selling the moment it moved out of the index, DFA stopped buying and looked for opportunities to sell.

Improving Passive Investing

The next major step in passive investing - improving on index investing - was paying attention to momentum. There is considerable evidence across all major markets that stocks that have recently gone up will continue to go up and stocks that have recently gone down will continue to go down. Some active managers build portfolios by buying stocks with positive momentum and selling stocks with negative momentum. Unfortunately, the trading cost of managing an entire portfolio on a momentum strategy more than offsets the advantage. However, momentum trading is an opportunity to add value through patient trading because there is no additional trading cost. Passive investors applying momentum screens to their trading are merely changing the timing of trades they would have made anyway and therefore generate no additional trading cost.

This problem is especially acute for small cap investing since stocks that fall into the buy range often continue to decline in price and stocks that rise out of the hold range often continue to rise in price. DFA applies their patient trading philosophy to allow stocks with momentum to reach equilibrium before buying or selling.

Even The Vanguard Group, the creator of the first retail index fund, has recognized limitations to indexing. Vanguard formerly used Russell indexes for several of their index funds. However, Russell indexes are widely used by many index funds. Active managers have learned to take advantage of indexers who use several of these indexes. Russell indexes are rebalanced at regular intervals and their rebalancing is widely known in advance.

Active investors can buy stocks that will be added to these indexes in advance and then sell at a profit when index funds buy to follow the index. This was not a problem when indexes were created because they were not real. There were no actual trades being made, just notes in a ledger or entries in a computer model. However, in the real world, it is costly for too many investors to buy and sell the same stocks at the same time. Vanguard changed the basis of

©RCG; All rights reserved

several of its index funds from Russell indexes to the less widely indexed MSCI indexes to reduce this cost.

Building Wealth

While Vanguard is still technically indexing, they are beginning to think like passive investors. When indexes go from tracking virtual portfolios to building real portfolios, changes must be made. The objective of benchmarks is to measure. The objective of portfolios is to build wealth. These different objectives require subtle changes to achieve their differing objectives with maximum efficiency.

The drawback to passive investing is that it generates "tracking error," which is the deviation of the actual results of the portfolio from the relevant index. The value added by passive investing does not result in higher returns each and every year. Passive investing adds small increments of value that can be overwhelmed by randomness in the short run. However, randomness tends to even out over time and consistent value added shows up over longer periods. The DFA Micro Cap Fund fund has generated an annualized return of 10.84% from January 1, 1982 through December 31, 2008, while the CRSP 9-10 index has generated a return of 9.54% during that same period. The DFA Micro Cap Fund has generated that return net of all trading cost and management fees, while the CRSP 9-10 has been encumbered by no trading cost or management fees.

Other DFA funds follow similar principals applied as appropriate for varying asset classes. Some have bettered their benchmarks, others have not. While every passive fund will not better an index alternative over every time period, it is expected that applying passive principles where appropriate over an entire portfolio will add value over long periods of time. It just makes good sense that this is so.

(1) Passive investing is an imprecise term that generally includes index investing as one type of passive investing. Passive strategies other than index investing are sometimes called structured investing, although that term can also be applied to some active strategies. Some define any deviation from indexing as a form of active management. By this definition, the passive strategies discussed here are active strategies. We define these strategies as passive in that they are passive with respect to their forecast of the future. For the sake of this discussion, active strategies are strategies that vary their forecast of the future while passive strategies maintain a constant forecast of the future.
(2) The DFA Micro Cap Fund was called the Dimensional 9-10 Fund when it was launched December 23, 1981.
(3) The smallest 20% is measured by market capitalization but counted by companies. Out of approximately 6,000 companies, the smallest 20% is the smallest 1,200 companies. These small companies are identified by market capitalization, but represent much less than 20% of the market capitalization of the stock market.

We are the largest fee-only financial planning and investment management firm in Florida.

Resource Consulting Group
PO Box 4930
301 E Pine Street, Suite 300
Orlando FL 32802
Phone: 407/422-0252
Fax: 407/649-8795
Website: www.resourceconsulting.com

©RCG; All rights reserved