



THE
POWER
OF
PASSIVE
INVESTING

MORE WEALTH WITH LESS WORK

RICHARD A. FERRI

Contents

Foreword

Preface

Acknowledgments

Part I: The Active Versus Passive Debate

Chapter 1: Framing the Debate

In the Beginning, There Were Active Funds

Passive Investing Makes Its Case

All about Indexes and Benchmarks

The Portfolio Management Debate

Summary

Chapter 2: Early Performance Studies

Cowles Commission Report

The Quiet Period

The Rise of Mutual Funds

The Roaring 60s

Summary

Chapter 3: The Birth of Index Funds

The First Indexed Portfolios

The First Index Fund

Summary

Chapter 4: Advances in Fund Analysis

The Early Years in Review

Building on Success

The Three Factor Model

Three-Factor Analysis for Everyone

Four-Factor Models and Beyond

Does Anyone have Skill?

Summary

Chapter 5: Passive Choices Expand

The Growth of Indexing

The First Fixed Income Index Fund

International Equity Index Funds

Real Estate Investment Trusts

U.S. Small Cap

Revisiting SPIVA Performance Studies

Active Management Invades Indexing

Summary

Chapter 6: Portfolios of Mutual Funds

Efficient Portfolios

Portfolio Choices

The Bottom Line Is Your Bottom Line

Summary

Part II: Chasing Alpha and Changing Behavior

Chapter 7: The Futility of Seeking Alpha

All That's Needed Is a Crystal Ball

Past Performance as a Way to Predict Future Returns

Fund Expenses as a Predictor of Top Performance

Ratings as a Predictor of Top Performance

Qualitative Factors as a Predictor of Top performance

Summary

Chapter 8: Active and Passive Asset Allocation

Tactical Versus Strategic

Mutual Fund Flows Show Bad Timing

Measuring the Timing Gap

Dumb Money versus Smart Money

Putting It All Together

Summary

Chapter 9: Changing Investor Behavior

Helping People Go Passive

Three Non-Indexers

Investing Is Serious Business
Summary

Part III: The Case for Passive Investing

Chapter 10: The Passive Management Process

The Five Step Process
Investment Policy Statements
Summary

Chapter 11: The Passive Case for Individual Investors

Begin at the End
Estimating Future Obligations
The Asset Side
Matching Assets to Obligations
Asset Allocation
Risk!
Investment Decisions
Hired Help
Summary

Chapter 12: The Passive Case for Charities and Personal Trusts

Your Role as a Trustee
Laws Governing Trusts

[**Trusts and Passive Investing**](#)
[**Private Trust Management**](#)
[**Nonprofit Organizations**](#)
[**Passive Versus Active Investing**](#)
[**Watch Out For Conflicts of Interest**](#)
[**Summary**](#)

[**Chapter 13: The Passive Case for Pension Funds**](#)

[**Legal Acts Governing Pensions**](#)
[**The Plight of the Small Plan**](#)
[**Self-Directed Retirement Plans**](#)
[**Summary**](#)

[**Chapter 14: The Passive Case for Advisors**](#)

[**More Risk Means More Fees**](#)
[**Types of Advisors**](#)
[**The Role of the Fiduciary Advisor**](#)
[**What Clients Expect from Advisors**](#)
[**What Advisors Present**](#)
[**Summary**](#)

[**Glossary**](#)

[**Notes**](#)

[**About the Author**](#)

Index

Additional Praise for The Power of Passive Investing

“The retail stockbroker will soon become as extinct as the dinosaur, and good riddance. Thousands of investment professionals, tired of selling the same old lies, and millions of their clients, tired of hearing them, have deserted the brokerage business for a more elegant, effective, and honest way of managing money. Twenty years ago, Rick Ferri helped pioneer that transition. If you’re an advisor or a broker, you owe it to yourself to read *The Power of Passive Investing*; if you’re an investor, you owe it to your pocketbook.”

—Bill Bernstein, author, *The Investor’s Manifesto*

“I’m a big fan of Rick’s books, and this is his best yet. It’s *the* book on how to effectively harness the power of passive investing. Whether you are an individual investor or are responsible for billion-dollar portfolios, this book is critical to your success.”

—Allan Roth, author, *How a Second Grader Beats Wall Street*

“Rick Ferri has written yet another terrific book. The numerous studies he reviews provide powerful support for passive investing and guide trustees and other fiduciaries toward this ideal solution.”

—W. Scott Simon, principal, Prudent Investor Advisors, LLC

“Passive investments deserve a place in almost all investors’ portfolios, but the range of choices has never been so complex or treacherous. There are now every bit as many flawed, gimmicky, or overpriced index funds as there are those from active managers. If you want to navigate this new terrain successfully, you’ll find Rick Ferri’s *The Power of Passive Investing* an essential text.”

—Don Phillips, Managing Director, Morningstar, Inc.
“Powerful! The extensive research behind this book makes a compelling case for a passive investing strategy. Ignore the information in this book at your own peril.”

—Mel Lindauer, *Forbes* columnist and co-author of *The Bogleheads’ Guide to Investing* and *The Bogleheads’ Guide to Retirement Planning*

“*The Power of Passive Investing* is as much an enlightening history lesson as a compelling argument for building a portfolio on a foundation of index funds. Rick Ferri invigorates a long-standing debate with fresh proof and perspective that come from managing millions of dollars and reading reams of research. Don’t mistake *passive* for wishy-washy; Ferri’s arguments are as sound, precise, and forceful as you’d expect from a retired Marine Corps fighter pilot.”

—Robert Brokamp, CFP, Senior Advisor, The Motley Fool’s
Rule Your Retirement service

“If you doubt the power of passive investing, check out Rick Ferri’s new book—and you’ll discover a wealth of evidence that should sway even the most ardent fan of active investing.”

—Jonathan Clements, author, *The Little Book of Main Street Money*

“Rick Ferri convincingly lays out the damage done by investing in actively managed mutual funds. He proves why we should be grateful to Jack Bogle for implementing index funds as a shield against Madoff-type shysters, lawsuits, unnecessary risk, and high costs. His clear writing, serious research, sound logic, and nuggets of wisdom illuminate both old and new-to-me dimensions of the compelling case for indexing.”

—Ed Tower, Professor of Economics at Duke University

Old-school index investing seems so simple, it's amazing that someone like Rick Ferri, who just tells us the truth, is so rare. And what is the truth? That most investors are underperforming the market and being fleeced by Wall Street. We're lucky to have a crusader for common sense like Rick on our side.

—Jim Wiandt, President and CEO, IndexUniverse

“Few people understand indexing better than Rick Ferri. In *The Power of Passive Investing*, Rick clearly explains the sophistication of passive investing and how it will enhance account performance. If you haven't yet incorporated passive investing into your portfolio, this book will convince you.”

—Taylor Larimore, co-author of *The Bogleheads' Guide to Investing* and *The Bogleheads' Guide to Retirement Planning*

“Rick Ferri has brilliantly assembled hordes of unbiased, highly technical investment research so that the average investor can understand and benefit from what the smart money has known for decades. If you care about how much you'll retire with, you'll read *The Power of Passive Investing*.”

—Mitch Tuchman, CEO, MarketRiders, Inc.

“Rick Ferri has gathered a wealth of research. A passive investment strategy is a great approach because it allows a person to focus on more important things in life.”

—Craig Israelsen, author of *7 Twelve: A Diversified Investment Portfolio with a Plan*

“I found this book to be an outstanding resource for the passive investor as well as those who could benefit from this approach. It's another most excellent contribution by Rick Ferri.”

—Sheryl Garrett, CFP, AIF, Founder, Garrett Planning Network

“This book is an enormous gem of a history lesson on a profoundly sophisticated (and simple) strategy that has changed the world of investing forever. Rick Ferri’s work is a must read for everyone who accepts responsibility for their own financial well-being, giving readers the authority to turn away from Wall Street and make intelligent investment decisions on their own.”

—Bill Schultheis, advisor and author, *The New Coffeehouse Investor*

“Enemies of passive investing aren’t going to like this book, but who cares what they think? Ferri provides more damning evidence against stock picking and other money-losing strategies that bomb investors’ portfolios. In the end, passive investors win.”

—Ron DeLegge, host, *The Index Fund Investing Show*

“Having originally been trained in the hedge fund space to think actively, I know there is a large group of investors with an ‘active management’ state of mind. However, given what I know of many retail investors and a surprising number of institutional investors, I can’t help but think that for their own benefit, the passive-oriented approach espoused by Rick in this book is a likely path to minimizing future regret.”

—Richard C. Kang, Chief Investment Officer and Director of Research, *Emerging Global Advisors, LLC*

“‘Odds are you’ll earn well below market returns in your portfolio over your lifetime if you believe that the mutual funds you’re choosing or your advisor selects will beat the markets.’ Strong words, but in this eminently readable book, Rick Ferri makes a more than compelling case in favor of passive investing. Wouldn’t you like your portfolio to be managed by nothing but managers who shoot par? If you’re a professional or a retail investor,

following the lessons introduced in this book will unquestionably improve your bottom line.”

—Harold Evensky, President, Evensky & Katz

“In this well-crafted book, the author ponders the question of why pay high fees to active managers when index funds—those that follow a real market benchmark, not just a disguised active investment strategy—can do better on a risk-adjusted basis? A strong case is built for passive investing, with arguments backed with market facts and a thorough review of decades of unbiased academic and practitioner studies. At the same time, Rick reminds us of the power of strategic allocation over tactical allocation in meeting a client’s long-term financial goals. This book is a valuable resource, and I highly recommend it.”

—Seddik Meziani, PhD, Professor of Finance and Economics,
Montclair State University

“By focusing on the irrefutable facts, Rick Ferri has put together an unassailable case for *The Power of Passive Investing*. Advisers who implement the principles outlined within this book will strengthen their relationships with clients by delivering solutions in lieu of products.”

—Rudy Aguilera, Principal, Helios LLC

The Power of Passive Investing

Books by Richard A. Ferri

The ETF Book

All About Asset Allocation

All About Index Funds

The Bogleheads' Guide to Retirement Planning (with Mel Lindauer, Laura Dogu, and Taylor Larimore)

Protecting Your Wealth in Good Times and Bad

Serious Money: Straight Talk about Investing for Retirement

The Power of Passive Investing

MORE WEALTH WITH LESS WORK

Richard A. Ferri

Foreword by John C. Bogle



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Foreword

In *The Power of Passive Investing*, Rick Ferri has given us a comprehensive guide to what is proving to be a virtual revolution in investment strategy. Up until the 1980s, “stock picking” was the dominant method of investing by individual investors. Then, through the 1990s, professional investment supervision through actively managed mutual funds was ascendant. But, gradually, index investing—buying and holding a portfolio representing the entire stock (or bond) market, or various sectors of those markets—has attracted the most attention (and dollars) from investors.

Rick’s book begins with the historical background of index funds. As one who was present at the creation of the first index mutual fund in December 1975, I can attest to the accuracy of his chronology. (My first decision at the upstart firm Vanguard, which I founded and which began operations in May 1975, was to form the world’s first index mutual fund.) We also learn about the other pioneers of the concept of indexing, including Treynor, Samuelson, Malkiel, Ellis, and Sharpe.

The simple fact is that indexing wins because indexing *must* win. After all, we investors as a group are destined to be average. (In a stock market with a 7 percent *gross* annual return, we all divide up that 7 percent.) But after we account for the costs of investing—what I call the “croupier” costs, an estimated 2½ percent—we (again, as a group) earn a net return of 4½ percent. The best index funds win simply because they eliminate management fees and sales loads, and minimize operating costs and portfolio turnover and its costs. In so doing, they provide their services at an annual cost of as little as 1/10th of 1 percent of assets. It is the “relentless rules of humble arithmetic” that drive the theory of passive investing.

But Ferri takes us from theory to reality, providing scores of examples and tabulations that prove that very point. Like many analysts, he finds that it is not past fund performance but low costs that are the best predictor of future (relative) fund returns. In one particularly striking exhibit, he shows that an investor holding a portfolio of five equally-weighted mutual funds has but a 3 percent probability of beating the stock market index over 25 years. (For a holder of 10 funds, the probability is only 1 percent). Again, the historical record confirms the hypothesis.

The Power of Passive Investing also deals soundly with such broad areas as savings and investment, asset allocation, and the use of financial advisers. That is Rick's profession, and he is an outspoken advocate for the indexing approach. By charging minimal fees for his services, he walks the walk that reflects the talk he talks in this fine book. I commend it to you.

John C. Bogle
Valley Forge, PA
September, 2010

Preface

Did you ever buy something because you thought it was a superior product, only to be disappointed with the results? That's the problem with most mutual funds. They don't deliver on their promise.

Investors buy mutual funds in most cases because they believe the fund manager will earn superior returns over a market average. But that's not what typically happens. Most funds that try to beat the market underperform the market, some by a wide amount. Investor hope fades quickly as the reality of mediocre results roll in. Then they search for new funds, finding new hope, and fail again. This vicious cycle has been happening in the mutual fund industry for almost a century.

Odds are you'll earn well below market returns in your portfolio over your lifetime if you believe that the mutual funds you're choosing or your advisor selects will beat the markets. That's not going to happen, at least not in the long term. Perhaps one or two funds will achieve this difficult goal if they survive long enough, but a portfolio of several funds will not beat the markets in aggregate over time. That's almost a certainty.

The advertising from fund companies will always imply that their managers have delivered superior returns and that you can capitalize on this skill and earn superior returns in the future. That's wishful thinking. As a group, mutual fund managers have no special talents and outperformance is more a matter of luck than skill. The academics have been saying this for decades.

There is an alternative. The failure of active fund managers to deliver on their promise of high returns while continuing to charge high fees creates a compelling case for passive investing. Passive investing is all about investing in low-cost passively managed index funds and exchange-

traded funds (ETFs) that match the financial market returns less a tiny fee for expenses. This strategy lands your portfolio much closer to the market's return than active fund management, and it ensures that you'll earn your fair share of those returns.

Your goal as an investor is to earn the highest return feasible given the specific amount of risk chosen for a portfolio. A passively managed portfolio holding index funds and ETFs will outperform an overwhelming majority of portfolios using actively managed mutual funds that try to beat the markets with the same amount of risk. Said another way, a passive portfolio will greatly increase the probability you'll reach your financial goals.

This book provides you with the detailed studies and undeniable evidence favoring a passive investing approach. It's filled with academic research and data that goes back many decades. This information clearly shows that trying to beat the market has never been a reliable investment strategy in the past, and there's no reason to believe it will beat a passive approach in the future. Passive investing increases the probability that your portfolio and the portfolios you may oversee for others will succeed. Passive investing IS power investing!

Possible but Not Probable

Wall Street is full of promises. Companies that actively manage mutual funds promote their products based on the perception that they're staffed by very smart and informed people and that they'll earn higher returns than the markets. What investors don't see, and most don't consider, is the academic facts proving that most funds don't achieve this goal. There's only a low probability that any fund will achieve superior returns. While it's possible, it's not probable.

A sign on the highway promoting the Powerball lottery only displays the possible amount you could win; it doesn't tell you the low probability of winning. Most investment opportunities are sold the same way. Wall Street promotes the possibility of earning superior returns—not the probability.

Low odds for selecting a winning mutual fund isn't the only problem for investors. A second problem is payout. The few active funds that are winners don't pay enough excess return over the market's return to make up for the selection risk. There are a large number of losing active funds, and many of those losing funds fall far short of the market's return. The few winning active funds don't perform well enough to make up for the poor results of the large number of losing funds.

A third problem for active mutual fund investors is the shortfall created when multiple funds go into a portfolio. A portfolio of several actively managed funds has lower odds of success than each fund independently. As more actively managed mutual funds are added to a portfolio, the outperformance rate for the total portfolio drops dramatically. This problem compounds over time, and after enough time, the probability for outperforming a passive approach drops to near 0 percent.

Winning actively managed funds are only a small percentage of the total funds outstanding, and identifying these winning active funds in advance is nearly impossible. There are no proven methodologies that accurately predict future winning active funds. Of course, that doesn't stop many market gurus who will claim to have a winning active fund picking formula that they'll sell you for a fee. But that's just marketing spin meant to separate investors from their money.

Attempting to earn above market returns by picking actively managed mutual funds is an inefficient use of time

and money. Knowing this fact, and acknowledging it allows you the freedom to go in a different direction—to change religion in a sense.

Passive versus Active Investing

The Power of Passive Investing lays out an irrefutable case for buying low-cost passively managed index funds and ETFs. It amplifies an investment philosophy that's been academically proven over the decades to deliver better returns than beat-the-market fund strategies. With the power of passive, you can build a more profitable portfolio that meets your needs and the needs of the people whose money you oversee.

Passive investing is based on the premise that all financial market participants in the aggregate are better at determining securities prices than an individual who disagrees with those prices and attempts to predict price direction and earn excess profits. It has to be this way. For every buyer of securities there must be a seller. The return of the market is the only return available to investors, and it's shared by all investors. If one person earns a higher return it means someone else missed out. There is no other return.

But there's a problem: Investors don't earn the market return in aggregate. Money management doesn't come free. Take out a few hundred billion dollars per year in expenses to trade securities and manage investments, and you can easily understand why it isn't possible for investors to outperform the markets over the long term. The average investor must underperform the markets given the costs of investing.

You wouldn't know this by reading advertisements from mutual funds; brokerage firms; money management companies; advisors; or what's written in most books,

magazines, investment newsletters, and web sites. They make it seem as though everyone is winning. That's simply not true and can't be true.

The Power of Passive Investing makes the case for creating a sound long-term investment policy using low-cost index funds and ETFs that gets you closer to the natural returns of the markets. It's also about clarifying and quantifying the purpose for investing, and then implementing a prudent plan that has the best chance for meeting this goal within a framework of controlled risk.

Mutual Funds are a Great Idea

Mutual funds are a great investment vehicle. They allow investors to participate in the global financial markets at a relatively low cost by pooling assets together with other investors to gain economy of scale. In addition, fund shareholders have daily liquidity. They can purchase or redeem fund shares any day the market is open.

The modern mutual fund industry had its start in Boston in 1924. Despite its meager beginnings, the industry survived the Crash of 1929 and the Great Depression that followed. Today, there are over 7,000 different distinct mutual funds including about 1,000 exchange-traded funds offered by hundreds of mutual fund companies.

It wasn't until 1976 that the first publicly available index fund was launched by the Vanguard Group. The concept was slow to catch on. However, it didn't take long for investors to realize the value that indexing offered. Today, there are hundreds of index funds tracking practically every asset class, investment category, and style.

Exchange-traded funds had their beginning in late 1993. Most of these products are also designed to track indices. Exchange-traded funds are a type of mutual fund. The main difference between a traditional open-end mutual fund and an ETF is that the ETF shares trade continuously during the

day on an exchange rather than at the end of the day with a fund company, as traditional mutual funds do.

Between open-end index funds and exchange-traded products, anyone can create an all-passive portfolio using products that are low cost, tax efficient, and hassle free. Investors who prudently select and maintain a portfolio of low-cost index funds and ETFs will earn higher returns with less risk than those who cling to actively managed funds. It's just a matter of time.

Passive investing with index funds and ETFs works. However, you won't find many passive portfolios in this book. This book makes the case for passive investing. You'll have to read other books for details on asset allocation recommendations and fund selection methods. Several books are highlighted within these chapters.

Index Funds Make Most Active Funds Obsolete

It wasn't necessary for actively managed mutual funds to beat the market prior to the introduction of index funds because they were the only game in town. They were the only option available. Mutual fund companies fulfilled their obligation to investors by offering a broadly diversified portfolio of securities that individuals could not replicate on their own at the same cost. In this regard, actively managed funds were a good deal for investors. But that era has passed.

Today, actively managed funds aren't needed to gain broad diversification in an asset class. Index funds and ETFs perform that function much more efficiently. The costs are lower, diversification is broader, the transparency of fund holdings is superior, and the tax benefit from lower turnover helps investors whose accounts are subject to taxation.

The growth of index funds and ETFs across the spectrum of asset classes has put actively managed fund companies on the defensive. Since the actively managed funds are no longer the most efficient way to gain broad diversification at low cost, the active fund industry has had to fashion another reason for being. This new reason for being is to beat the market.

In a sense, index investing has forced active managers into their difficult beat-the-market mission. After Vanguard introduced index funds in 1976, the active fund industry reacted with some interesting comments. The head of the largest active fund company at the time asked investors why anyone would want just average returns. Another called it Bogle's Folly after Vanguard founder John C. Bogle. Still another fund company went as far as printing a poster that labeled index funds as un-American.¹

Active funds were no longer the most efficient way to invest in the markets after the introduction of index funds. This put tremendous pressure on the stodgy fund industry. Index funds forced the active managers to prove their worth with outperformance and answer for underperformance. They never had to do that before.

How have active funds performed in the new mission? One word sums it up: terrible. The active fund managers have unilaterally failed in their attempts to beat the market after adjusting for risk. As a group, net of all fees and expenses, their strategies have underperformed the benchmark indexes in every fund category and every style, and across every continent.

In 1975, Charles Ellis labeled active management among professional investors as a "loser's game." Ellis said, "Most institutional investment managers continue to believe, or at least say they believe, that they can and soon will again 'outperform the market.' They won't and they can't."² Active investing is a loser's game. The active fund managers don't

beat the market, and active investors who try to time mutual fund purchases and sales are equally unsuccessful.

Ironically, the reason active managers don't beat index funds isn't because the managers are dumb. In fact, the opposite is true. The investment industry attracts some of the brightest financial minds in the world. The problem is economics. It is competition and cost. There are too many smart people trying to beat the markets and too few opportunities available. Couple this with high operating expenses and the net result has been and will be below-market returns.

Portfolio management using active mutual funds is obsolete. A well designed and implemented long-term investment policy that uses index funds and ETFs has the higher probability of meeting financial goals. It is the prudent choice for your money and for other portfolios you may oversee. It is your answer to a better performing portfolio.

Overview of Chapters

The Power of Passive Investing is divided into three parts. Part I defines the active versus passive debate, reviews academic literature over the decades, and makes the case for investing in individual index funds and ETFs over individual actively managed funds. Part II focuses on portfolios of active mutual funds versus index funds and the unsuccessful methods people use in their attempts to choose winning active funds. Part III makes the case for passive investing for four different types of investors: individuals, private trusts and charities, pension funds, and investment advisors.

Part I: Active versus Passive

In the beginning, there was only active portfolio management. Index funds didn't exist. People selected individual securities themselves, or hired portfolio managers to select securities, or purchased mutual funds that selected securities.

Over the years, actively managed mutual funds became the product of choice for many investors. It was the economical solution to gain broad diversification at a lower cost than buying individual securities. Fund shareholders pooled their assets together and were entitled to their share of gains and income from the fund. It was a fair system of exchange, even though the results generally underperformed the markets'.

Index funds didn't exist until late in the twentieth century. High fixed commission rates on Wall Street and a lack of computing power made indexing prohibitively expensive. Commission deregulation in 1975 and increased computing power helped foster the first index mutual funds. In 1976 the Vanguard Group launched its first index, tracking the S&P 500.

With the advantage of a bull market at their back and continued lackluster performance by the managers of active funds, index funds began an important growth phase starting in the early 1980s. This was the beginning of a new era for mutual fund investors. Low-cost and broadly diversified index funds became a viable alternative to high-cost and riskier actively managed funds.

Part I tracks the active versus passive debate from its beginnings early in the twentieth century up to the present day. It covers early research through current research. Many exhaustive academic studies are reviewed in this section, some going back to the 1930s. The conclusion of these studies, covering all periods, is that the active managers as a group didn't earn superior returns. There were some funds that did beat the market, but not many, not by much, and

not for long, and the winners could not have been identified in advance.

The entire premise for adopting a passive strategy is based on probability and payout. Active funds outperform passive funds only about one-third of the time over a 5 year period. But this is just the beginning of the problem. The winning active funds change from year to year, and the average excess payout for picking a winning active fund isn't high enough to justify taking the risk.

Since the odds are against active funds, it follows that the payouts for the winning active funds make up for the losses derived from selecting losing active funds. But they don't. There are many more losing active funds than winning active funds, and the shortfall from some of the losing active funds is quite large. The returns from winning active funds are far below a fair payout, given the high odds of picking a losing fund and the average performance shortfall from those funds.

It's interesting that two vocal supporters of passive investing come from unlikely groups: famous active investors and the federal government. Investment greats such as Warren Buffett, Peter Lynch, and David Swensen are all outspoken advocates for passive investing. In addition, the U.S. government's Thrift Savings Plan (TSP) for federal employees has only passive investment options available for participants.

Today, there are hundreds of passively managed index funds competing against thousands of actively managed mutual funds. Investors can choose a passive alternative in almost every asset classes and style, including U.S. and foreign equity funds, bond funds, commodities funds, and even currencies.

If low probability weren't bad enough on the fund level, the odds that a portfolio will outperform the market diminish with every extra active fund added to the portfolio. In

addition, the longer active funds are held in a portfolio, the worse the performance gets relative to an all-index fund portfolio, until the odds reach a point where there is almost no chance the active fund portfolio will outperform the index fund portfolio.

Part II: Chasing Alpha and Changing Behavior

Naysayers of passive investing will point to some active funds that have outperformed the market. That's absolutely true. There are always active funds that beat the market. Those who know how to pick winning funds in advance will earn excess profits. But that's almost an impossible feat to accomplish with consistency and skill. Seeking winning active funds may satisfy one's competitive spirit but it runs completely counter to achieving a portfolio's investment objective. It's possible that an active strategy will be found that generates consistently high returns, just like it's possible to win the lottery. It's just not probable.

Even when a consistently superior active investment strategy is identified, other investors will copy the methodology and thereby quickly erase its benefit. The very few winning active strategies that are identified always carry the seeds of their own destruction.

Poor market timing decisions by investors also lower their portfolio performance. Many investors attempt to beat the market by tactically shifting their mutual fund weights based on some prediction of short-term market returns. This simply doesn't work. Statistics show that investors lose over 1 percent per year by trying to shift their investment in front of the next market move.

A better strategy is strategic allocation. Fixed weights are assigned to each asset class in a portfolio and they are kept in line through regular rebalancing. Investors who use a