Passive Capital Management

Hitting Themselves in the Head with a Hammer: How Investors Relentlessly Underperform the Benchmarks

While physically hitting yourself in the head with a hammer sounds preposterous, the financial equivalent is performed year after year by millions of investors. In this article I will outline how the average investor consistently lowers their own odds of matching the returns offered by equity and fixed income indices. The primary sources of portfolio erosion include: excessive costs (commissions and fees), market timing, tax inefficiency, and inflation. John Bogle, founder of Vanguard, published a detailed analysis of these sources of underperformance in a paper entitled "The Relentless Rules of Humble Arithmetic" which is available online at www.vanguard.com. As I will explain in this article, when it comes to investing, the key is to remember two things: "less *is* more" and "you get what you *don't* pay for."

Excessive Costs: 1.5 – 2.0% Portfolio Erosion

Costs matter. Numerous studies have shown that only about 20% of all active portfolio managers will outperform their respective benchmarks over any 10-20 year time period (a reasonable investment horizon for many people). Even though it is impossible to know in advance which managers will be successful, the average investor continues to pay about 1.5% of their assets to these active mutual fund managers in the hope that they will be one of the few lucky ones. While some fees are necessary for good advice and low-cost investment vehicles, it is important that you only pay a fee if you get something of value in return. Poor advice and perpetual underperformance destroy value and, therefore, aren't worth a penny.

Market Timing Penalty: (at least) 2.0% Portfolio Erosion

Active management is conducted by human beings. Human beings generally have a bad habit of letting emotions dictate their investment strategy. For example, people usually decide to increase their exposure to stocks *after* the markets have been strong, and they pull money out of the market *after* the market has been weak. This sort of emotional market timing will ensure that investors meaningfully underperform the indices over time. It is impossible for anyone to know in advance what the various market segments will do going forward. So take the time to understand your risk profile, develop an appropriate asset allocation model for your portfolio, and *stick to it!* John Bogle estimates that the average investor loses approximately 3.7% in annual performance because of poor market timing.

Tax Inefficiency: 1.5-2.0% Portfolio Erosion

Because active portfolio managers tend to buy and sell stocks on a regular basis, a relatively high percentage of their capital gains will be short-term in character and, therefore, these gains will be taxed at a high rate (marginal income tax rate – up to 35% in 2007). While passively managed funds will also recognize gains over time, a much higher percentage of these gains are long-term in character and are taxed at only 15%.

1)Bogle, John C., "The Relentless Rules of Humble Arithmetic," *Financial Analysts Journal*, Volume 61, Number 6, November/December 2005.

The Humble Arithmetic

So what do these sources of portfolio erosion leave for the average investor? Not much, given the risks taken:

Average Real Return of the S&P 500: 10.0% (after deducting 3% for inflation)

Less	Excessive Costs	(1.5-2.0%)
Less	Market Timing Penalty	(2.0%)
Less	Tax Inefficiency	(1.5-2.0%)

Net Real Return to the Investor = 4.5%

If investors *minimized costs*, were more *tax efficient* and did *not try to time the market* then the return profile would be much improved:

Average Real Return of the S&P 500: 10.0%

Less	Modest Costs	(1.0%)
Less	Market Timing Penalty	0%
Less	Modest Taxes	(1.0%)

Net Real Return to the Investor = 8.0%

A $100,000 investment held for 20 years that earns 4.5% per year will be worth $241,000. On the other hand, a $100,000 investment held for 20 years that earns 8.0% per year will be worth $466,000. Therefore, minimizing costs and adhering to a disciplined asset allocation model can significantly impact your future quality of life.

In conclusion, it is very important to control those factors that you *can* control - costs, asset allocation and tax efficiency - and to not spend much time or money on things you *cannot* control - market fluctuations and inflation. While brokerage firms and mutual fund companies pretend that they can pick the right stocks and outperform the market benchmarks, 80% of the funds underperform their benchmarks over time. As John Bogle explained, investing "is a zero-sum game before costs and a loser's game after costs". In other words, most financial intermediaries do not add value - they only subtract value.

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