Are You Earning Market Returns?

This is one of the first questions we ask investors when we begin discussing the benefits of a passive investment strategy with them. Believe it or not, most investors do not earn market returns due to excessive fees, poor diversification, destructive market-timing, and tax inefficiency - or a combination of all of these. A recent study by Dalbar, Inc. showed for the ***20 year period between 1991 and 2010, the S&P 500 Index had an annualized return of 9.1% while the average investor earned only 3.8%.*** That's a lot of money left on the table. Why? If the market is offering these returns for simply participating, why aren't investors taking advantage of that? Many investors try to "outsmart" the market in an attempt to capture "alpha" or outperformance but they ultimately capture "negative alpha" or underperformance. They try to "time the market" by moving in and out of investments and, inevitably, they let their emotions (fear and greed) dictate their investment decisions. Many people confuse speculation with prudent investing.

True investing means participating in capitalism in a disciplined, patient manner. In a market-based economy, investors commit funds to businesses to help them grow and thrive with the expectation of sharing in the profits that are generated. Capital markets must generate rewards for those investors over the long term or people would stop investing and capitalism would cease to exist. ***Passive investing is a disciplined strategy for capturing the returns that the global capital markets provide to investors who are willing to commit their financial resources.*** These returns are available to all investors who choose to accept them.

We have listed below the 2012 performance data for some of the major asset classes (Source: Dimensional Fund Advisors). Clients of Passive Capital Management, LLC have allocations to these market segments in customized portfolios designed to meet their own financial objectives within their own appropriate risk/reward framework.

Asset Class Performance – 2012

U.S. large company equities: +15.9%
U.S. large value equities: +22.1%
U.S. small company equities: +18.4%
U.S. small value equities: +21.7%
U.S. diversified real estate: +17.5%

International developed small company equities: +18.9%
International developed large company equities: +17.8%
International developed large value equities: +16.6%
Emerging markets large company equities: +19.2%
U.S. 1-3 Year Treasury bond index: +0.5%

In the results for 2012, stocks performed better than Treasury bonds, small company stocks performed better than large company stocks, and value stocks generally performed better than growth stocks. Academics have identified these **three risk factors - market, size and value - as the dimensions of returns**. These are systematic risks that, over time, investors are likely to be compensated for taking. Eighty years of data confirm that over the long term, stocks outperform bonds, small companies outperform large companies and value companies outperform growth companies. This is true across the globe.

Incorporating these risk factors into portfolios is one way Passive Capital Management, LLC's investment strategy of asset class investing differs from index investing. Most indices are reconstituted once or twice each year with pre-announcements alerting investors to the coming changes. Asset class funds, on the other hand, are determined solely on the characteristics of the stocks and they include all the stocks that fit the given characteristics. There is no requirement to track a specific index or need to try to predict which stock may outperform another. Investing in asset class funds, rather than index funds, can provide broader diversification and help you capture the returns that each segment of the market offers.

The trend toward passive investing continued in 2012 as more passive investment vehicles were launched and existing passive products, as a group, gained market share versus active products. The competition across products has benefited our clients through broader investment options and lower product costs. **Instead of competing with the capital markets, we believe that the best opportunity for investors to enjoy a successful investment experience is to take advantage of what the markets offer.**

The Passive Capital Management, LLC investment philosophy is founded on the following core principles:

- **Asset allocation will be the primary determinant of performance.**
- **Diversification will improve risk-adjusted returns for most investors.**
- **Expected returns are a function of systematic risk.**
- **Costs matter.**
- **Tax efficiency will matter for many investors.**
- **Disciplined rebalancing ensures that you maintain an appropriate level of risk throughout all phases of the market cycle.**
- **Liquidity and transparency matter – every PCM portfolio is liquid and transparent.**

Mimi H. Boblitz
Principal

Scott D. Reinhardt, CFA
Principal and Co-founder

Passive Capital Management, LLC
2328 W. Joppa Road, Suite 120, Lutherville, MD 21093, 443-275-2703
Two Clinton Square, Suite 215, Syracuse, NY 13202, 315-478-3130
www.passivecapital.com
A registered investment advisor