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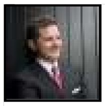

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I cover low-cost index fund and ETF investing.

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Index Fund Buyers are Skilled Investors

People who buy market matching index funds have more investment skill that those who try to beat the markets by picking actively-managed mutual funds. The proof is in performance.

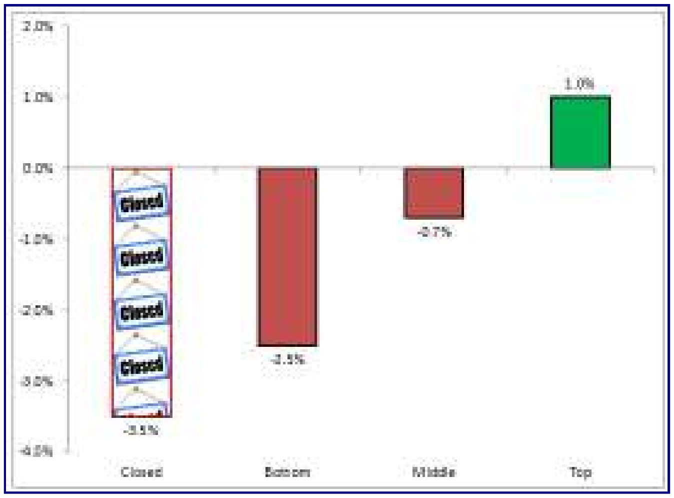
Any fair study of mutual fund performance soon uncovers that low-cost index funds achieve better performance than a large majority of actively-managed mutual funds without adding risk. This statement is true for index funds covering every asset class, investment style and fund category. Index fund investors use this knowledge to effectively increase their portfolio performance. This decision embodies the very definition of investment skill.

Merriam-Webster's dictionary defines skill as "the ability to use one's knowledge effectively and readily in execution or performance." Investment skill is when knowledge is effectively used to earn a higher return without adding risk. For that reason, people who invest in all index funds, all the time, are more skillful investors than those who try to beat the market by picking actively-managed funds.

The math supporting this declaration of skill is straightforward. The average, diversified equity mutual fund return relative falls far short of a comparable index fund over a typical 5-year period. The few funds that do beat index funds do not beat it by much and not for long.

Figure 1 shows the relative performance of actively-managed equity funds by quartile. About one-quarter of all active funds beat a comparable index fund by 1 percent annually over 5 years. The second quartile underperformed by .7 percent and the third quartile underperformed by much more. The remaining quartile went out of business or merged with other funds after performing poorly.

Figure 1: US Equity Active Fund Performance Relative to Index Funds Annualized over 5 Years



Source: The Power of Passive Investing, Richard A. Ferri, John Wiley & Sons, 2010

Figure 1 shows that actively-managed mutual funds attempt to outperform index funds, but few succeed. In addition, the underperforming and closed funds fell about 2 percent short while the outperforming funds beat the index by only 1 percent.

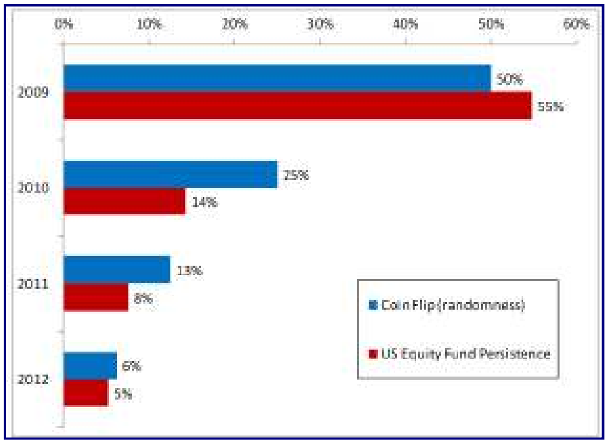
The difference in return is largely due fees. Index funds that track markets have very low expenses while active funds have much higher expenses. The higher expenses incurred by investors who try to beat the markets will weigh heavily on their results over time.

The message from Figure 1 is clear. Active fund investors skate on very thin ice. Most investors in active funds will not achieve the results of index funds and those who do win, won't win by enough to compensate them for the risk. Chasing low odds and low payouts defines a lack of skill.

Critics of indexing will point to the one-quarter of active funds that do outperform and claim they have a secret formula for picking these winning funds in advance. Students of statistics know that's a false statement. Manager skill is extremely difficult to detect in advance because there is little consistency in winning manager performance. This means consistency in winning is more luck than skill. Today's winning funds have a high probability of losing in the future.

Figure 2 illustrates how difficult it is for a winning fund manager to win 2, 3, 4, and 5 years in a row. The results are no better than flipping a coin.

Figure 2: Active Fund Managers That Remained in the Top 50 Percent for 5 Years Straight Starting in March 2008.



Source: S&P Persistence Scorecard, March 2012

Past winning active fund managers find it extremely difficult to stay just in the top-half of their peer group for any period of time. Only 55 percent of top-half managers ending in March 2008 were able to stay in the top-half the following 12 months, ending March 2009. Of those managers, only 14 percent were in the top-half for three years in a row and 8 percent stayed in the top-half for four years straight, ending in March 2010. Just 5 percent were able to persist in the top-half all 5 years, while random luck puts the odds at 6 percent.

What all persistence studies show is that active manager performance is mainly due to luck, not investment skill. Picking winning stocks or bonds isn't like playing chess, where skill is the sole driver of performance, according to Michael Mauboussin, investment strategist and author of The Success Equation, Untangling Luck and Skill in Business, Sports and Investing. A champion chess player almost always beats lesser players because it's a game of skill. With investing, this year's winning manager often becomes next year's losing manager. Mauboussin contends a pattern of inconsistency in an activity points to outcomes that are largely a result of luck, not skill.

My latest book, The Power of Passive Investing, documented a 90 percent probability that an all index fund portfolio, holding 10 funds in different categories, will outperform a portfolio holding 10 comparable randomly selected active funds over a 5-year period. The probability goes up to 97 percent if the portfolio is held for a 20-year period. If consistent performance is a product of skill as Mauboussin contends, than index fund investing is certainly a skillful decision for an investor to make.

This brings us back to my original premise: people who buy index funds have more investment skill than people who buy actively-managed funds. They understand that index fund portfolios outperform portfolios using active funds almost all the time and use this knowledge to increase their portfolio performance.
