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Summary: A previous article, ["The Solution - ONLY follow financial strategies that are scientific, passive, diversified, savings focused, risk controlled, low cost, and tax efficient,"](#) suggested that individuals are much better off with a well-considered financial viewpoint. A stable set of financial beliefs can help you to keep focused and on track throughout your life. This follow-up article discusses the lifetime risk reduction benefits of passive strategies to your financial plan.

Passive, index-oriented investment strategies tend to be superior, because they narrow the range of outcomes, and thus, they reduce the total investment risk associated with your portfolio. The superiority of "passive" over "active" investment strategies was established decades ago. Two things are wrong with active strategies:

a) They increase your risk without increasing your expected gross return. b) They cost more and thus lower your expected net return. Those who perpetuate this spurious "debate" usually make money from active investment fees and other costs, either directly or indirectly. Just ignore them. They will never really go away or stop talking, but you do not have to listen to them or believe them. Most often, those who argue for passive investing do so by arguing that on average the lower implementation costs of passive investment strategies will increase net investment returns. The most succinct presentation of this lower-cost-higher-returns argument is Professor William F. Sharpe's elegant two-page paper, "[The Arithmetic of Active Management](#)," published in 1991 in *The Financial Analysts' Journal*. While the relative costs of active and passive strategies are very important, the higher risk and higher uncertainties of active strategies are just as important. Unpredictably, active strategies can lead either to significantly higher or to significantly lower returns. The key issue is that active strategy outcomes are more unpredictable even before any higher costs are considered. Active strategies introduce a very large and completely unnecessary element of added lifetime personal financial planning risk. To the contrary, passive strategies narrow the range of your outcomes. Because passive strategies target a market return, the expected variance around the market return tends to be much narrower than the variance around more active strategies. Studies of actively managed equity growth mutual funds illustrate this point. See "[How many mutual funds are needed for a well-diversified portfolio? - a commentary](#)" which discusses a study by Professor Edward O'Neal that showed a 12 to 1 ratio for the best performing equity growth mutual fund compared to the worst performing equity growth mutual fund over a 19-year period from 1976 to 1994. If you make the wrong choices in fund selection, then this wider variability of returns can subject you to far greater risks when compared to a passive market index strategy. You cannot get rid of overall market risk, but you do not have to take on additional active risks that could doom your lifetime financial plan to failure. Of course, you might figure that you will be lucky and only choose higher performing mutual funds and ETFs for your investment portfolio. Guess again. Millions of naive investors chase performance, get in late, pay higher costs, and fall full farther and farther behind a market return. See: "[Do mutual fund Morningstar Ratings changes influence individual](#)

[investors?](#)" and "[Does it pay to trade when the Morningstar Rating of a mutual fund changes?](#)" Also, see "[Can a limited number of stocks provide complete portfolio diversification?](#)" which discusses a study by William J. Bernstein, who demonstrated that most randomly chosen stock portfolios will underperform the market return. The primary reason is that stocks with stellar long-term performance records are relatively few in number and are not obvious choices before the fact. Therefore, more portfolios will not contain them and thus will under-perform the market average. Those who perpetuate this un-ending and self-serving active versus passive pseudo-debate in front of individual investors are predominantly the same professionals who make money from the individuals whom they can draw into their active investment strategies. The scientific finance literature provides miniscule support for active strategies and instead provides a very large body of evidence favoring passive strategies. While academics constantly test whether certain strategies are likely to "beat the market," the academic consensus is that active strategies are inferior to passive strategies. Considering that reliable methods to select supposedly superior managers beforehand are lacking and that proper comparisons of strategy returns should always be net of all investment costs, taxes, and implementation time commitments, the case for active strategies evaporates completely. Active strategies arrive in a multitude of polished guises. However, they usually are easy to spot, simply because they promise higher returns and they cost a lot more to implement. Directly or through intimation, promoters will always promise to be better, but there will be no performance warranty. While performance variations for active strategies are much wider and some may deliver superior results, the average active strategy will tend to trail the market return to the extent of its higher costs. The under-performance of some active strategies will be ghastly. If your personal financial plan relies on active strategies and it comes up short, you will find that the warrantee on any direct or implied promise of better performance expired the day, hour, minute, and second that you bought your investment. Concerning the selection of better investments, the primary variable that tends to predict better investment performance is lower costs. On average, the lower the cost of an investment, then the better the net performance will be. The more professional investment management fees you pay directly or indirectly, the lower your net return. If you want to understand scientifically based mutual fund and ETF selection criteria, see: "[Scientific mutual fund and ETF screening criteria -- a summary](#)." Generally, passive and therefore lower-cost strategies allow you to ride the market's return with the lowest fare ticket. More often than not, you are likely to have a fatter wallet when you reach your destination. On an after-risk, after-cost, after-tax, and after-your-valuable-time basis, passive strategies have proven superior. On occasion, some roads in life are both better and easier. Passive index investing is one of these roads. Think about how you invest and evaluate whether there is a better way. (See: [Passive individual investors are "free riders": who benefit from the higher costs of active traders](#))

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