

## **Pay less to get more (Part 1 of 2)**

**Category : Cost Control and Investment Performance Improvement Articles**

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Summary: This two-part article begins a series of articles on investment cost reduction by *The Skilled Investor*. Excessive investment costs are a plague on your personal financial planning. Excessive investment expenses are one of the most significant barriers to lifelong family financial security. While financial services industry sales people tell you that you need to pay more to get more, the correct answer is the opposite. If you pay less, you are likely to get more. In the uncertain and volatile world of financial investments, investment cost reduction is the one strategy that is most likely to improve the future value and investment performance of your bond and stock portfolio, while reducing your investment risk. When you drive your investment costs down to the bare bones minimum, you will simplify your personal finances. When you reduce your costs, you will also stop feeding the purveyors of bogus financial strategies who feed off your assets. If you are not willing to pay, they will go after someone else. Many individual investors hope that, if they pay higher investment fees, they will get higher investment returns. Unfortunately, for the average investor the opposite tends to be true — particularly after investment costs and capital gains taxes are taken into account. Over the long-term, passive investment strategies focused on very broadly diversified index funds tend to yield gross portfolio returns equaling the gross return of the broad securities markets. In addition, if these investment strategies are also highly cost-effective and tax-conscious, then net long-term portfolio returns will only be slightly lower than gross market returns due to the minimal costs and taxes associated with passive market index fund strategies. In contrast, the scientific investment literature has repeatedly demonstrated that active investment strategies most often lead to inferior rather than superior net risk-adjusted investment portfolio returns. The primary reasons are fourfold:

\* First, the investment securities industry offers products to make a profit. If you are willing to pay more because you think superior past performance will persist, the financial industry is willing to keep accepting your money. A large part of the amateur investing public naively chases historical performance, and the financial industry has mastered this game. If they make more in fees now, they are happy. If past performance does not persist, they have no skin in your personal investment game. However, they will always have another batch of expensive funds to sell to you, some of which happened to do better in the past. Would you now like to try one of them with your diminished portfolio assets? Many individual investors seem never to learn, and their persistent demand is why the active management industry thrives. (See: [The illusion of superior professional investment manager performance](#))\* Second, actively managed investment strategies require high cost professionals to manage and high trading costs to execute. The more you try to win, the more it costs. The more it costs to play the game, the harder it is to win. (See: [The investment industry is not your investment partner](#))\* Third, the financial industry incurs very significant sales and marketing costs to convince investors to take a chance and commit their money. If you become a customer, you get the privilege of paying to be sold to, when you pay sales loads charges and annual sales and marketing fees. (On the other hand, if you are not willing to pay high investment fees, then you will

not have to listen to all the wrong-headed promotional hype and rubbish that comes with this territory. See: [How can individual investors trust, when so much investment information is rubbish?](#))

\* Fourth, by targeting subsets of the overall securities market, the average active strategy will incur additional investment risks without additional securities market compensation. The scientific investment literature has shown that markets pay risk premiums over the long-term, but they tend not to provide risk compensation for betting on subsets of available securities. (See: [Asset class investment risk premiums -- your reward for taking investment risk](#)) In effect, active strategies take on more investment risk without risk compensation compared to fully diversified passive investment strategies. In the short-term, some investors will be lucky, but most others will not. Over the long-term, however, good and bad luck tends to even out, and active investors tend to fall behind, because of their higher costs and higher taxes. Meanwhile, they take a bumpier road in terms of higher portfolio price volatility or risk. (See: [Passive index investment strategies are superior, because they narrow the range of outcomes](#)) A short, clearly written, and excellent paper on active management written by William F. Sharpe is available. Its title is "The Arithmetic of Active Management." Dr. Sharpe is a Stanford University Professor Emeritus and co-recipient of the Nobel Prize in Economic Sciences (1990). His article was published in 1991 in The Financial Analysts' Journal (Vol. 47, No. 1, January/February 1991. pp. 7-9). Professor Sharpe convincingly argues that in any period the performance of the average actively managed fund mathematically must trail the performance of the average passively managed fund by the average difference in fund management costs. In April 2007, this article was available on Professor Sharpe's website. ([Find Professor Sharpe's website](#)) ([Find "The Arithmetic of Active Management"](#))[Go to Part 2 -->>](#)

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