

## **[Pay less to get more \(Part 2 of 2\)](#)**

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

**Published by [The Skilled Investor](#) on Apr/12/2007**

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

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.

[The scientific investment literature provides pitifully little encouragement that individual investors can: \\* predict individual prices of stocks and bonds or the future value of the securities markets\\* select a securities portfolio that will beat the market consistently, and/or\\* identify and hire investment managers who will deliver superior performance net of their added costs.](#) While there is very [substantial variation in the returns achieved by one individual investor or professional investment manager, when compared to another, failure or success is overwhelmingly due to luck rather than skill. Resulting from real-time competition among armies of high and low skill investors, risk-adjusted securities market prices tend to make everyone mediocre over the long-term. Luck dominates, when informed investors on both sides set market prices that continuously balance supply and demand and rapidly adjust, as new positive and negative information becomes known. Sustained securities selection prowess is very, very scarce, and certainly, it is not available for individual investors to hire at a reasonable price that leaves them a net profit. \(See: \[Can you really beat the securities markets?\]\(#\)\)](#) Superior and sustained skill-based performance net of costs and taxes has been too elusive to find after hundreds of scientifically constructed securities market studies. While lucky past winners may tout their historical prowess, the scientific investment literature has repeatedly demonstrated that better past performance simply is not a predictor of future performance. The small print of the legally required, &ldquo;protect-your-behind&rdquo; securities disclosures is actually correct. All the securities industry&rsquo;s promotional &ldquo;Historically, We&rsquo;re Been Better than the Other Guy&rdquo; marketing messages just draw your attention toward meaningless superior historical performance charts or stars that are predominantly accidental. Surprisingly to most investors, it turns out that only the very worst of past performance tends to be a very slight indicator of future performance. Relatively poor past investment performance slightly predicts relatively poor future investment performance. Again, excessive costs seem to be the main culprit associated with past poor performance leading to poor future performance. (See: [Do Morningstar Ratings predict risk-adjusted equity mutual fund performance?](#)) The average active individual investor is clearly less knowledgeable and skilled than the average active professional investor. The scientific investment literature indicates that the average active individual investor who self-assembles a portfolio composed of individually purchased stocks and bonds will continue to make systematic errors, which will cause him to trail the performance of the average professional manager. In doing somewhat better, it is likely that professionals do better partly at the expense of amateurs. For example,

individual investors tend to sell their winners quickly and hold on to their losers practically forever, and most professionals know to do just the opposite. Since very slight price trend persistence has been detected in some securities prices over time, professionals have tended to capture more value through this practice, and individuals have captured less. Nevertheless, scientific studies have not shown that professionals or amateurs can pick securities in the first place that will eventually demonstrate this price trend persistence. Professionals just seem to do a better job of harvesting returns from the winners that they have been lucky enough to pick. (See: [Do the new Morningstar star ratings predict superior mutual fund performance?](#)) The logical conclusion might seem that, as portfolio managers, individual investors should relegate themselves to the sidelines and hire active professionals to play for them. There is strong scientific evidence that the average investor does a very poor job of managing his personal portfolio of individual securities. In the process, he fails to diversify adequately and his returns badly trail a passive index fund strategy. Almost all individual investors should fire themselves as portfolio managers and buy funds instead. (See: [What is the cost to individual investors of sub-optimal portfolio diversification?](#)) To achieve diversification economically, individual investors are almost compelled to buy mutual funds and exchange traded funds. In doing so, they must hire professionals. Nevertheless, individual investors still do not have to buy the higher cost actively managed funds, when numerous and much lower cost passively managed funds are available. The scientific investment literature has also shown that efforts to identify active managers who will consistently beat the market have been futile. Counting the number of years a fund manager has been with a fund, judging where she went to school, estimating the number of gray hairs on his balding head, or other such factors have not distinguished which active manager will do better or worse in the future. While active professionals generally do better than amateurs do, overall their added costs far exceed their value-added. Individual investors face a simple cost-benefit dilemma. The average actively managed professional fund prices its services well above its value-added in terms of increased returns. Since there is no reliable means to detect beforehand which professional or fund will actually deliver superior performance, the average individual investor inevitably will pay more and get less. (See: [What is efficient market pricing in the securities markets?](#)) The only way escape this dilemma is to avoid playing this beat-the-market game entirely. Instead, the more reliable, albeit still risky, road to higher expected long-term risk-adjusted returns involves targeting a passive market return, while aggressively driving down investment costs and avoiding unnecessary investment taxes. Relatively efficient securities markets allow passive market index investors to take a free ride on the higher costs paid by active investors. Active investors pay the significant costs of making securities market prices relatively efficient and the market's return very hard to beat. Passive investors ride to the same destination, but their lower priced tickets mean that they are more likely to have fatter wallets at the end of the journey. Chance will still be a significant factor. However, the range of variation in success or failure for the investors who targeted a passive, index return will tend to be much narrower, compared to those who pay a lot extra again and again as they keep swinging for the fences. (See: [Passive individual investors are "free riders" who benefit from the higher costs of active traders](#))

---

SCROLL DOWN FOR LINKS TO OTHER ARTICLES IN THIS CATEGORY