Passive individual investors are "free riders" who benefit from the higher costs of active traders

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Summary: The inexhaustible supply of active traders provides an opportunity for investors not to play the game. By accepting the market price as the best price, passive investors can target a market return and drive costs and taxes down. They can benefit from efficient risk-adjusted prices and market liquidity without bearing the higher costs of active market participants. The global securities markets provide significant value to the world’s market-based economies and to investors. By providing liquid, real-time forums to trade securities at constantly evolving fair market values, the securities markets provide vital capital services. At any point in time, the constant competition among active market participants results in relatively efficient current prices that investors can rely upon as the best current estimate of the risk-adjusted fair market value of a security. However, this competition is endless and not without significant costs to active traders. Investors have a significant choice to make about the securities markets regarding their direct and indirect trading strategy. First, they could choose to be passive and accept the current price as the best price. In doing so, they could trade as infrequently and as cost- and tax-efficiently as possible. Second and alternatively, they could be active believing that the current market price can be beaten through some form of cleverness that will outsmart market opponents. In doing so, they must accept higher costs and taxes, which they believe their higher risk-adjusted returns will more than cover. The securities markets have always had a more than ample supply of active traders who follow the second strategy above. We have every reason to believe that this will be the case in the future. The supply of active traders seems always to be inexhaustible. Meanwhile, a passive investor can be reasonably certain that these market activists will squeeze almost all pricing inefficiencies out of the markets. Therefore, investors have a stark choice between the two strategies above. They can join in the competitive fray and take their chances on winning returns in excess of their higher activist costs and taxes. Alternatively, they can follow a passive strategy, target a market return, and focus on cost- and tax-minimization. Passive investors become what economists call “free riders.” They benefit from the competition between active investors without bearing the extra costs and taxes associated with activist trading, research, portfolio management, time commitment, etc. Securities market free ridership is why a passive rather than active strategy is superior for the average individual investor. See these related articles: ->“Beware of large and hidden mutual fund costs” ->"Excessive investment costs are a huge problem for individual investors" ->“How much do hidden mutual fund trading expenses cost you?” ->“Invest in fixed income securities through bond mutual funds with low investment fees” ->“Is it worth paying higher bond mutual fund management fees?” ->“The investment industry is not your investment partner” ->“What is the cost to investors of sub-optimal diversification?"