Adam Smith Advisors

A Cherry Tree Affiliate

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ADAM SMITH INSIGHTS: *Published by Keith Tufte, President of Adam Smith Advisors, LLC, with insights on investing and wealth management.*

INVESTING QUOTE OF THE MONTH:

"Most investors will find that the best way to owns stocks is through index funds." — Warren Buffett (great investor)

BUFFETT'S MILLION DOLLAR BET (AGAINST ACTIVE MANAGEMENT)

Warren Buffett

Warren Buffett is so confident in index-based funds that he offered to wager $1 million that the S&P stock index could outperform a group of hedge funds chosen by an investment professional over a 10-year period. He got one person to take that bet, a hedge fund manager named Ted Seider. This bet started in 2008, so we are in the last year of the competition. Over this nine year period the simple S&P index fund is up 85%, while the collection of top hedge funds chosen by Mr. Seider are up only 22%. It is not even close. These results are not surprising. Most actively managed hedge funds and mutual funds lag behind the index primarily because they are much more expensive, and they have higher transactions costs. Mr. Buffett estimates that over half of the hedge fund gains went towards management fees. These actively managed, expensive hedge funds are great for the fund managers, but perhaps not so great for the client investors. Actively managed funds are ones where the portfolio manager tries to outperform the market (usually unsuccessfully) by picking a handful of "hot" individual stocks/bonds, making industry sector bets, and/or timing the market.

ANOTHER LOUSY YEAR (AND DECADE) FOR ACTIVELY MANAGED FUND PERFORMANCE

Last year (2016), 66% of U.S. large-cap mutual fund managers, 89% of mid-cap mutual funds, and 85% of small-cap funds underperformed the index they were trying to beat (according to data from S&P Dow Jones research). Over the past five years 88% of U.S. large company active mutual funds, 90% of mid-cap fund managers, and 96% of small-cap funds lagged their respective benchmarks. New data just released show that over the past 15 years 92% of large-cap, 95% of mid-cap and 93% of small-cap actively managed funds trailed their respective benchmarks. The performance of actively managed international stock funds and U.S. bond mutual funds compared to indices are equally disappointing over long time periods. The financial services industry does not want you to see this data, because they make much more money from expensive active funds than they do from low cost index funds. As if this data were not bad enough for active managers, I would point out that these statistics are using pre-tax returns. Since actively managed funds trade more often and therefore are less tax-efficient than index funds, the odds of an actively managed fund beating the index on an after-tax basis are even worse than the numbers shown above. The odds of a portfolio of 5-10 of these actively managed funds on average outperforming the indices are also much worse than the numbers shown above for a single fund.

WHY DO SO MANY INVESTORS AND ADVISORS STILL USE ACTIVE FUNDS?

Would you use an investment strategy with 80%-90% odds of failure? It is the triumph of hope, greed, and advertising over reason and facts. Most investors are simply not aware of the horrible track record actively managed funds have relative to the indices they are trying to beat. The fund companies spend a great deal of advertising boasting about their recent winning funds, but are very quiet about the majority of their other lagging funds. All we hear about are the winners. They merge or quietly shut down the loser funds. Many mutual fund firms and advisors have a financial incentive to continue to push actively managed funds, because the fees and potential profits for them are much larger than low cost index funds. People want to believe they can beat the market, find a hot money manager, find a hot stock, and get rich quick even if the odds of doing so are greatly stacked against them. Demonstrating that you can't fool all the people all the time, there is a strong trend towards index-based investing and away from actively managed funds.

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IF YOU CAN'T BEAT THEM, JOIN THEM!

> "Both large and small investors should stick with low-cost index funds." — Warren Buffett.

We think the smart thing for investors to do is to stop trying to "beat the market" using actively managed mutual funds and hedge funds (with horrible odds of success as shown above) and simply invest in the "market" with index-based funds. Our investment strategy focuses on strategic asset allocation, and we use low-cost index based mutual funds and exchange-traded funds (ETFs) to invest in each of the different diversified asset classes. "Both large and small investors should stick with low-cost index funds." – Warren Buffett. More and more investors are getting the message that index-based funds are a smart alternative to the expensive, actively managed funds pushed by many investment firms and advisors. Index-based funds have been steadily gaining market share from actively managed funds over the past decade, and investors bailed out on actively managed funds (in favor of index funds) in record numbers during 2016. More investors are preferring the reliability and low costs of index funds over taking the slim odds of finding a stock picker who can beat the market.

ADVANTAGES OF INDEX-BASED FUNDS OVER ACTIVELY MANAGED FUNDS

Index funds have lower costs (often 50%-90% lower), lower trading and turnover costs, are more tax efficient, are more transparent, are more diversified, provide more consistent performance, and provide better performance on average. Index funds also eliminate one risk of investing- the relative performance risk that your actively managed portfolio manager goes on a cold streak by picking some horrible stocks or sectors and lags way behind the market for several years. Numerous studies by Morningstar and others have shown that the best (and perhaps only) predictor of future fund performance is the fund's expense ratio (where lower is better). Studies also show that recent good 3-5 year performance by an actively managed fund does not imply any higher odds of success going forward. The winners do not repeat over the next 3-5 years, on average.

CONCLUSION

We are evidence-based investment managers, not "hot stock/story/sector/fund manager" investors. We invest using long-term strategies where the overwhelming research and evidence shows it is a rational and smart way to invest. We are frugal and do not like to spend any more of our client's money on investment costs or income taxes than is absolutely necessary. We believe very strongly in our index-based fund approach to investing, the evidence strongly backs us up, and more and more investors and advisors are starting to come around to our approach.

Adam Smith Advisors, LLC (ASA) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, (CIO of ASA) has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at http://www.cherrytree.com.

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