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Second Quarter 2007

# Financial Fables

## Beyond Index Investing

In 1940, Congress passed the Investment Company Act that created mutual funds, a great concept. People pool their money together, go out and hire a very, very bright person to manage that money, and get diversification with a relatively small amount of money. Over time a lot of people had a good investment experience this way. But it became apparent, particularly to the financial economists, that active management (as it is traditionally called) has serious problems. It has to do with transactions and with relying on people's outlook for the future, forecasting the performance of markets and individual securities.

Index funds first appeared in the 1970s as a response to the poor performance of active management. The idea being if you couldn't beat the market, why not just buy the market? At the time, many investment professionals dismissed the new index funds as a fad, referring to the strategy as "guaranteed mediocrity." But as one prominent fund manager after another failed to keep pace with these low-cost alternatives, assets began to flow into index funds.

Index funds solved many of the problems that are inherent in active management. Over the last 30 to 35 years a lot of people have had a successful investment experience with index funds. But here again, as we go through time, we see there are some real problems with index funds. A traditional passive manager is compelled by an index. These managers value relative returns—how closely they match index performance—over absolute returns. They try to replicate an index by buying and selling when the index reconstitutes and matching its weights through time. There's a huge cost associated with this approach, particularly in the illiquid segments of the market where there is a very high cost of trading.

In the 1980s, asset class funds were developed in response to the problems associated with traditional index funds. Research showed that asset class representation can be captured without pure index weights. This allowed asset class managers to let the weights fluctuate within boundaries. Sometimes, a stock will be held at double its "index" weight, sometimes at half. The flexibility of not needing to buy or sell any particular stock just to maintain perfect weights, which is absent in traditional index funds, allows for better execution (i.e. lower costs).

Asset class manages don't pick stocks or time markets because these activities add risk without expected returns. However, their portfolios do not perfectly replicate indexes of illiquid securities either, because to do so is costly for trading. The savings in execution costs and the elimination of stocks that do not truly represent an assets class, make every dollar invested go further to capture the effect on returns of different asset classes.

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