Longview "INSIGHTS" Newsletter

"helping clients grow, protect and distribute their wealth"

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This is a report published by Five Star Wealth Manager Keith Tufte of Longview Wealth Management, LLC with insights on investing and wealth management.*

INVESTING QUOTE OF THE MONTH:

"Most investors, both institutional and individual, will find that the best way to own stocks is through index funds." – Warren Buffett

ANOTHER LOUSY YEAR FOR ACTIVELY MANAGED FUNDS

An amazing 84% of actively managed U.S. equity mutual funds lagged the overall composite stock market index in 2011. That is the worst one-year performance in the 10 years that Standard & Poor's has been keeping track.

There are two main types of fund management: actively managed and index-based. Active managers do research and try to pick a portfolio of 30 - 100 stocks that they think will beat the overall market. I used to be one of them. The other type of fund management is index-based. These index funds or exchange traded funds (ETFs) simply invest in the whole index for that asset class. We prefer index-based funds.

Asset Class	% Active Funds Lagging Index 2006-2011
U.S. Equity Large Core Funds	68%
U.S. Equity Mid-Cap Core Funds	87%
U.S. Equity Small-Cap Core Funds	71%
U.S. Real Estate (REIT) Funds	70%
International Stock Funds	78%
Emerging Market Stock Funds	83%
Intermediate Government Bond Funds	67%
High Yield Bond Funds	96%
Mortgage Backed Bond Funds	75%
General Municipal Bond Funds	79%

Source: www.standardandpoors.com/indices/spiva/en/us

Over long periods of time (5 years) roughly 75% of actively managed funds lag their benchmark indices before taxes. We track this data from Standard & Poor's, which does ongoing research tracking actively managed funds versus their respective index. Over longer periods of time (such as 10 years) even fewer of them outperform the index on a pretax basis. After taxes, only a very slim minority are able to beat the index since active management is less tax efficient than index investing.

HOW CAN THIS HAPPEN?

Most actively managed funds lag their index primarily because they are much more expensive and have higher transaction costs. The average expense ratio on an actively managed equity fund is approximately 1.3% per year, according to Lipper, Inc. That means that actively managed funds may start 1.3% behind the index each year. The average expense ratio on our index-based funds is much lower (.25%-.30%), saving our clients approximately 1% per year (or adding 1% to their annual returns).

Numerous studies have shown that recent past performance of funds has no predictive power going forward. Morningstar itself has done studies to try to predict future fund performance based on many different factors (past performance, risk, fund manager tenure, etc.) and they (and others) have found that the single best predictor of future fund performance is the expense ratio on the fund (lower being better). The common strategy of picking funds that have the best recent performance is looking backward, and is a dangerous strategy that does not work. Fund managers that have great performance for a few years attract billions of dollars in additional assets to manage, making it exponentially more difficult to continue beating the market.

The Standard & Poor's statistics show that the odds of one actively managed fund beating the index over 5 years is only about 25%. However, most investors actually own a portfolio of many funds in their portfolio for diversification. The odds that you can build a portfolio of many actively managed funds, that together as a group will outperform the index, is even less, since each fund in the portfolio only has a 25% chance of winning. Author Rick Ferri calculates the probability of an all-actively managed portfolio of 10 funds beating an all-index fund portfolio over 10 years at only 6%, and over 20 years at only 1%.

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WHY DO MOST ADVISORS AND INVESTORS STILL USE ACTIVELY MANAGED FUNDS, GIVEN THEIR LOUSY TRACK RECORD?

1. They have not seen the statistics above which show that the vast majority of these funds lag the market. The financial services industry would like to keep these statistics hidden from investors.
2. The banks, brokerage firms, and fund companies have large marketing budgets which boast about their recent winners, but are very quiet about the majority of their other active funds. All we hear about are the winners. They merge or shut down the loser funds.
3. Many investment advisors and financial services firms make more money by selling expensive, actively managed funds. There are significantly higher fees and profits to be shared.
4. The triumph of hope (and greed) over common sense and reason. People want to believe they can beat the market, find a "hot money manager," find a hot stock, and get rich quick. Many people will try to "beat the market" even when the odds are dramatically stacked against them.

WE BELIEVE:

> "Most of the mutual funds I have are index funds."
> — Charles Schwab

1. The most important factor in driving portfolio risk and returns is asset allocation, not stock picking or fund picking or market timing.
2. Index based funds will continue to outperform the vast majority of actively managed funds, especially on an after-tax basis, due to their much lower costs and expense ratios.
3. The same actively managed funds that beat the market in the past are not the same ones that will beat the market in the future. They usually don't repeat as winners. S&P also studies the persistency of top performing funds. Of the top 25% performers among large company stock funds during 2001-2006, only 12% of them remained in the top quartile during 2006-2011. Random expectations would suggest a repeat rate of 25%. There is no consistent way of predicting which actively managed funds will outperform in the future.
4. Index based funds are lower cost, more tax efficient, more diversified, more transparent, and more consistent than actively managed funds.
5. By investing in index-based funds you are eliminating one risk of investing: relative performance risk - the risk of significant underperformance due to poor stock picking.
6. Our index-based strategy is likely to beat the majority of other investors and advisors over time and after taxes. This is because most of them use expensive, actively managed funds and the majority of those funds will lag behind the indices, some by a wide margin.

INDEX-BASED FUNDS AND EXCHANGE-TRADED FUNDS (ETFs) ARE GAINING SHARE

Demonstrating that you can't fool all the people all the time, there is a strong trend towards index-based investing. More and more investors are catching on. The market share of index funds and ETFs increased from 11.3% to 25.5% between 2001 and 2010.

Longview Wealth Management, LLC provides unique wealth management services for a select group of client families to give them peace of mind. Longview is run by Keith Tufte, who has over 23 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 any friends/relatives/business associates that you think may have an interest. Please visit our website at www.longviewwealth.com.

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