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**The price of active investing: Would you believe \$100 billion?**

American mutual fund investors are spending a lot of money in a vain quest to beat the market, says famed finance professor Kenneth R. French of Dartmouth. French has made public preliminary results from his detailed study of the costs investors pay to own actively-managed funds whose goals are to beat the U.S. stock market. The estimated annual cost so far is \$100 billion, French says. And, to make it worse, the evidence suggests that the average investor falls behind the market. The smart investors are the ones who buy simple index funds that charge modest fees to replicate the stock market's results, he adds.

French's study looks at funds that invest in U.S. stocks. He included open-end funds—most commonly used by individual investors—along with closed-end funds and exchange-traded funds. He included the fees and expenses of the funds, the transaction costs for trading, and other costs. In order to find the cost of active management, he totaled all of the costs and then subtracted the cost of investing in a passively-managed index fund. The difference was the cost investors paid in their attempts to beat the market.

The estimated annual dollar cost for 2006, the last year covered by the study, was \$99.2 billion, and it is assumed that amount grew to at least \$100 billion last year. This compares with an estimated annual cost of \$7 billion back in 1980. It is ironic that the cost of active management keeps growing, even though market developments since the 1980s have served to reduce some of the typical costs of investing. Today's mutual funds can take advantage of discounted commissions and smaller bid-ask spreads, while investors pay small direct sales charges on mutual fund sales.

French contends that the costs of investing make this less than a zero-sum game. In a zero-sum game each person's losses or gains are matched by another person's losses or gains. This, French says, would be the case in the investment markets if there were no costs. But the \$100 billion annual price tag associated with active investing means that it is really a negative-sum game. The costs reduce the pie that is divided among all of the investors who participate, he says.

Adding final insult to injury, the cost of active investing is growing because many players have opted out and begun using index funds, French said. That means the group of investors who bear the costs of active management has gotten smaller, giving each one a large share of the expenses. French says that the portion of the stock market invested in indexed funds has grown to nearly 18% since 1986.

There is an easy answer: use indexed funds and passively-managed asset class funds. Investors in these funds are assured that they will earn what the market earns, minus a small cost paid to the fund. Such a no-brainer strategy will also help the investor to beat the great mass of active investors who are constantly in search of a winning formula or a winning portfolio manager. Also, this strategy eliminates the pain of underperforming the market.

## **International stocks can help dampen your portfolio's risk**

Foreign stock markets were on fire last year, handily beating the U.S. market and drawing the attention of domestic investors. The Brazilian stock market gained 44%, Germany 22%, China 96%, and India 47%. The U.S. market, as measured by the Standard & Poor's 500 Index, gained just 3.5%. And that was not an isolated, one-year event: foreign stocks on average have outpaced domestic stocks over the last five and 10-year periods. Some investors undoubtedly will begin chasing those returns, but is that the reason to invest internationally?

Those investors miss the key reason for international investing—reduction of risk through diversification, says Karen L. Lewis, a finance professor at the Wharton School. Despite the globalization of world financial markets, international stocks still offer a significant diversification benefit, she found in a recent academic study. Foreign stocks still move differently enough from U.S. stocks that their inclusion in a portfolio helps to dampen its volatility. “The bottom line is that there still are benefits to international diversification in 2007 and 2008,” Lewis says.

Conventional wisdom has held that international stock market diversification has diminished as it has become easier for investors to put their money anywhere in the world. But Lewis says her research showed that over the past 20 years “the covariance between foreign markets and the U.S. market has increased only slightly” and that the volatility of foreign markets has actually declined. She says a U.S. investor can reduce the volatility of a portfolio by 15% by mixing in foreign stocks. To do this it takes a foreign stock allocation of about 20%, she says.

She warns that investors can't get the same diversification by using American Depositary Receipts—foreign stocks that are listed on U.S. exchanges. “The diversification properties of (ADRs) are inferior to investing in foreign markets directly,” she concludes.

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