

Step 1 ~ Active Investors

Copyright © 2005 Index Funds Advisors, Inc. All Rights Reserved.

STEP 1

Active Investors



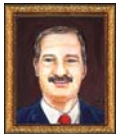
"The investor's chief problem - and even his worst enemy - is likely to be himself."

- Benjamin Graham, legendary American investor, scholar, teacher and co-author of the 1934 classic, *Security Analysis*



"The deeper one delves, the worse things look for actively managed funds."

- William Bernstein, *The Intelligent Asset Allocator*



"The sheer magnitude of the difference we discovered between the total returns earned by funds and the results captured by the average shareholder is shocking and tragic. [Over four years: Funds = 5.7%, Investors = 1%.]"

- Charles Trzcinka, professor of finance, Indiana University. "What Fund Investors Really Need to Know," *Money Magazine*, June 2002



"Over the 10-year period ending 2003, 142 of the largest, smartest pension funds in the USA lost an average 0.3% per year in their active large cap domestic equities programs, relative to simply investing in index funds."

- Keith Ambachtsheer, *The Ambachtsheer Letter*, June 2005



"The common theme unifying this book is that security markets are nearly efficient, meaning most securities are usually priced appropriately given their risk and return attributes," and "Proponents of the efficient market hypothesis believe that active management is largely a wasted effort and unlikely to justify the expenses incurred. Therefore, they advocate a passive investment strategy [index funds] that makes no attempt to outsmart the market."

- Zvi Bodie, Alex Kane, and Alan Marcus, *Investments*



"The results of this study are not good news for investors who purchase actively managed mutual funds. No investment style generates positive abnormal returns over the 1965 to 1998 sample period. The sample includes 4,686 funds covering 26,564 fund years."

- James L. Davis, "Mutual Fund Performance and Manager Style," 2001



"Why does indexing outmaneuver the best minds on Wall Street? Paradoxically, it is because the best and brightest in the financial community have made the stock market very efficient. When information arises about individual stocks or the market as a whole, it gets reflected in stock prices without delay, making one stock as reasonably priced as another. Active managers who frequently shift from security to security actually detract from performance [compared to an index fund] by incurring transaction costs."

- Burton G. Malkiel, Chemical Bank Chairman's Professor of Economics, Princeton University, *The Wall Street Journal*

"Most investors are pretty smart. Yet most investors also remain heavily invested in actively managed stock funds. This is puzzling. The temptation, of course, is to dismiss these folks as ignorant fools. But I suspect these folks know the odds are stacked against them, and yet they are more than happy to take their chances."

- Jonathan Clements, *The Wall Street Journal*, February 2001

"[Most investors would] be better off in an index fund."

- Peter Lynch, famous stock picker, *Barron's*, April 1990

"...the best way to own common stocks is through an index fund..." and "...those index funds that are very low-cost... are investor-friendly by definition and are the best selection for most of those who wish to own equities."

- Warren Buffett, chairman of Berkshire Hathaway, "Chairman's Letter to Shareholders," 1996 and 2003

1 1.1 INTRODUCTION

Step 1: Recognize an active investor.

The first step in any recovery program is to recognize that there is a problem. In the 12-Step Program presented in this book, that means identifying the traits of an active investor and specifying why those traits are problematic. The following list describes a number of common behavior patterns of active investors:

- own or plan to own actively managed mutual funds,
- select stocks they think can outperform a market—this is referred to as stock picking,
- think there are times to be in a market and times to be out of a market—this is called time picking, generally known as market timing,
- think that active managers with the best track records are best for managing their investments—this is called manager picking,
- shift in and out of styles or indexes in an effort to chase returns—this is called style drifting,
- are primarily invested in the S&P 500 thinking this provides adequate diversification,
- believe that now is the best time to invest in certain sectors such as healthcare, technology, large cap or small cap,
- invest without considering risk capacity or risk exposure,
- invest without first studying the academic research that explains how and why free markets work,

- keep a stash of Roloids on hand to cope with short-term market volatility.

1.2 DEFINITIONS

1.2.1 Active Investors

The overwhelming majority of investors are active investors. Extensive research by many academics and investment professionals has shown that investors cannot beat a market in the long run with stock, time, manager or style picking. So, it is disconcerting that about 70% of all institutional money and about 90% of individual investors' assets invested in U.S. stocks are still actively managed. Active investors who claim to outperform a market also claim the power to predict the future. When accurately measured, this is simply impossible. See Table 1-1 for a summary of the differences between the two investment approaches.

As Table 1-1 illustrates, analytical techniques that active investors use are best described as qualitative or speculative. They include predictions of future sales and earnings growth, and are often based on gut feelings and intuition.

The 12-Step Program presented in this book is designed as a recovery program for active investors. Active investing has been shown to be detrimental to investors, and this program is the treatment of choice to cure this problem.

1.2.2 Index Funds Investors

The index funds investing approach is best described as quantitative or scientific. Indexing techniques include the statistical analysis of 78 years worth of risk and return data as well as extensive measurements of numerous performance criteria.



Step 1: Active Investors

Table 1-1

The Difference Between Two Investment Strategies		
Subject	Active Investing	Index Funds Investing
Return Objective	Beat a market	Obtain the return of a market, index or asset class
Style Definition	40% drift from classification	Pure and consistent classification
Average Equity Individual Investor Returns over 20 years	3.70% per year according to Dalbar for 20 year period ending 2004	S&P 500 = 13.20% annualized Index Portfolio 100* = 15.32% annualized
Approach	Stock Picking, Time Picking, Manager Picking, or Style Drifting	Buy and hold a globally diversified portfolio of index funds
State of Mind	Stressed	Relaxed
Taxes and Portfolio Turnover	High (20-40% of return over 10 years) Turnover averaged 112% in 2004	Low (less than 8% of the return over 10 years) Turnover averages 10%
Net Performance	Well below the index by the amount of fees, expenses, taxes, and missed opportunities	The index return, less low fees, low taxes, and tracking error
Individual Investors	Currently about 85% of equity funds	Currently about 15% and growing rapidly, since 1999
Institutional Investors	Currently about 56% of domestic stock assets	Currently about 44% and growing
Proponents	Virtually all Brokerage Firms, Mutual Fund Companies, Market Timing Services, Investment Press and Brokerage Training Programs	The Univ. of Chicago, Nobel Prize Recipients, Vanguard Group, Dimensional Fund Advisors, Barclays Global Investors, Warren Buffett, and Charles Schwab & Company
Analytical Techniques	Art - Qualitative, Disregard for Risk, Forecasting, Predicting the Future, Feelings, Intuition, Luck, Betting, Gambling, Speculation	Science - Quantitative, Risk Management, Long Term Statistical Analysis, Accurate Performance Measurements, (like Insurance companies)

*Sources, Updates, and Disclosure: ifa.com/btp, Greenwich Research Associate, John Bogle, and Dalbar, Inc.

Unlike active managers, managers of index funds are far less active in the buying and selling of stocks. Indeed, managers of index funds do not pick stocks or styles, time markets or make attempts to forecast the future.

Investing in index funds is a growing trend. Approximately 15% of all individual assets and 44% of all institutional assets are currently invested in index funds. In addition, many institutional funds are 100% indexed. Even Charles Schwab & Company in their “Core and Explore” program recommends that investors put 80% of their large-cap assets into index funds. Charles Schwab himself has 75% of his mutual fund investments invested in index funds. Other indexing proponents include Warren Buffett,

Barclays Global Investors, Dimensional Fund Advisors (DFA), the Vanguard Group, numerous academic institutions, Nobel laureates and Index Funds Advisors along with a handful of registered investment advisors. In addition, insurance companies use a similar approach to indexing when setting premiums for the risks they take when insuring against thousands of random events.

Most investors believe that investing in index funds means investing in familiar market indexes such as the Standard & Poor’s 500 Index. S&P 500 Index Funds are structured with the aim to provide the same investment performance as the index. By holding all the stocks in the same proportion as the S&P 500 Index, the fund

represents about 85% of the market value of all U.S. companies, mostly large blue chip stocks. However, familiar market indexes such as the S&P 500, Russell Indexes, and Wilshire Indexes, were not originally designed as investment vehicles.

In the early 1980s, index funds expanded to customized indexes designed to capture specific risk factors. Originally designed for large pension funds, customized institutional-style index funds are meant to capture various financial risk factors or dimensions of the market. Exposure to a risk factor such as company size or value constitutes a risk dimension of the market. Investors have been compensated with higher returns for risk exposure to these risk factors since 1926. These dimensions of the market can also be referred to as indexes.

Index funds can be defined as groups of stocks that have common risk and return characteristics and comply with specific and clearly defined sets of rules of ownership, which are held constant regardless of market conditions. These groups of stocks include companies from the United States, foreign countries, and emerging markets. There are additional indexes within these markets such as small value, large value, small growth, large growth and real estate securities as well as fixed-income investments such as short-term and long-term treasury bonds, municipal bonds, and corporate bonds. Companies are purchased and held within the index when they meet the index parameters. Stocks are sold when they move outside of these parameters and no longer meet the index rules of construction.

An example of a traditional index fund is Barclays iShare that trades the Russell 2000 Value Index. Generally, the Russell 2000 Value

Index contains the companies with lower price-to-book ratios and lower long-term growth.

An example of a customized index fund is DFA's Micro-Cap Index Fund, which invests in securities whose market capitalization (price per share multiplied by number of shares outstanding) falls within the smallest 4% of the universe of all U.S. companies. This includes all stocks traded on the New York Stock Exchange, the American Stock Exchange, and those listed in the National Association of Securities Dealers Automated Quotation Over-the-Counter (NASDAQ OTC) market. In June 2005, Russell also introduced a micro-cap index. Another example would be DFA's Small-Cap Value Fund. The fund invests in companies ranked in the lowest 8% by size as well as the highest 25% measured by a value measurement known as a book-to-market ratio (BtM). DFA funds are the most highly regarded index funds, and they are now available to individual investors through a small qualified group of independent registered investment advisors who have demonstrated their understanding and commitment to the concepts described in this 12-Step Program. There are no fees of any kind paid by DFA to financial advisors who advise their clients to invest in DFA funds.

1.2.3 Beating the Market

The phrase "beating the market" can be defined as the attempt to obtain a higher net return from a portfolio of stocks, bonds or mutual funds rather than from a relevant index or benchmark. The net return includes adjustments for all commissions, loads, fees, expenses, risks, and federal and state taxes. It is calculated over a reasonable period of at least 10 years, but preferably over 30 years. The net return of an active investor's stock portfolio can then be paralleled to an index fund or a blend of index funds with a comparable risk.

The only way an investor can over perform or underperform an index is to simply invest in something other than the index. But, since the index is the only source of long-term risk and return data, why would investors subject their hard earned savings to anything other than the index? The most basic tenet of all investing is that exposure of money to a higher level of risk should be rewarded with a higher expected return. In contrast, lower levels of risk should correlate to a lower expected return. One of the problems with measuring the performance of stock market investing is the lack of a standardized system of benchmarks from which to measure performance. This lack of available benchmarking is the black hole of investing. If there are no definitive risk benchmarks, it is impossible to determine if the exposure to risk has been properly rewarded. In other words, has an active investor really beaten a market with repeatable skill or can his different results be attributed to an inappropriate benchmark comparison or just luck?

1.2.4 Risk Measurements

There are many measurements used by investment professionals and academics to try to capture and compare risk. These include markets, benchmarks, asset classes, styles, style boxes, investment objectives, risk factors, market dimensions, market segments, categories, market averages, buckets of stocks, rules of ownership, slices of the market, industry classifications, and indexes such as Dow Jones Indexes, Standard & Poor's Indexes, Russell Indexes, Wilshire Indexes, Morgan Stanley Capital Indexes, Fama and French Indexes, CRSP Indexes, and the Wired Index. In addition, diversification and measures of volatility such as standard deviation are also used to capture risk. These are all attempts to identify common risk and return characteristics among groups of stocks or bonds.

Because investment professionals have such an abundance of options, they're likely to use the measurement that best suits their purpose. This tendency can be harmful to investors. To reduce confusion, "market" or "index" will often be used as a substitute for these terms in this book.

An appropriate challenge to the investment industry is a call to action to develop an SEC-approved standard to measure the risk of various investments. The Three-Factor Model, which is explained later in the book, developed by Eugene Fama and Kenneth French in 1992, would be an excellent starting point. Already, it is considered a risk measurement standard by academics. A more widespread use of this method would benefit investors immensely.

1.3 PROBLEMS

1.3.1 Active Investors are Everywhere

About 90% of investors are active investors. The most popular strategies in attempting to beat a market include stock, time, manager, and style picking.

Stock pickers try to pick winning stocks rather than diversify their portfolio. Time pickers try to make money off timing the markets. They think they can strategically pick specific times to get in and out of a market, believing this approach is more profitable than a buy-and-hold strategy. Manager pickers buy stock portfolios or mutual funds managed by money managers who seem to have the best recent performance record. Style pickers identify which style will be the next to perform above and beyond the others. The overwhelming majority of individuals who are invested in stock mutual funds hold shares of an actively managed mutual fund. However, as

more information is leaking out to the public, more investors are moving to index funds.

1.3.2 Active Investors are Gamblers

Active investors are commonly under the illusion that they can predict the future direction of market prices. They believe they have a special understanding of the market, a superior edge over other less knowledgeable investors, and are immune to disaster. The truth is that all investors have access to very similar information. Still, many investors believe they are smarter and more sophisticated than the average investor. They fail to realize just how much investment performance depends on luck. Most of them eventually pay dearly for this mistake. Active investing in the stock market is akin to gambling in a casino. Take a look at the numerous comparisons in various news articles below. Note the references to the addictive gambling nature of active investors.

Excerpt from *USA Today*, May 18, 2005, "Could Hedge Funds Cause Market Meltdown?": "When something becomes so popular, you know you're late to the party," says Scott Black, president of investment firm Delphi Management. "A lot of this is gambling with other people's money."

Excerpt from *Times Online*, May 18, 2005, "Investors Beware of 'Lemming' Behavior": "Investors appear to have been caught up in a whirlwind of speculation and gambling," says Professor Johnnie Johnson, a researcher from the Center for Risk Research. "Their appetite for gain led to an explosion of excitement, with rational judgment being one of the first victims."

Excerpt from *www.gamblingmagazine.com*, May 19, 2005, "Online Stock Trading Dangers":

"After two months tethered to his computer keyboard, Mr. Anderson says in an interview, 'It only took a few trades to really just wipe me out.' Now deeply in debt and living at home with his parents, he recalls dispiritedly, 'It was sudden. I remember one day I was lying in bed in the fetal position, saying what the hell did I do?'" and "...mental-health professionals say some of today's obsessed day traders...may actually be addicted to online trading."

Excerpt from *www.abanet.org*, July/August 2001, "Other Bumps in the Road: Gambling": "Paul Good, a clinical psychologist in San Francisco, developed 11 warning signs that may reveal whether an investor is actually a gambler in disguise. Anyone who exhibits five or more of these signs may have a gambling problem. Sign One: High-volume trading in which the action has become more compelling than the objective of the trade."



Paul Samuelson

Paul Samuelson, MIT economist, Nobel laureate and early fan of the indexing technique had this to say about the gambling tendencies of active investors: "My guess is that indexing will have a larger role if you call me 10 years from now than it does now. But it will still be a minority mode of investing. Why? There is something in people; you might even call it a little bit of a gambling instinct. They want to be interested in the process of investing, and it's traditionally been difficult to get too jazzed up about indexing. I tell people investing should be dull. It shouldn't be exciting. Investing should be more like watching paint dry or watching grass grow. If you want excitement, take \$800 and go to Las Vegas."

The active investor's addiction to beating the odds is often as strong as any other addiction.

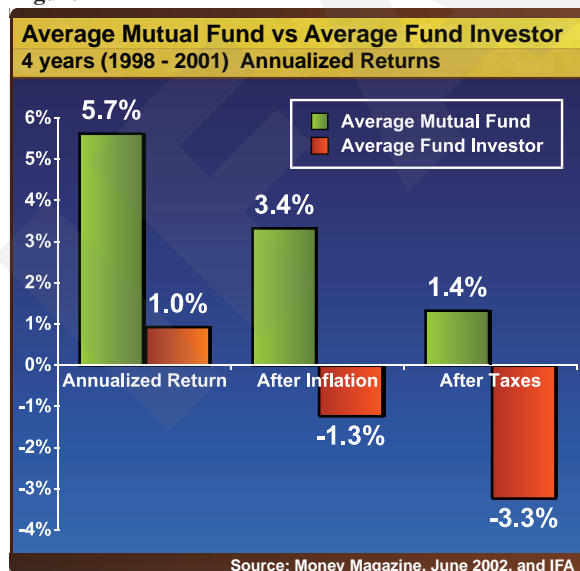
Step 1: Active Investors

Like gambling, active investing can be extraordinarily exciting for investors who get carried away by the adrenaline of winning. Conversely, it can create significant agony for those who experience the losing side of risk. One of the biggest mistakes made by active investors is they believe there is skill involved when the stock market proves profitable. Many of today's day traders are learning this lesson the hard way. There are an estimated 40 million online accounts in the United States. Stories of mounting losses are becoming more prevalent as the odds of playing the markets take their toll on this new breed of investors. Just like casino gambling, there are more tales about the winners than the losers, and the stories rarely give an accurate accounting of true net profit.

1.3.3 Active Investors Lose

In the June 2002 edition of *Money Magazine*, financial journalist, Jason Zweig, gets to the bottom of annual returns. He describes the difference between the returns that mutual funds report and the actual returns of the average investor in those funds. Active investors chase hot funds. As a consequence, they end up with less than one-

Figure 1-1



fifth of the funds' annual returns. When inflation and tax estimates are deducted, it is not a pretty picture for active investors. See Figure 1-1.

Table 1-2 enumerates some of the details of a unique study performed by Charles Trzcinka, professor of finance at the University of Indiana. The large gap between the funds' and shareholders' returns was a shock to even the researchers. The reason for this gap is attributed to active investors who followed the destructive behavioral patterns that Dalbar has been describing since 1994. These patterns include waiting for funds to have a good year or two then pouring in a flood of cash just before the fund reaches its peak. Finally, active investors ride the fund to near bottom and sell.

Table 1-2

Average Mutual Fund vs Average Fund Investor Annualized Return 1998-2001			
Largest Gaps Among The Largest Funds (Avg Gap = 4.7%)			
Mutual Fund Name	Fund Return	Shareholder Return	Difference
Fidelity Aggressive Growth	2.8%	-24.1%	-26.9%
Vanguard Capital Opportunity Fund	29.2%	5.2%	-23.9%
Invesco Dynamics Inv.	7.0%	-14.4%	-21.4%
Janus Mercury	13.9%	-7.4%	-21.3%
Fidelity Select Electronics	21.7%	7.6%	-14.0%
Van Kampen Emerging Growth	13.2%	-0.7%	-13.9%
Alliance Premier Growth	3.4%	-9.2%	-12.5%
SEI Inst. Mgd. Large Cap Growth	2.5%	-8.3%	-10.8%
Fidelity Growth Company	12.4%	1.9%	-10.5%
Fidelity OTC	7.7%	-2.7%	-10.4%
Narrower Gap Among Index Funds from Dimensional Fund Advisors			
DFA US Large Cap Value	7.7%	7.4%	-0.3%
DFA US Micro Cap	9.8%	8.2%	-1.6%
DFA US Small Cap Value	8.8%	8.6%	-0.2%
DFA US Small Cap	8.1%	7.6%	-0.5%
DFA Large Company	5.5%	1.5%	-4.0%

Source: Money Magazine, June 2002

Step 1: Active Investors

One encouraging exception is DFA's institutional index funds. DFA investors are limited to either large institutional investors or individuals who have been educated by specially trained investment advisors. Because the shareholders of these funds buy and hold diversified portfolios at all times, they ride out the market gyrations and end up obtaining market rates of returns, as noted in Table 1-2. A study released by Dalbar in 2006 came up with similar results, but over a much longer period. The study indicated that during the 20 years from 1986 to 2005, the average stock fund investor earned returns of only 3.90% per year, while the S&P 500 returned 11.93%. On an inflation adjusted return, the average equity fund investor earned \$19,625 on a \$100,000 investment made in 1986, while the inflation adjusted return of the S&P 500 would have been \$400,938 or 20 times greater, as shown in percentage terms in Figure 1-2 and in dollar terms in Figure 1-3.

The Dalbar studies reveal that the behavior of average fund investors is an obstacle to reaching the published performance of the financial markets in which they are invested. Clearly, investor behavior can have a far more negative impact on investment performance than investors realize.

Some investors can benefit from enlisting an investment educator, coach or mentor who will focus on changing their investing behavior, encouraging long-term investing, and discouraging the gambling practices of trying to beat a market. Active investors are constantly on an emotional roller coaster ride, which leads them to negative returns on average, after all expenses and taxes. The information in Figure 1-4 looks sadly familiar to many investors. As the value of their investments go through their eventual ups and downs, investors wait until they feel excitement that their investments are on the rise. Once

Figure 1-2

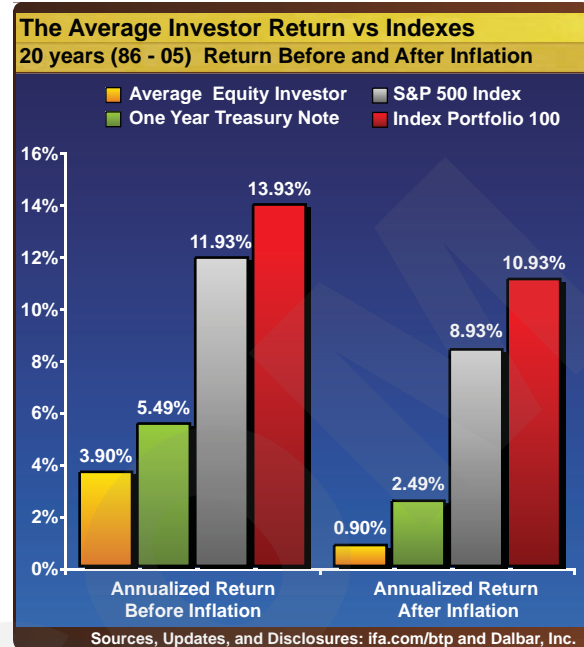
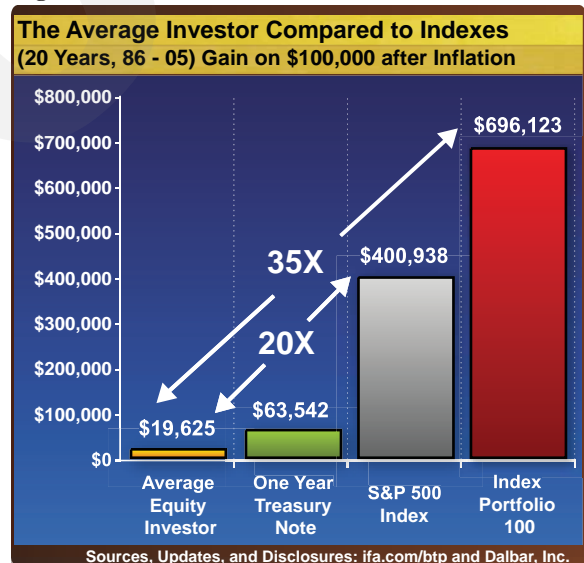


Figure 1-3



they buy and the price takes a downturn, they then become fearful and sell. This cycle of buying after the price has gone up and selling after it has gone down leaves investors with losses, doubt and regret. The lessons in this 12-Step Program should allow investors to resist the

Step 1: Active Investors

Figure 1-4



behaviors that have caused them such despair and poor results in the past.

1.3.4 The Poor Accounting of Active Investors

Active investors often do not properly account for their gains and losses. Common mistakes include the exclusion of sales, commissions, taxes, and cash flows in and out of their portfolios. Another common error is quoting the returns of only the portion of their portfolio that performed well or a time period that did well. Then there is the problem of hearing only from the gambling winners and not hearing from the losers, who seem to disappear into thin air. For example, since 1961, 28% of mutual funds have vanished from the database commonly used to analyze them. Consequently, there is no accounting for their almost certain poor performance.

1.3.5 Stock Market Prices are Random

The Random Walk Theory describes the way stock prices change unpredictably as a result of unexpected news appearing in the market. This “random walk” of changing prices has created a misconception among investors that stock prices

change randomly for no rational reason. Investors are actually reacting to news, and thereby creating random movements in the prices.

1.3.6 Stock Markets are Efficient

The Efficient Market Theory explains the process of free and efficient financial markets. First, information about stocks is widely and inexpensively available to all investors. Second, all known and available information is already reflected in current stock prices. Third, the price of a stock agreed on by a buyer and a seller is the best estimate of the true value of that stock. Finally, stock prices change almost instantaneously as new information appears in the market. All of these factors make it nearly impossible to capture returns in excess of a market’s return. The only issue of concern is the relationship between risk, return, time, and correlation.

1.3.7 When Risk Capacity is not Matched with Risk Exposure

Risk is the source of investment returns, yet investors prefer to avoid risk. It serves investors well to learn about and embrace risk in accor-

dance with their capacity level. Risk capacity defines the risk level that is appropriate for a particular investor. Many investors invest in portfolios that are mismatched to their risk capacity. A thorough analysis looks at an investor's investment time horizon, net worth, income, investment knowledge, and attitude toward risk. Investors can then review investment choices and make a selection that matches their individual risk capacity.

An investment policy is a statement of the risk capacity assessment and the resulting risk exposure in the form of an asset allocation of indexes. Most investors do not get around to fully assessing their risk capacity, and find themselves without an investment policy for their short-term and long-term investments. Without this policy, they are easily persuaded to change their course. As a result, they lose out on the long-term returns that would result from subjecting their capital to market risk.

1.3.8 The High Cost of Turnover

High turnover creates short-term capital gains in a mutual fund or a portfolio of individual stocks. In taxable accounts this can create an additional insurmountable barrier to beating an index. The average mutual fund turns more than 90% of its stock each year. This high percentage forces the distribution of realized capital gains by mutual funds, which become tax liabilities for the funds' shareholders. Active investors incur far greater federal and state taxes, since almost all of the capital gains are short term and are taxed up to 46%. On the other hand, index fund investors buy and hold, so they rarely incur realized capital gains. When they do, they are long-term gains that are taxed at 15%. Tax managed index funds harvest losses to offset gains and eliminate dividend-paying stocks to reduce taxes paid on dividends. These tax-managed funds nearly elimi-

nate the federal and state taxes associated with actively managed funds.

1.3.9 The Emotional Stress of Active Investing

Investment returns are far more dependent on investor behavior than the performance of the investment. Investors generally make bad decisions under the pressure and stress of trying to outperform a market. These shortfalls are directly attributed to investors overreacting to constantly changing conditions in financial markets, resulting in brief holding periods for mutual funds. The tendency of investors to bail out of stock funds during market downturns and buy back in after the market has recovered obviously harms performance.

When the stock market performs well, as it did for most of the 1980s and 1990s, investors are more prone to believe they can beat a market. When they get lucky and make a profitable investment call more than once, they are lured into thinking they are successful market forecasters. Unfortunately, this false sense of confidence can lead them to the poorhouse.

The media continues to foster and encourage the high emotions of active investing. Many ads lead investors to believe they can beat a market through stock picking and time picking. In a September 1999 advertisement from online broker, Ameritrade, an image of a scowling young woman was displayed. Her quote read as follows: "I don't want to just beat the market. I want to wrestle its scrawny little body to the ground and make it beg for mercy." The ad goes on to say, "Ready to take on the market? The sooner you do, the sooner you can show that lily-livered stock market who's boss." Finally, it ends with, "Believe in yourself." Investing should not be based on beliefs. It should be grounded on a thor-

ough analysis of the extensive body of research performed by conflict-free academics. Then, certain conclusions should be drawn from facts, not beliefs.

1.3.10 More than 1,500 Investors can be Wrong

The lack of investor education has generated a lot of recent interest. Most school systems have not incorporated an educational program for investing. The average investor is unprepared to make decisions about investing. Investors usually receive their education in bits and pieces from advertisements, television, magazines, newspapers or books. These sources are created by an industry that generates huge margin interest, fees, and commissions from the trading of active investors. Most of the promotion and education provided by the investment industry is designed to encourage investors to gamble in the stock market.

Money Magazine and the Vanguard Group conducted a study in 1997, which randomly selected 1,555 investors from across the United States, and asked them 20 basic questions on investing. The respondents received a 67% or an “F” grade! In a 2000 update of the survey, only 37% of the respondents’ answers were correct. Why do investors continue to invest in something they do not understand?

1.4 SOLUTIONS

1.4.1 Active Investors Anonymous

Several years ago I learned a painful lesson. After selling a business, I turned about \$6 million over to several active managers. What a mistake. I woke up one morning to discover I had lost a \$30 million opportunity. After thoroughly

researching the science of passive investing and index funds, I concluded I needed to withdraw my investments from those stockbrokers and actively managed mutual funds, and put them into index funds.

As a result of that painful lesson and years of research, I’m now passionate about educating others about the benefits of passively investing in index funds. A 12-step recovery program is critically needed for investors, and this is why I wrote this book and launched Active Investors Anonymous.

1.4.2 The History of 12-Step Recovery Programs

The concept of a 12-step recovery program originated in 1935 and today is used to treat more than 30 addictions, including gambling, alcohol, overeating, drugs, and sex addictions. Millions of people rely on such programs to cure addictions that have taken control of their lives.



Dr. Carl Jung

In the early 1930s an American alcoholic named Rowland H. (only the last initial is used to keep him anonymous) traveled to Switzerland to undergo treatment from the world renowned psychologist, Carl Jung. After a couple of unsuccessful trips, Dr. Jung told Rowland that he needed a “profound spiritual experience” to enable him to stop his drinking. In other words, he needed to find a higher power. Other patients who had taken Dr. Jung’s advice had overcome their addictions and changed their behaviors.

The 12-step program is partially based on the replacement of an addiction with a higher power, whatever that may be for a person. For the active investor on the road to recovery, the perfect high-

er power to turn to is the abundance of academic research available on investing. As investors became more familiar with the Nobel Prize-winning stock market research outlined in this book, many experienced investing epiphanies, and transformed their thinking and investment behaviors. Many “stockaholics” have already been cured.



Rex Sinquefeld

Rex Sinquefeld, a director at DFA, attended the University of Chicago in the 1970s. Sinquefeld said, “Every time one of my professors talked about efficient markets, I thought I was looking at Moses coming down from the mountain, and I took that seriously.” Sinquefeld went on to create the first S&P 500 Index fund in 1973, and now the firm he cofounded, DFA, is known as the mecca of sophisticated indexing. Maybe Sinquefeld had his profound spiritual experience in that classroom.

I had my epiphany while listening to Professor Eugene Fama of the University of Chicago and director of research at DFA discuss the Three-Factor Model at a financial conference.

1.4.3 The Big Book on Investing

When the founder of Alcoholics Anonymous, Bill W., needed a vehicle to carry his message to millions of alcoholics, a book was the only affordable method. So, he wrote *Alcoholics Anonymous* in 1938. That book has become affectionately known as “The Big Book.” Coincidentally, 1938 was the same year that Alfred Cowles created what was later to become the Standard & Poor’s 500. Cowles did not know that his creation would go on to become the first index used to establish an index fund by Rex Sinquefeld.

This book is a modified 12-step program designed to educate investors on how to overcome the emotional desires to actively invest. Some refer to it as the “Big Book on Investing.” In 1938, Bill W. was limited to books as an affordable method of communication. But, today we have the Internet. It’s a medium I take full advantage of in my mission to lead investors to a highly efficient, tax-managed, low-cost and risk appropriate portfolio. The same material in this book, with additional updates, can be found on Index Funds Advisors’ Web site at www.ifa.com.

1.4.4 Top Investors Agree

Billionaire asset allocator Warren Buffett, who is often called “the Oracle of Omaha” for his straightforward advice, recommended index funds to his own Berkshire Hathaway fellow shareholders. In his 1996 Chairman’s letter, dated February 1997, Buffett wrote, “Let me add a few thoughts about your own investments. Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals.” In February 2003, he wrote, “...those index funds that are very low cost (such as Vanguard’s) are investor friendly by definition and are the best selection for most of those who wish to own equities. And, his February 2004 letter states: “Over the [past] 35 years, American business has delivered terrific results. It should therefore have been easy for investors to earn juicy returns: All they had to do was piggyback corporate America in a diversified, low-expense way. An index fund that they never touched would have done the job. Instead many investors have had experiences ranging from mediocre to disastrous.” For Berkshire Hathaway vs. IFA Indexes, see Figure 11-5 on page 217.

Even though some professionals outperform a market, it is a different group of professionals that do so each year. A consistent methodology to identify them in advance has yet to be discovered.



Benjamin Graham

Benjamin Graham, the father of fundamental stock analysis, and a man revered by Warren Buffett, also relinquished the idea that investors can expect to beat a market. Shortly before his death in 1976, he said: “I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago when [the Security Analysis by] Graham and Dodd was first published; but the situation has changed.... [Today] I doubt whether such extensive efforts will generate sufficiently superior selections to justify their cost.... I’m on the side of the ‘efficient’ market school of thought.”

1.4.5 Index Funds Investors Win

Investors in index funds usually win over active investors over long periods of time. The path to recovery for active investors begins with understanding the following steps outlined in this book.

1.5 SUMMARY

More than 90% of investors engage in active investing strategies. A 12-step program can best address the emotional hurdles an active investor needs to clear. The first step of every 12-step recovery program is admitting there is a problem. Hopefully, this first step has helped you rec-

ognize active investing behavior, and realize that such harmful behavior can be changed.

1.6 REVIEW QUESTIONS

Questions will appear at the end of each step to affirm the reader’s understanding of the information presented in that particular step. At www.ifa.com, you can find a similar test of your knowledge, which will result in a “Certified Indexer” certificate for those with a passing score.

1. Investment managers of index funds engage in:
 - a. stock picking
 - b. market timing
 - c. manager picking
 - d. analytical techniques best described as speculative
 - e. analytical techniques best described as scientific
2. A Dalbar study showed that the average investor earned \$19,625 on a \$100,000 investment over a 20-year period, while the S&P 500 gained:
 - a. \$15,200
 - b. \$38,613
 - c. \$591,337
 - d. \$400,938
 - e. \$567,239
3. In a February 1997 letter to shareholders, Warren Buffett stated, “the best way to own common stocks is:
 - a. to own his company, Berkshire Hathaway.
 - b. to have your broker pick 10 growth stocks.”

- c. to buy at the bottom of the market and sell at the top.”
 - d. to own an index fund that charges minimal fees.”
4. When 1,555 investors were given a test of 20 basic questions in 2000 regarding investing, the average score was:
- a. none correct
 - b. 37% correct
 - c. 60% correct
 - d. 95% correct
5. PriceWaterhouseCoopers found that one of the largest obstacles warding off investors from investing in index funds was:
- a. the high management fees of index funds
 - b. the emotional drive, desire or need to beat a market
 - c. the below market performance of index funds
 - d. the difficulty in finding an index manager
 - e. the high taxes generated by index funds