



## OVERVIEW OF THE 12-STEP PROGRAM FOR ACTIVE INVESTORS



**Step 1. Active Investors: Recognize an active investor.** Active investors hope to pick winners among the many stocks, times, managers or investment styles. But, the problem with the methods deployed by active investors is that markets are moved by news. News is unpredictable and random. Therefore, the movements of stocks, markets, managers, and styles are unpredictable and random. Markets are also efficient, meaning that news is rapidly reflected in market prices. As a result, active investing is not a viable strategy. The only reliable source of long-term returns is from consistent exposure to economic risk factors that have nearly 80 years of history.



**Step 2. Nobel Laureates: Recognize that Nobel Prize winners researched the market.** Nobel Prizes have been awarded to academics for their analysis of how stock markets work. The allure of their findings is that they're not biased by a need to earn a commission or sell you an IPO, magazine or newspaper. More than a hundred years of academic research has concluded that index funds are an investor's best investment. Sadly, the great majority of investors have never read these academic studies so they continue as active investors.



**Step 3. Stock Pickers: Accept that stock pickers do not beat the market.** The primary factor influencing the success of a stock picker is simply luck. In numerous studies, only about 3% of stock pickers beat their benchmark. Most stock pickers invest in stocks that have done well recently; however, those same stocks do poorly in subsequent periods. The performance of stocks is random, just like the news that influences their prices. Therefore, it is not possible to consistently pick stocks that will be top performers in the future.



**Step 4. Time Pickers: Understand that no one can pick the right time to be in or out of the market.** When 32 market timing newsletters were compared to the S&P 500 Index over a 10-year period, not one of them beat the broad market index. The primary reason for this inability to time the market is the high concentration of returns and losses that occur in a time period of a few days. In a 10-year period, about 88% of the total gain was highly concentrated in just 40 days. It is impossible to pick those 40 days in advance. Professors studied 15,000 predictions by 237 market timers and concluded that "There is no evidence that [market timing] newsletters can time the market."



**Step 5. Manager Pickers: Realize that the winning managers were just lucky.** The S&P 500 Index consistently outperformed 98% of mutual fund managers over the past three years and 97% over the past 10 years, ending October 2004. In two 30-year studies, the S&P 500 outperformed 97% and 94% of managers. In addition, only about 12% of the top 100 of managers repeat their performance in the following years. Therefore, it is not possible to consistently pick next year's hot mutual fund manager. Index portfolios consistently capture the risk and return of markets, which in a high risk index portfolio has been 14% annualized for the past 50 years, compared to 11% for the S&P 500.



**Step 6. Style Drifters: Comprehend active management style drift.** Most mutual fund managers drift from one recent winner to another playing fast and loose with investor's money. A fund's stated objective is altered by these style drifters. One study indicated that 40% of mutual funds drift from their originally stated style. To make matters worse for these drifters, style performance rotates randomly, and therefore it is not possible to consistently predict tomorrow's winning style.



**Step 7. Silent Partners: Recognize the partners in your returns.** There are partners that subtly take a large slice of your investment return. In taxable accounts, over a 15-year period, active investors keep only about 50% of the total return earned by their initial investment. Meanwhile, investors in index funds keep about 85% of the total return by maintaining tight controls over the silent and often invisible partners of high fees, expenses, cash drag, taxes, transaction costs and more. By minimizing the cost of these silent partners investors will increase their expected returns.



**Step 8. Riskese: Understand how risk, return and time are related.** Lawyers speak legalese and the best investors speak riskese. Learning the language of riskese requires investors to have a basic understanding of the concepts of risk, return, time, and correlation. Understanding riskese is essential for successful investing. Most investors instead chase the short-term returns of stocks, markets, managers or styles, and never truly understand the impact of risk, time, and correlation on their returns. The more fluent you speak riskese, the higher your risk capacity, risk exposure and expected returns.



**Step 9. History: Understand the historical risks and returns of indexes.** Long-term data is required to estimate the expected risk and return for different stock market indexes. We now have almost 80 years of monthly risk and return data on several important indexes. This mountain of empirical evidence proves that index funds are the most reliable and logical investment choice. Since you can not predict the future based on recent events, the study of long-term stock market data is the only source of probability distributions of the expected risk and return of investments.



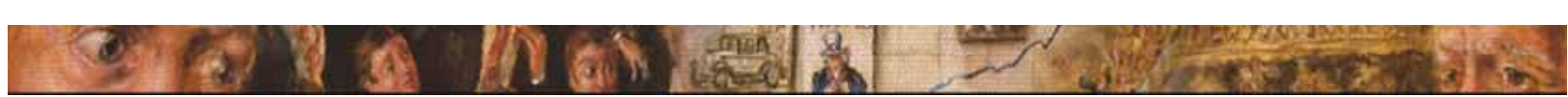
**Step 10. Risk Capacity: Analyze your five dimensions of risk capacity.** A Risk Capacity Survey will help you determine your individual and unique risk capacity. Five dimensions of your risk capacity will be thoroughly measured resulting in a score and corresponding index portfolio. These risk capacity dimensions include time horizon, investment knowledge, net income, net worth, and attitude toward risk. This is your single most important contribution to the investing process, resulting in an Investment Policy Statement that will provide the guidelines for your financial future.



**Step 11. Risk Exposure: Analyze your five dimensions of risk exposure.** Over 90% of the returns of diversified portfolios of index funds can be explained by their exposure to five dimensions of risk. Those dimensions include market, size, value, term and default. Once investors have determined their risk capacity in Step 10, they will be matched to one of 20 index portfolios. Index funds are utilized to minimize taxes and maximize expected returns. A simulation of a properly designed index portfolio shows an outperformance over the S&P 500 Index by 3% annualized for the last 50 years at the same level of risk and after the deduction of mutual fund fees and investment advisory fees.



**Step 12. Invest and Relax: Invest, relax and stay balanced.** The road to recovery for active investors ends with a recognition that a strategy of buying, holding, and rebalancing a portfolio of index funds is the best way for investors to maximize the expected returns of their investments. A financial advisor that speaks riskese and understands how markets work can best design, implement, and maintain a risk-appropriate, tax-managed, and highly efficient portfolio of low-cost index funds for investors. After investors implement this prudent investment plan, they can kick back and relax.



# Twenty Risk Capacities



100



95



90



85



80



75



70



65



60



55



50



45



40



35



30



25



20



15



10



5