

Skill or Luck?

Bill Miller Gives His Two Cents on Index Funds

In an interview with *Money Magazine* for its July 2007 issue, Bill Miller, manager of the Legg Mason Value Trust Fund describes his improbable 15-year streak of outperforming the S&P 500. Miller's incredible run has many industry insiders and investors scratching their heads in bemusement as to whether his success is attributed to pure luck, calculated skill, or even poor benchmarking (Legg Mason's Value Trust Fund had risk levels (standard deviation) of a value index, but was compared against the S&P 500).

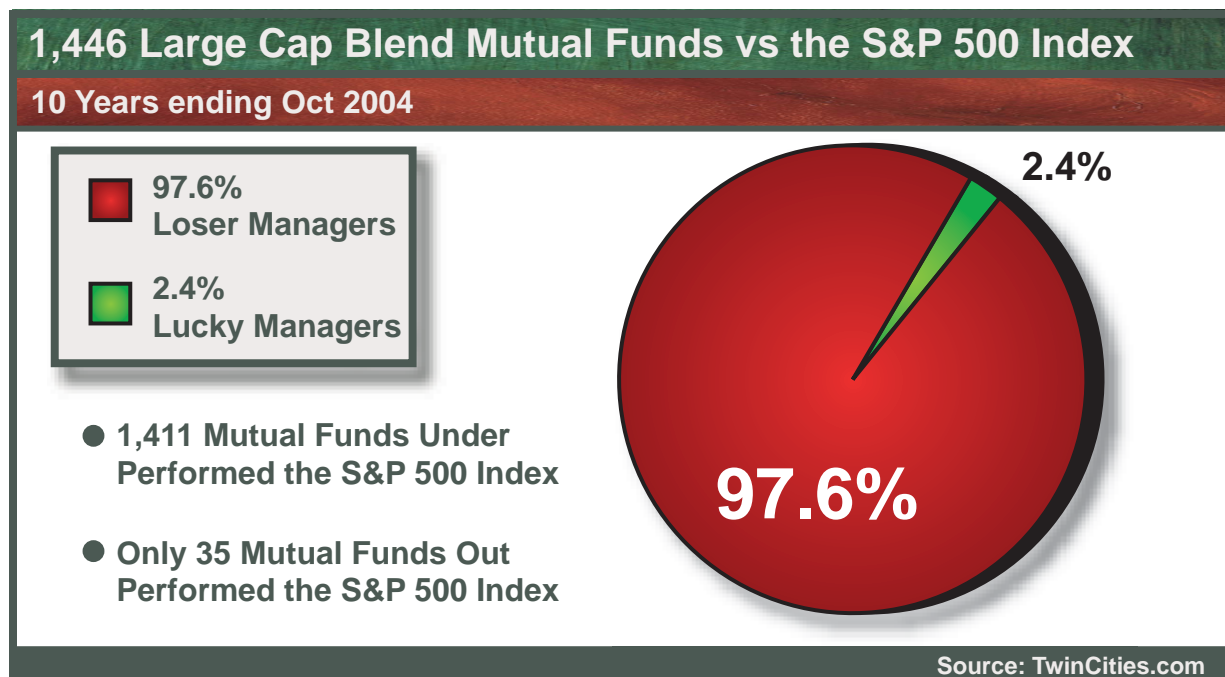
While Miller credits his own past success in the active management arena to a “modicum of skill,” he himself recommends that investors buy index funds. Specifically, Miller told *Money* that a “significant portion of one's assets in equities” should be comprised of index funds. “Unless you are lucky, or extremely skillful in the selection of managers, you're going to have a much better experience going with the index fund,” Miller adds.

While musing on the extent to which luck played a factor in his record-breaking 15-year streak, he claims that “on a purely random basis, the odds of 15 consecutive calendar years [of beating the market] would be a couple million to one.” If Miller's gauge of the likelihood that an investor might choose a successful manager is this hopeless, then clearly it makes more sense to steer clear of actively managed funds altogether and direct all investable assets into low-cost index funds—an investment that will always match the index and eliminate the extra expenses associated with active management, including excessive fees and taxes.

Miller's recent comments resonate with a similar message he delivered in a *Wall Street Journal* interview he gave in January 2005. Specifically, in regards to his “then 14-year streak, Miller confessed to the *Journal*, “As for the so-called streak, that's an accident of the calendar. If the year ended on different months it wouldn't be there and at some point the mathematics will hit us. We've been lucky. Well, maybe it's not 100% luck—maybe 95% luck.” The mathematics did catch up with him and Miller's streak ended with a resounding thud in 2006.

Miller is the most famed poster boy for active investing and asserts that risk should be diversified across actively managed funds in addition to index funds. Yet, he points out that the problem with active investing is that investors change their managers too often, seeking to capture short-term performance. He asserts that over 10, 15, or 20 year periods, “the odds that you will get a manager who can outperform the index over those time periods are about one in four.” Research

does not bear out this figure. A study conducted by TwinCities.com and based on Morningstar data shows that over the 10-year time period from October 1995 to October 2004, the odds of finding an active manager that beat the S&P was less than 3 in 100—a far cry from Miller’s “one in four” estimate. The results of the study are shown in the figure below.



Although Miller suggests some investment in actively managed funds, the daunting odds as to the likelihood of beating the indexes appear to suggest that a more rational method is to invest in a risk-appropriate, globally diversified blend of index funds. An investor who does so would avoid the gambling away of any portion of one’s fortune on a manager whose predictions offer little hope of panning out.

Miller himself acknowledges the challenge of beating indexes because index funds’ cost-efficiency facilitates higher expected returns. “Costs are lower, not just in management fees, but also lower in trading costs,” Miller asserts.

Armed with a keen awareness of the difficulty of happening upon—and sticking with—an active manager who will defy the odds and deliver a successful long-term track record, investors would be wise to heed the words of Bill Miller--reigning king of active investing--and invest in index funds.

If you wish to learn more about indexing, please visit www.ifa.com or purchase Mark Hebner’s “*Index Funds: The 12-Step Program for Active Investors*” here. ■