Keep It Simple, Says Yale's Top Investor

By GERALDINE FABRIKANT

IT has been a time to worry even the savviest investors. The credit markets have been in a crisis, the domestic stock market has been shaky and overseas markets haven't been much better.

What should an individual investor do?

Don't try anything fancy. Stick to a simple diversified portfolio, keep your costs down and rebalance periodically to keep your asset allocations in line with your long-term goals. That is the advice of David F. Swensen, who has run the Yale endowment since 1988, relying on a complex strategy that includes investments in hedge funds and other esoteric vehicles. The endowment earned 28 percent in its last fiscal year, which ended June 30, beating all other endowments. It finished the year with $22.5 billion.

For most people, he recommends a very basic approach: use index funds, exchange-traded funds and other low-cost instruments, and stick to your long-term asset allocation — even when the markets are in tumult.

Don't be distracted by market forecasts, he said. "You have to diversify against the collective ignorance," he said. "I think nobody is in a position to react to these big macro-issues. Where is the dollar going to be or what is G.D.P. growth going to be in China? For every smart person on one side of the question, there is another smart person on the other side."

For most individual investors, he said, copying the strategies of institutions like Yale is virtually impossible: big investors have access to fund managers and arcane strategies that are beyond the reach of most people.

"The only people who should get involved are sophisticated individuals who have significant resources and a highly qualified investment staff," Mr. Swensen said.

"Most people do not have the resources and time to pick market-beating managers" of hedge funds, private equity funds or funds of funds, he said. And he said that the techniques used by hedge funds often result in higher taxes than those of index funds.

So he advocates another approach, which he outlined in the book "Unconventional Success: A Fundamental Approach to Personal Investment" (Free Press, 2005). He proposes a portfolio of 30 percent domestic stocks, 15 percent foreign stocks, and 5 percent emerging-market stocks, as well as 20 percent in real estate and 15 percent each in Treasury bonds and Treasury inflation-protected securities, or TIPS.

The real estate investment can be made through real estate index funds. Though the real estate market has declined and your portfolio is below its target allocation to it, he said, don't try to time the market. Go ahead and rebalance because no one really knows where the market's bottom is.

Diversification will buffer a portfolio from declines in specific asset classes. For example, he said: "If the dollar declines dramatically, you have foreign and emerging-market equities. And a declining dollar may well be associated with inflation, but a diversified portfolio would include TIPS," to provide a hedge. "That means if any of these scenarios play out, an investor has sizable chunks of his portfolio that protect against them," Mr. Swensen said.

ALAN S. ORLING FOR THE NEW YORK TIMES

David F. Swensen manages investments for the $22.5 billion endowment at Yale.

When possible, he said, rebalancing should be done in a tax-sheltered account, like an I.R.A. or a 401(k), to avoid tax liabilities. "When you are putting fresh money to work," he said, "you put it in an asset class where you are underweight and take money out of a class that is overweight."

He says it is fruitless for individual investors to pick stocks. "There is no way that an individual can go out there and compete with all these highly qualified and compensated professionals," Mr. Swensen said.

HE criticized the approach of Jim Cramer, the CNBC host, who encourages investors to trade stocks in strategies that Mr. Swensen says cost heavily in commissions and taxes.

"There is nothing that Cramer says that can help people make intelligent decisions," Mr. Swensen said. "He takes something that is very serious and turns it into a game. If you want to have fun, go to Disney World."

Brian Steel, a spokesman for CNBC, responding on behalf of Mr. Cramer, said Mr. Cramer "had a long history of success as a trader and fund manager." He added that Mr. Cramer is a proponent of long-term investing and thorough research.

Mr. Swensen says investors should forget market timing entirely. Once an individual sets up a program, it should be rebalanced quarterly or semiannually, he said, "but it should be disciplined."

When the markets decline, try not to pay attention, he said. "Let yourself off the hook," he said. "If you pursue the sensible long-term policy, look at it over a 5- to 10-year period. Don't look at five months." □

New York Times

Rules of the Fund Road: Watch the Fees, and Don't Look Back

Jeff Sommer

June 1, 2014, Page BU 3

Investing would be easy if you could predict the future. Unfortunately, I can't help you with that. But I do know a little about what works and what doesn't work.

How an investment performed in the past doesn't work: Past performance doesn't guarantee future results. That thought should be familiar, since the Securities and Exchange Commission requires that it be published in all advertising dealing with mutual fund performance.

How much a fund charges in expenses does work. Within certain limits, fee levels provide an excellent guide to the future. Of course, fund fees in themselves don't guarantee that you'll do well with a particular investment; a bad bet doesn't magically turn into a good one if the fees are low. But all things equal, you will be a lot better off if hefty fees aren't eating up your returns. And low fees may tell you much more than that: When fees are low, the chances are much greater that an overall investment portfolio will outperform its peers.

These aren't new ideas. But they are worth reconsidering right now, with five years of bull market returns behind us. Those performance numbers have radically improved the appearance of even the most ordinary of mutual funds and exchange-traded funds. But do those rosy numbers tell us much about the future, especially if the market changes direction?

Based on a new data analysis by Morningstar, the mutual fund tracking company, the old wisdom is likely to remain relevant today: Past performance isn't likely to help you pick a mutual fund or E.T.F. for the future. But the level of a fund's fees probably will.

Morningstar started with the investment universe that existed in June 2008. That was a turning point in the markets, though no one knew it with certainty at the time. The financial crisis would soon deepen, and a recession was already underway, though it wouldn't be officially declared for months to come. The stock market was about to plunge horrifically, only to rebound in March 2009 and begin an epic bull market. None of that was clear at the time, either. At an important and difficult moment, it would have been very helpful to have a reliable guide to choosing investments.

Russel Kinnel, the director of fund research at Morningstar, examined fund fees as a guideline for mutual fund performance over the subsequent five years. And at my request, Annette Larson, a senior research analyst at Morningstar, ran a computer program aimed at analyzing whether fund performance over the previous three, five and 10 years would have been useful for picking funds.

The results were clear for fund fees, and Mr. Kinnel posted them on the Morningstar site. "I've found that low cost is the best single predictor of subsequent performance available," he said in an interview. "It's definitely not past performance. You should start with an allocation decision — say, you want to put a certain amount of money into the stock market — and then your next

step probably ought to be to look for the cheapest funds that will give you that allocation. If you select your fund from that inexpensive group, you'll probably outperform."

In his study, Mr. Kinnel divided funds into five groups — quintiles — based on their expense ratios, a widely used measure of basic fund fees that can be easily found through Morningstar and many other services. The higher the expense ratio, the greater the fund's cost for investors.

In each of Morningstar's 112 fund categories — like small-cap growth stock, large-cap value stock, or intermediate-term bond — the funds in the cheapest quintile in June 2008 generally outperformed other funds in their peer groups over the next five years. And as the fund quintiles became more expensive, the percentage of funds that outperformed their peers dropped. The cheapest group of domestic equity funds, for example, outperformed 56 percent of their peers. The most expensive group in that category outperformed only 24 percent of their peers.

Those numbers refer to what Mr. Kinnel calls a fund's "subsequent total return success rate" — the percentage of funds that existed in June 2008, survived as stand-alone entities for five more years and outperformed others in their category. The idea was to avoid "survivorship bias," which afflicts studies that compare only those funds in existence at the end of an extended period. That would paint a rosier picture than investors actually experienced, because fund sponsors have an incentive to close or merge funds that perform poorly.

But remember that outstanding performance is no guarantee of future results. The Morningstar research performed for me certainly demonstrated that. It showed that in 2008, stock funds with the best past performance generally did not fare well in the subsequent five years.

For example, domestic stock funds in the top performance group in the previous three, five and 10 years generally did worse than most peers later. For bond funds, the results were different. Past performance was generally associated with better returns, perhaps because the bond market was more stable than the stock market in the ensuing years.

In short, investments with good past performance sometimes do well later and sometimes do very badly. Performance itself won't tell you much about how an investment will fare in the future. Low cost won't guarantee good results, either, but it almost always provides useful information and it improves your chances of success enormously.

John C. Bogle, the founder of Vanguard, has been saying that for decades. In an email conversation, he put it this way: "In the mutual fund industry, you not only don't get what you pay for, fund investors as a group get precisely what they don't pay for. Therefore, the less you pay, the more you get. And if you pay nothing, you get everything."

So, as a starting point, try to pay very little. You'll probably be better off later.

Buttonwood

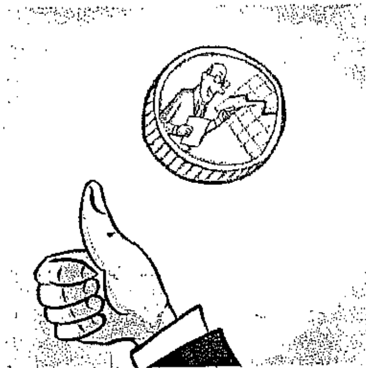
Most trading strategies are not tested rigorously enough

LET me tell you about the perfect investment offer. Each week you will receive a share recommendation from a fund manager, telling you whether the stock's price will rise or fall over the next week. After ten weeks, if all the recommendations are proved right, then you should be more than willing to hand over your money for investment. After all, there will be just a one-in-a-thousand chance that the result is down to luck.

Alas, this is a well-known scam. The promoter sends out100,000 e-mails, picking a stock at random. Half the recipients are told that the stock will rise; half that it will fall. After the first week, the 50,000 who received the successful recommendation will get a second e-mail; those that received the wrong information will be dropped from the list. And so on for ten weeks. At the end of the period, just by the law of averages, there should be 98 punters convinced of the manager's genius and ready to entrust their savings.

As a paper* published last year in the *Journal of Portfolio Management* argued, this is a classic example of the misuse of statistics. Conduct enough tests on a bunch of data—run through half a million genetic sequences to find a link with a disease, for example—and there will be many sequences that appear meaningful. But most will be the result of chance.

This is a problem that has dogged scientists across many disciplines. There is a natural bias in favour of reporting statistically significant results—that a drug cures a disease, for example, or that a chemical causes cancer. Such results are more likely to be published in academic journals and to make the newspaper headlines. But when other scientists try to replicate the results, the link disappears because the initial result was a random outlier. The debunking studies, naturally, tend to be less well reported.



Faced with this problem, scientists have turned to tougher statistical tests. When searching for a subatomic particle called the Higgs Boson, they decided that to prove its existence, the results had to be five standard deviations from normal—a one-in-3.5-million chance.

Financial research is highly prone to statistical distortion. Academics have the choice of many thousands of stocks, bonds and currencies being traded across dozens of countries, complete with decades' worth of daily price data. They can back-test thousands of correlations to find a few that appear to offer profitable strategies.

The paper points out that most financial research applies a two-standard-deviation (or "two sigma" in the jargon) test to see if the results are statistically significant. This is not rigorous enough.

One way round this problem is to use "out-of-sample" testing. If you have 20 years of data, then split them in half. If a strategy works in the first half of the data, see if it also does so in the second out-of-sample period. If not, it is probably a fluke.

The problem with out-of-sample testing is that researchers know what happened in the past, and may have designed their strategies accordingly: consciously avoiding bank stocks in 2007 and 2008, for example. In addition, slicing up the data means fewer observations, making it more difficult to discover relationships that are truly statistically significant.

Campbell Harvey, one of the report's authors, says that the only true out-of-sample approach is to ignore the past and see whether the strategy works in future. But few investors or fund managers have the required patience. They want a winning strategy now, not in five years' time.

The authors' conclusions are stark. "Most of the empirical research in finance, whether published in academic journals or put into production as an active trading strategy by an investment manager, is likely false. This implies that half the financial products (promising outperformance) that companies are selling to clients are false."

For the academics, the lesson is simple. Much more rigorous analysis will be needed in future to reduce the number of "false positives" in the data. As for clients of the investment industry, they need to be much more sceptical about the brilliant trading strategies that fund managers try to sell them.

All this will leave many readers wondering how to invest their savings. That's fine. Buttonwood has an investment strategy that is sure to boost your wealth. Just send your e-mail address and a stock tip will arrive every month...

* "Evaluating Trading Strategies" by Campbell Harvey of Duke University and Yan Liu of Texas A&M University, *Journal of Portfolio Management*, 40th anniversary issue http://www.iijournals.com/doi/abs/10.3905/jpm.2014.40.5.108

Economist.com/blogs/buttonwood

The Economist February 21, 2015

NEW YORK TIMES

May 18, 2013

What Stock to Buy? Hey, Mom, Don't Ask Me

By N. GREGORY MANKIW

OVER the last few weeks, as the stock market has reached new highs, my thoughts have turned to my 85-year-old mother.

"O.K. Mr. Smarty-Pants," she often asks me, "what stock should I buy now?"

She first asked me this question when I was an undergraduate at Princeton, majoring in economics. She asked again when I was a graduate student at M.I.T., earning a Ph.D. in economics. And she has asked it regularly during the last three decades when I have been an economics professor at Harvard.

Unfortunately, she has never been happy with my answers, which are usually evasive. Nothing in the toolbox of economists makes us good stock pickers.

Yet we economists have written countless studies about the stock market. Here is a summary of what we know:

THE MARKET PROCESSES INFORMATION QUICKLY One prominent theory of the stock market — the efficient markets hypothesis — explains how answering my mother's question would be a fool's errand. If I knew anything good about a company, that news would be incorporated into the stock's price before I had the chance to act on it. Unless you have extraordinary insight or inside information, you should presume that no stock is a better buy than any other.

This theory gained public attention in 1973 with the publication of "A Random Walk Down Wall Street," by Burton G. Malkiel, the Princeton economist. He suggested that so-called expert money managers weren't worth their cost and recommended that investors buy low-cost index funds. Most economists I know follow this advice.

PRICE MOVES ARE OFTEN INEXPLICABLE Even if changes in stock prices are unpredictable, as efficient markets theory suggests, we should be able to explain these changes after the fact. That is, we should be able to identify the news that causes stock prices to rise and fall. Sometimes we can, but often we can't.

In 1981, Robert J. Shiller, a regular contributor to this column and an economics professor at Yale, published a paper in The American Economic Review called, "Do Stock Prices Move Too Much to Be Justified by Subsequent Changes in Dividends?" He argued that stock prices were too volatile. In particular, they fluctuated much more than a rational valuation of the underlying fundamentals would.

Mr. Shiller's paper prompted a storm of controversy. My reading of the subsequent academic literature is that his conclusions, though not all his techniques, have survived the debate. Stock prices seem to have a life of their own.

Advocates of market rationality now say that stock prices move in response to changing risk premiums, though they can't explain why risk premiums move as they do. Others suggest that the market moves in response to irrational waves of optimism and pessimism, what John Maynard Keynes called the "animal

spirits" of investors. Either approach is really just an admission of economists' ignorance about what moves the market.

HOLDING STOCKS IS A GOOD BET The large, often inexplicable movements in stock prices might deter someone from holding stocks in the first place. Many Americans, even some with significant financial assets, avoid stocks altogether. But doing so is a mistake, because the risk of holding stocks is amply rewarded.

In 1985, Rajnish Mehra and Edward C. Prescott, both now at Arizona State University, published a paper in the Journal of Monetary Economics called "The Equity Premium: A Puzzle." They pointed out that over a long time span, stocks have earned, on average, about 6 percent more per year than safe assets like Treasury bills. This large premium, they said, is hard to explain with standard economic models. Sure, stocks are risky, so you can never be certain you'll earn the premium, but they are not risky enough to justify such a large expected return.

Since the paper was published, economists have made some limited progress in explaining the equity premium. In any event, the large premium has convinced most of us that stocks should be part of everyone's financial plan. I allocate 60 percent of my financial assets to equities.

Stocks may be an especially good deal today. According to a recent study by two economists at the Federal Reserve Bank of New York, given the low level of interest rates, the equity premium now is the highest it has been in 50 years.

DIVERSIFICATION IS ESSENTIAL Every time a company experiences a catastrophic decline — consider Enron or Lehman Brothers — reports emerge about employees who held most of their wealth in company stock. These stories leave economists slapping their heads. If there is one thing we know for sure, it is that sensible financial management requires diversification.

So, if you have more than 5 percent of your assets in any one company, call your broker and sell. Doing otherwise means exposing yourself to extra risk without extra reward.

SMART INVESTORS THINK GLOBALLY One widely documented failure of diversification is what economists call home bias. People tend to invest disproportionately in their home country.

Most economists take a more global perspective. The United States represents a bit under half of the world's stock portfolio. Because Europe, Japan and the emerging markets don't move in lock step with the United States, it makes sense to invest abroad as well.

Which brings me back to my mother's question: If I could pick just one stock for someone to buy, what would it be? I would now suggest something like the Vanguard Total World Stock exchange-traded fund, which started trading in 2008. In one package, you can get low cost and maximal diversification. It may not be as exciting as trying to pick the next Apple or Google, but you'll sleep better at night.

N. Gregory Mankiw is a professor of economics at Harvard.

Asset management

Index we trust

Vanguard has radically changed money management by being boring and cheap

Jun 11th 2016 | From the print edition

WHEN John Bogle set up Vanguard Group 40 years ago, there was no shortage of scepticism. The firm was launching the first retail investment fund that aimed simply to mimic the performance of a stock index (the S&P 500, in this case), rather than to identify individual companies that seemed likely to outperform. Posters on Wall Street warned that index-tracking was "un-American"; the chairman of Fidelity, a rival, said investors would never be satisfied with "just average returns"; and the Securities and Exchange Commission (SEC), Wall Street's main regulator, opposed the firm's unusual ownership structure. The fund attracted just $11m of the $150m Vanguard had been hoping for, and suffered net outflows for its first 83 months. "We were conceived in hell and born in strife," Mr Bogle recalls.

Vanguard now manages over $3.5 trillion on behalf of some 20m investors. Every working day its coffers swell by another billion dollars or so. One dollar in every five invested in mutual or exchange-traded funds (ETFs) in America now goes to Vanguard, as does one in every two invested in passive, index-tracking funds, according to Morningstar, a data provider. Vanguard's investors own around 5% of every public company in America and about 1% in nearly every public company abroad. Although BlackRock, a rival, manages even more money, Vanguard had net retail inflows of $252 billion in 2015, more than any other asset manager.

Impressive as they are, however, these statistics still understate Vanguard's influence. By inventing index-tracking, and providing it at very low cost, the firm has forced change on an industry known for its high margins and overcomplicated products. Delighted investors and disgruntled money managers speak of "the Vanguard effect", the pressure that the giant's meagre fees put on others to cut costs. Some rivals now sell passive products priced specifically to match or undercut it.

Ask any employee for the secret of Vanguard's success, and they will point to its ownership structure. The firm is entirely owned by the investors in its funds. It has no shareholders to please (and remunerate), unlike the listed BlackRock or Fidelity, a privately owned rival. Instead of paying dividends, it cuts fees. Mr Bogle's rationale for this set-up is simple: "No man can serve two masters." The incentives of the firm and its customers are completely aligned, he says. Competitors implicitly agree. "How are we supposed to compete when there's a non-profit disrupting the game?" complains one.

Bill McNabb, Vanguard's current CEO, says the ownership structure permits a virtuous cycle, whereby its low fees improve the net performance of its funds, which in turn attracts more investors to them, which increases economies of scale, allowing further cuts in fees. Even as the assets Vanguard manages grew from $2 trillion to $3 trillion, its staff of 14,000 or so barely increased. Meanwhile, fees as a percentage of assets under management have dropped from 0.68% in 1983 to 0.12% today (see chart). This compares with an industry average of 0.61% (or 0.77%, when excluding Vanguard itself). Fees on its passive products, at 0.08% a year, are less than half the average for the industry of 0.18%. Its actively managed products are even more keenly priced, at 0.17% compared with an average of 0.78%.

The index-trackers account for over 70% of Vanguard's assets and over 90% of last year's growth. Investors are gradually absorbing the idea that, in the long run, beating the market consistently is

impossible, Mr McNabb says. That makes being cheap more important than being astute. Last year investors in America withdrew $145 billion from active funds of different kinds and put $398 billion into passive ones.

"In an industry with serious trust issues, Vanguard has proven an exception to the rule," says Ben Johnson of Morningstar. Its investors stay with it roughly twice as long as the industry average. The firm actively shuns short-term "hot money" because it brings extra trading costs. Mr McNabb tells the tale of the CEO of a foundation who wanted to park $40m with a Vanguard fund for a few months. When the fund turned him away, he "went ballistic", complaining to the SEC, but Vanguard did not budge.

Vanguard also insists on keeping things simple. It offers only 70 different ETFs, compared with 383 at BlackRock. It steers clear of voguish products, such as funds of distressed energy firms. It refused, presciently, to set up an internet fund in the late 1990s.

But Vanguard's conservatism can also be a weakness. It has been slow to expand abroad: its customer base is 95% American. It was slow to get into ETFs as well, allowing BlackRock to become the biggest provider, although Vanguard is catching up. BlackRock is also a one-stop shop for all manner of investments, including alternatives such as private equity and hedge funds, whereas Vanguard caters only to the mainstream. This may be one of the reasons why it does less well with the biggest institutional investors, which want lots of investment options and the kind of bespoke service that Vanguard does not offer.

There is always a chance that a clever fintech startup, or a tech giant like Apple, might create a cheaper or simpler way for individuals to invest, luring away some of Vanguard's customers. As it is, it is getting harder for Vanguard to keep cutting fees: to shave its average fee by a hundredth of a percentage point, it needs to attract an extra $560 billion in assets under management. And heavier regulation is always a risk. Last year the industry's giants won an important battle when they convinced regulators that, unlike banks, fund managers should not be subject to more onerous rules simply because they are big. But talk of rules intended to stem panic in collapsing markets has not gone away.

Nonetheless, there is plenty of room for Vanguard to keep growing. Only a third of American equities are held by index-tracking funds, and a smaller share elsewhere. Regulators in America and beyond are discouraging or barring financial advisers from receiving commissions from firms whose products they recommend—a move that should push even more money to Vanguard as advisers lose the incentive to offer expensive products (Vanguard refuses to pay commissions).

As the move from defined-benefit to defined-contribution pensions continues, and as Asia sets up its retirement systems, there will be growing demand for the sort of "DIY" investing that has underpinned Vanguard's success. With interest rates and investment returns expected to be low for years to come, keeping fees down will be more important than ever. As Tim Buckley, the firm's chief investment officer, puts it: "The biggest advantage Vanguard has, aside from its structure, is the greed of our competitors."

From the print edition: Finance and economics

Playing the 'January Effect'

By Ben Levisohn

The new year is still seven weeks away, but already some investors are preparing to take advantage of the January Effect.

The good news: There seems to be a logical basis for the famous trading pattern. But capitalizing on it isn't always easy.

Popularized decades ago, the January Effect—the idea that small and beaten-down stocks outperform larger and stronger ones during the first month of the year—has tantalized investors looking for a way to game the market.

From 1927 through 2004, small stocks beat large stocks by an average of 2.5 percentage points during January, according to research by University of Kansas professors Mark Haug and Mark Hirschey, while cheap stocks beat more expensive ones by 2.4 points.

Taking advantage of the January Effect has been a difficult proposition, however. Since the pattern was identified, academics have been drilling down into returns to discover which types of stocks were driving the action and the factors responsible for them.

At the beginning, it was observed that stocks generally performed better in January than in other months. The discovery that the January Effect was stronger in an index in which each stock is weighted equally than in a traditional market-value-weighted index led investors to focus on smaller stocks.

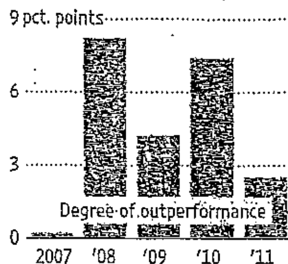
As the January Effect became better understood, it also weakened. During the 1970s, small stocks beat large ones by an average of 5.1 percentage points in January; during the 1990s, the outperformance dropped to one point.

"If everyone starts doing something, the strategy's effectiveness will be reduced," says Sudhir Nanda, a portfolio manager at T. Rowe Price Group in Baltimore.

The underlying reasons for the anomaly remain unclear. Some suggest it results from investors selling their weakest stocks in December to harvest their losses for tax purposes, then buying back the same stocks in January, giving the share prices an artificial boost. Others suggest mutual funds sell stocks with large losses to avoid mentioning them in their year-end report, and then buy them back in the new year.

Giant Killers

The 150 weakest stocks in the S&P 1500 have outperformed the index's average from mid-December through the end of January.



Source: Ned Davis Research

Even the time frame for the January Effect might be shifting forward a few weeks.

Each December, Ned Davis Research sends out a list of its January Effect Stocks, which is generated by screening for the smallest 150 stocks in the Standard & Poor's 1500-stock index that also are among the 10% of stocks furthest from their calendar-year closing high. From 1996 through 2009, the portfolio returned an average of 8.6% from mid-December through the end of January, well above the 1.2% gain in the S&P 500. From Jan. 1 to the end of the month, however, it returned just 3.5%.

If you are thinking of trying the strategy, be warned that transaction costs aren't included—and since small companies generally have wider bid-ask spreads than larger companies, those costs may be high.

Brian Sanborn, a strategist at Ned Davis Research, notes that the portfolio also is highly volatile, nearly twice as much as the S&P 500. The firm recommends putting no more than 5% of a portfolio's weight in the strategy.

A simple alternative for investors: Buy an S&P 600 small-cap exchange-traded fund during mid-December and sell it at the end of January. Such a strategy would have averaged a 0.2% return over the past 10 years, compared with a minus-0.9% loss in the S&P 1500, and been successful in seven of those years.

Pankaj Patel, a strategist at Credit Suisse, recommends screening for companies that are trading 25% below their 52-week highs, but no more than 15% above their 52-week low. That is because managers are unlikely to dump beaten-down stocks that have started rallying.

Mr. Patel also applies a value screen by finding the price/book, price/earnings, price/cash flow and price/sales ratios, along with the dividend yields of the stocks in an index like the S&P 500, and comparing them with their industry and to their own historical performances. Stocks that fall into the bottom half of the index in valuation make the cut. They include **Walgreen**, **Newfield Exploration** and **Lexmark International**.

When applied to the S&P 500, the strategy has outperformed the benchmark from Nov. 1 through Jan. 31 during each of the past six years—by as little as 0.4% in 2007 and as much as 14.2% in 2008. For small and midcap stocks, the strategy was successful in five of the six years.

Investors might be able to boost performance by buying the stocks in mid-November, to avoid the worst of the underperformance by weak stocks, and selling in mid-January, to avoid the rush of sellers, Mr. Patel says.

THE WALL STREET JOURNAL. Saturday/Sunday, November 12 - 13, 2011

Wall Street Journal

Index Funds Still Beat 'Active' Portfolio Management

There is no better way for individuals to invest in the stock market and save for retirement.

Burton G. Malkiel
June 5, 2017 6:19 p.m. ET

A recent report from Standard & Poor's adds impressive support to the large body of evidence suggesting the superiority of simple index investment strategies over traditional stock picking. At the start of every year, "active" portfolio managers declare that the current year will be the "year of the stock picker." But the results consistently fail to support that view.

For years S&P has served as the de facto scorekeeper demonstrating the dismal record of "active" portfolio managers. During 2016, two-thirds of active managers of large-capitalization U.S. stocks underperformed the S&P 500 large-capital index. Nor were managers any better in the supposedly less efficient small-capitalization universe. Over 85% of small-cap managers underperformed the S&P Small-Cap Index.

When S&P measured performance over a longer period, the results got worse. More than 90% of active managers underperformed their benchmark indexes over a 15-year period. Equity mutual funds do beat the market sometimes, but seldom can they do it consistently, year over year.

The same findings have been documented in international markets. Since 2001, 89% of actively managed international funds had inferior performance. Even in less efficient emerging markets, index funds outperformed 90% of active funds. Indexing has proved its merit in various bond markets as well.

The logic behind the empirical results is irrefutable. In any national market, all the securities are held by someone. Thus if some investors are holding securities that do better than average, it must follow that other investors do worse than average. Investing has to be a zero-sum game. For every winner there will be a loser.

But in the presence of costs, the game becomes negative-sum. The index investor will achieve the market return with close to zero cost. Actively managed funds charge management fees of about 1% a year. Thus, as a group, actively managed funds must underperform index funds by their difference in costs. And empirical evidence suggests that active funds underperform index funds by approximately the difference in their costs. Moreover, actively managed funds tend to realize taxable capital gains each year. Passive index funds are more tax-efficient, making the after-tax gap even larger.

In 2016 investors pulled $340 billion out of actively managed funds and invested more than $500 billion in index funds. The same trends continued in 2017, and index funds now account for

about 35% of total equity fund investments. Now a new critique has emerged: Index funds pose a grave danger both to the stock market and to the general economy.

In 2016 an AB Bernstein research team led by analyst Inigo Fraser-Jenkins published a report with the provocative title "The Silent Road to Serfdom: Why Passive Investment Is Worse than Marxism." The report argued that a market system in which investors invest passively in index funds is even worse than an economy in which government directs all capital investment. The report alleges that indexing causes money to pour into a set of investments without regard to considerations such as profitability and growth opportunities. Detractors also accuse index funds of producing a concentration of ownership not seen since the days of the Rockefeller Trust.

What would happen if everyone began investing in index funds? The possibility exists that they could grow to such a size that they would distort the prices of individual stocks. The paradox of index investing is that the stock market needs some active traders to make markets efficient and liquid.

But the substantial management fees that active managers charge give them an incentive to perform this function. They will continue to market their services with the claim that they have above-average insights that enable them to beat the market, even though they cannot all achieve above-average market returns. And even if the proportion of active managers shrinks to a tiny percentage of the total, there will still be more than enough of them to make prices reflect information.

Americans have far too much active management today, not too little. The S&P report reveals that ever-increasing percentages of active managers have been outperformed by the index. If anything, the stock market is becoming more efficient—not less so—despite the growth of indexing.

It is true that there will be a growing concentration of ownership among the index providers, and they will have increased influence in proxy voting. The possibility of excessive market power needs to be monitored by antitrust authorities, but index funds don't have an incentive to use their votes to encourage anticompetitive behavior.

Index funds have been of enormous benefit for individual investors. Competition has driven the cost of broad-based index funds nearly to zero. Individuals can now save for retirement far more efficiently than before by assembling a diversified portfolio of index funds. There is no better way to preserve and grow one's savings.

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Appeared in the June 6, 2017, print edition as 'Index Funds Still Beat 'Active' Portfolio Management