

Chuck Jaffe

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Listen to Buffett and Schwab: Be an indexer

Keeping it easy, cheap and simple

By Chuck Jaffe, MarketWatch



Bloomberg

Chuck Schwab, founder of **Charles Schwab & Co.** (NYSE:SCHW), talked last week about the **power and importance of indexing**, suggesting that low-cost diversified funds that track indexes are the best approach for 95% to 98% of Americans.

A few months ago, one of the few investment icons actually bigger than Schwab, Warren Buffett, revealed that if his wife survives him, his estate plan will recommend keeping 90% of her inheritance in the Vanguard Index 500 fund (MFD:VFINX), with the rest in short-term government bonds.

For investors who want to follow the leaders here, picking straightforward index ETFs and funds means finding the ones with the lowest costs and putting money to work.



Managing money for women on Wall Street

Women executives and women on Wall Street are busy. Here's how financial advisers can help.

But the spin has already started, suggesting that the indexing strategy can be tailored into something better.

Indeed, the evolution of exchange-traded funds — built mostly like index funds but traded like stocks — has made it so that investors have tremendous choice and opportunity.

With those choices, however, come some problems, because while a legend like Schwab can come out and recommend indexing for average Americans, he's not suggesting mucking up the strategy.

Look at any chart of the big, brand-name indexes — the S&P (SNC:SPX), the Russell 1000 (RSU:RUI), and moving on out to total-market options — and the construction of the Index doesn't seem to make much difference. You can basically lay the performance charts on top of each other and the differences are minute.

At that level — precisely what Schwab and Buffett were discussing — simple and low-cost wins; you're strapping yourself to the market (or a big chunk of it), planning to ride the long-term trend.

"The more refined your indexing strategy gets — going from broad market segments to sectors or countries or industries — the more wary you have to be of what it is you are buying," said Dan Wiener, chief executive officer at Adviser Investment Management in Newton, Mass., and the editor of The Independent Adviser for Vanguard Investors. "These indexes have been created out of thin air to provide a product that somehow differentiates itself from others, and you want to know where the index came from, what goes into it, how long has it been around, how often has it changed, will the provider be around in three years if the ETF doesn't draw a lot of assets and more.

"You change what you are trying to do with ETFs and you change how easy or hard they are to pick for your portfolio," Wiener said.

Vanguard founder Jack Bogle's advice to fretful investors: Shut your eyes and let indexes do the work

By [Chuck Jaffe](#)

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Bloomberg

John C. Bogle, founder of the Vanguard Group.

If the stock market's September-October flip-flop scared you, Jack Bogle has some advice on how to tackle what's about to happen next: Close your eyes.

Bogle, the founder of the Vanguard Group, the world's largest investment company, and patron saint of low-cost, long-term index investing, has not changed his tune in the 40-plus years since he started the company.

At age 85, Bogle's not about to change his ways now. And not because he's past learning new tricks or adjusting his thinking, but because decades of being right have created an unshakable courage in his convictions.

Many of his disciples share Bogle's audacity, but he laments the financial fortunes of all the people who haven't gotten the message yet.

This week, Bogle did a two-part interview (listen [here](#) and [here](#)) on my radio show, "MoneyLife with Chuck Jaffe," and while he did not break much new ground, it's always worth plowing important territory with someone who knows the lay of the land. Here are some highlights:

On markets:

"What's going on in the market is domination of short-term speculation over long-term investment," he said. "Long-term investors simply are not affected by the comings and goings of the market, where it looks like it goes up 100 points on odd-numbered days and down 100 points on even-numbered days.

"As I have said before, the daily machinations of the stock market are like a tale told by an idiot, full of sound and fury, signifying nothing," Bogle added. "One of my favorite rules is 'Don't peek.' Don't let all the noise drown out your common sense and your wisdom. Just try not to pay that much attention, because it will have no effect whatsoever, categorically, on your lifetime investment returns."

On why investors should ignore the noise and just aim for the index return over a lifetime:

"Returns are created not by the stock market, they are created by U.S. business, our corporations," he explained. "The formula I use for that is today's dividend yield, which is around 2%, and the subsequent earnings growth which could be around 5% — we're not sure but that's probably not a bad guess — and that's a 7% nominal rate of return on stock in terms of fundamentals.

"If you go back and look at the history of American business over the last century, you will find the [price/earnings] effect of stocks is zero. All of the returns are created as investment returns, dividend yields and earnings growth, and p/e effect — the speculative return — goes up and goes down and goes up and down for 100 years and ends up just where it started.

"So try to ignore these machinations and stick with getting the underlying returns that provide stocks as good investments," Bogle said.

On how many experts have declared indexing the winner over active management:

"This year, 2014, so far happens to be one of the great years for S&P 500 indexing. I hope nobody thinks it will be that way forever because it won't be.

"I am sorry to say it, fellow shareholders, but it doesn't get that good. Over the long run [indexing] should beat the competition by 150 to 200 [1.5% to 2.0%]," Bogle said. "Confidence in the mathematics — the relentless rules of humble arithmetic — enables you to get through..."

On how bond investors should look at the potential for interest rates to rise (several years ago, Bogle warned of a building bond bubble):

"When you talk about bond investors getting hurt when bond yields start to rise, the answer to that is really yes and no. Certainly yes, absolutely, on a short-term basis, but you shouldn't be investing in bonds on a short-term basis.

"Use the intermediate maturity around 10 years exemplified by the high-quality 10-year U.S. Treasury note," he added. "Basically today you are entering into a contract with the Treasury to give you 2.2% every year for the next 10 years. The Treasury will be good for that; there's no risk in that deal falling apart that I can see. The price of that Treasury [note] will drop a lot if rates will go up, however if you are reinvesting your income, you will have a higher total return over the 10-year period. So in a certain respect if you can stand the pain, we all should want rates to go up."

On exchange-traded funds:

"They're fine just so long as you don't trade them," Bogle said. "It's the ability to trade that distinguishes them [from a traditional index fund], and then there is the kind of Looney Tune section of the ETF market pursuing things that no investor should ever do.... Anybody who plays that kind of game [using leveraged or niche products] is a damned fool.

"The ETF is the greatest marketing innovation of the 21st century so far. Whether it's the greatest investment innovation of the 21st century so far, I can't imagine. I think it's counter-productive."

Advice for investors who can't be satisfied with shutting their eyes, doing nothing and letting indexing work in their favor:

"Divide your money into your long-term investment account and your funny money account for short-term speculation. Guess on funds, guess on markets, guess on stocks if you want to, because that gives you an opportunity to act on your speculative impulses.

But they will hurt you a lot so I recommend you have a funny money account of no more than 5% of your portfolio. I also recommend that after five years, check it out. Has it done better than the long-term investment or worse? I'd be astonished if at least 95% of those funny money accounts don't do worse."

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 MarketWatch
THE WALL STREET JOURNAL


Aug. 1, 2014, 5:00 a.m. EDT

Index funds superior to high-priced active management

By George Sisti

Editor's note: As a financial planner, George Sisti advocates index investing and has written passionately on the subject for *The Retirementors*. Investor Robert Ishitls, however, feels actively-managed funds are much more aligned and have a place in your retirement portfolio. [Read his take here.](#)

The theoretical benefits of active management have proven to be fables. So why are investors still paying high fees for disappointing, inconsistent and tax inefficient performance?

It's long been my contention that the two primary components of active management — market timing and stock picking — are modern day equivalents of alchemy, the pursuit of an illusion.

Index investors believe that the stock market is "efficient." This means that today's stock prices represent the consensus opinion of many smart people, incorporate all known information about a company and its prospects and will instantly adjust to new information. The market's consensus opinion isn't a perfect pricing mechanism but it has been awfully difficult to outsmart.

Providers of active management disagree. Some would have you believe that they can find and profit from mispriced securities. Others claim to have the ability to time the market, shifting between stocks and fixed income assets to avoid market declines. An ability to time the market has been, and continues to be, significantly overstated by many self-promoting money managers.

It is difficult to predict the long-term prospects of any company in the fast-changing global economy. A company's stock price will change as market participants respond to random and unpredictable new information. This "random walk" hypothesis was made famous by Burton Malkiel in his investment classic, *A Random Walk Down Wall Street* — required reading for all do-it-yourself investors. Unfortunately, most investors haven't read the book and are unaware of the poor track record of active management.

Any stock mispricing disappears as soon as it becomes known; making stock picking a short-term strategy. Stock pickers believe that they can outsmart the collective pricing judgment of all other market participants. It's as if the playground bully challenged everyone in school to a fight, not one at a time, but all at once. I can't think of a better analogy to explain the disappointing track record of stock pickers and why few have created value in excess of their fees.

So why are more than 85% of mutual fund assets invested in actively managed funds? One reason might be that many investors lack financial literacy and are influenced by fund advertising or the conflicted advice of commission based financial advisers. But do financially literate investors make better investment decisions than the average investor?

A recent study, [Financial Literacy and Mutual Fund Investments: Who Buys Actively Managed Funds?](#) interviewed more than 3,000 mutual fund investors and tracked the performance of their actively managed equity funds from May 2006 through May 2008.

The authors discovered a positive relationship between financial literacy and the likelihood that an investor would be aware of, and implement an index investment strategy. However, the majority of even the most sophisticated investors invested primarily in actively managed funds. Unfortunately, the performance of the funds chosen by financially literate investors did not yield a higher risk adjusted return than those chosen by less sophisticated investors.

One question in the survey was designed to measure a respondent's self-assessed "Better Than Average" (BTA) score:

"On average I am able to select securities which deliver superior returns compared to those securities selected by a typical investor."

There were five multiple-choice answers ranging from "strongly disagree" to "strongly agree". Survey participants with high BTA scores tended to be affluent, have above-average financial literacy and overestimate their ability to find outperforming actively-managed funds — what the authors call the "overconfidence phenomenon":

"Overconfidence is a possible explanation for why even highly sophisticated participants mostly select active funds ... We see that investors who are financially more literate believe themselves to be better than average in their fund choices. Apparently they are not."

There was also some evidence that sophisticated investors tend to buy funds that have recently performed well — adding [recency bias](#) and performance chasing to their overconfidence.

Financially literate investors tended to avoid mutual funds with sales loads. However, if a fund had good recent performance, they were likely to ignore high management fees even though high management fees create a greater long-term performance drag than a one-time, front-end sales load.

The Pied Piper of active management leads investors into a Twilight Zone of short-term speculation. It's an eerie world of greed, graphs, data massaging and half-truths; where the unwary are separated from their money.

Investors would do well to follow this advice from Warren Buffett:

"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."

Wealth accumulation is best accomplished by owning a prudent allocation of low-cost stock index funds for the long-term. Mix in some common sense, patience, and rebalancing. And please, stay far away from the active management Twilight Zone, where alchemists pursue illusions.

['Index funds beat active 90% of the time.' Really?](#)

[Whack-a-mole fund managers can't beat index funds](#)

[Warren Buffett to heirs: Put my estate in index funds](#)

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Currents

Pension reform's win-win



Josh Shapiro

Josh Shapiro

is the Montgomery County commissioners chairman and serves as chairman of the county's pension board

When trying to pare budgets and be more efficient, go where the money is.

That's why Montgomery County, the commonwealth's third most populous county, closely examined the costs associated with our \$450 million public employee pension fund. Public pensions are an area of significant potential savings, and of particular importance to state and local governments around the country.

Pennsylvania's funds have a shortfall of \$41 billion, and some other states have liabilities even higher. Unless there is another solution, these shortfalls will ultimately need to be filled by diverting funds from valuable investments like education, by raising taxes, by borrowing more money, or a combination of all three.

While so-called pension reform is the subject of much debate, there should be one public-pension issue upon which everybody can agree: the costs of managing pension assets. Unfortunately, this was absent from Gov. Corbett's recent proposal.

The goal of an asset manager is to maximize portfolio returns. The components of maximizing returns are twofold: fees and performance. The record is clear that passively managed funds have

fees than actively managed funds, and asset managers rarely beat the market over the long run. Therefore, shifting from higher-cost, lower-performing, actively managed investments to lower-cost, higher-performing, passively managed index funds will save governments in Pennsylvania and around the country billions of taxpayer dollars.

After a thorough review of our county's public-pension fund's performance and fees over many years, our pension board recently voted to move 90 percent of our pension-fund assets to a portfolio offered by Vanguard, a Valley Forge-based, investor-owned firm with hundreds of employees in our county. It is important to note that the county's reformed procurement process requires companies to disclose any financial or political dealings they may have had with county officials. Vanguard had none.

This shift will reduce the fund's management-fee expenses by more than two-thirds, a savings of more than \$1 million annually.

The switch also enables the county to eliminate one consulting firm and more than a dozen asset managers. The combination of lower management fees and lower personnel costs gives the passively managed funds at least a full percentage-point advantage on alternative investments. Plus, from a performance perspective, the S&P index had beaten our actively managed funds' annual perfor-

mance in eight of the last 10 years. The combination of reduced costs and higher returns is the proverbial win-win for county residents, employees, and retirees.

Governments have an obligation to be careful stewards of the public's money. If higher-fee, actively managed investments do not consistently outperform the market, we should not entrust public funds to them.

Two Pennsylvania funds — the State Employees' Retirement System (SERS)

and the Public School Employees' Retirement System (PSERS) — are substantially invested in higher-cost investment vehicles such as private equity, venture capital, real estate, and hedge funds. In fact, the two funds each pay about 1 per-

cent (or a total of about \$70 million) in manager fees, a rate seven times higher than Montgomery County will be paying for its diversified Vanguard mutual fund lineup and 20 times higher than those funds would pay if the commonwealth simply invested in an S&P 500 Index fund.

The PSERS fund earned about 12 percent on its investments in 2012, compared with the S&P 500 return of 16 percent. For that year alone the pension fund would have been better off by about \$1.25 billion if it was solely invested in the S&P. Even if the actively managed funds had matched the returns of the passive funds, the savings in fees would still have been hundreds of millions of dollars.

Of course, there will still be ups and downs in the market. And, as we've recently seen, down times can be very painful. But, over the long haul, the overall market has an impressive

of about 9.85 percent since its inception in 1926.

Real pension reform with lower fees and higher performance — that is the approach we've taken in Montgomery County and I strongly suggest that Pennsylvania follow suit.

E-mail Josh Shapiro at josh@montcopa.org, or follow him on Twitter at @Josh_Shapiro.



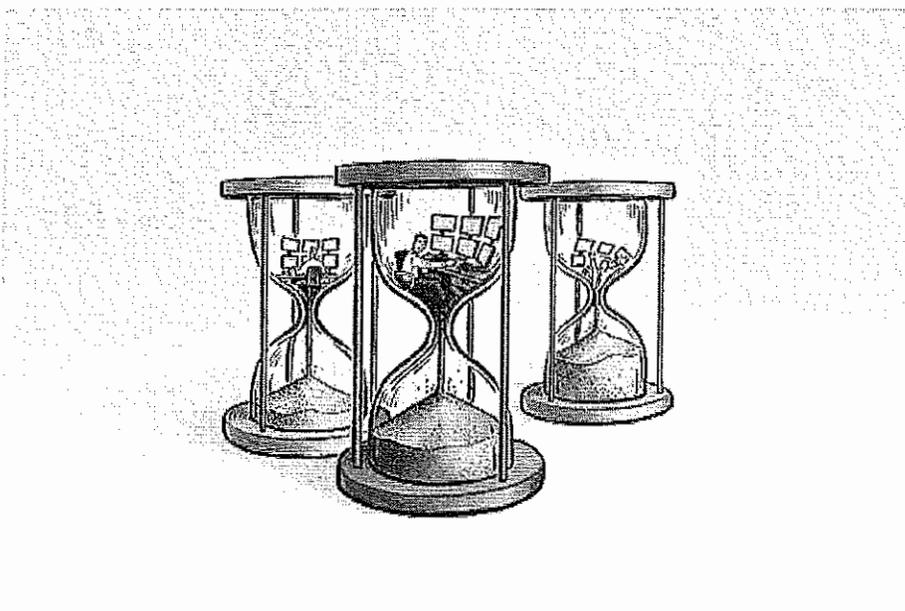
THE WALL STREET JOURNAL.

WSJ.com

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The Decline and Fall of Fund Managers

By Jason Zweig



Christophe Vorlet

Active fund management is outmoded, and a lot of stock pickers are going to have to find something else to do for a living.



The Intelligent Investor

By Jason Zweig

By Jason Zweig

COMMENTARY

The debate about whether you should hire an “active” fund manager who tries to beat the market by buying the best stocks and avoiding the worst—or a “passive” index fund that simply matches the market by holding all the stocks—is over.

So says Charles Ellis, widely regarded as the dean of the investment-management industry. Stock picking “has seen its day,” he told me this past week, as assets at Vanguard Group, the giant manager of market-tracking index funds, approached \$3 trillion for the first time. “With rare exceptions, active management is no longer able to earn its keep.”

If he is right, hordes of portfolio managers will eventually be thrown out of work—and financial advice could end up cheaper, better and more plentiful than ever before.

Mr. Ellis, 76 years old, is revered among money managers. He is the founder of the financial consulting firm Greenwich Associates, a former adviser to Singapore's sovereign-wealth fund, the author of 16 books and former chairman of Yale University's investment committee.

In an article in the latest issue of the well-respected Financial Analysts Journal, Mr. Ellis argues that fund managers equipped with sophisticated analytical tools, electronic trading and instantaneous access to news are engaged in an arms race resulting in a kind of mutually assured destruction of outperformance.

The faster and smarter each manager becomes, the more efficient the market gets and the harder it is for any manager to beat it. As a result, he writes, "the money game of outperformance after fees is, for clients, no longer a game worth playing."

No one gave a hoot about fees in the 1980s and 1990s, when 2% in fund expenses barely made a dent in the 18% average annual returns of U.S. stocks.

But since the beginning of 2000, stocks have returned an average of just 4% annually. A 1% fee is a quarter of that return.

Fees will come down because they have to.

And that, Mr. Ellis warns, will lead to "a wave of creative destruction" comparable to the changes that swept through the steel industry decades ago.

"Part of me thinks he's right, part of me doesn't want him to be right," says Theodore Aronson, an active manager who oversees \$25 billion in institutional assets at AJO in Philadelphia.

Of his firm's 15 portfolios, most available only to institutions, 14 have beaten their benchmarks since inception, and money continues to flow in. "I don't think the whole world is going to index," Mr. Aronson says, "but I'm not sure."

Humans always have believed in magic and miracles, and investors will probably never stop hoping to find the next Warren Buffett under some rock.

Furthermore, some managers will beat the market, some by skill and many by luck alone, even in today's hypercompetitive environment. While no one has ever come up with reliable ways of identifying those managers ahead of time, that won't stop many investors from trying.

So active management won't disappear entirely.

But index funds and comparable exchange-traded portfolios now account for 28% of total fund assets, up from 9% in 2000. And no wonder. Over the past one, three, five and 10 years, only one-fourth to one-third of all stock funds have beaten the index for their category, according to investment researcher Morningstar.

Meanwhile, index funds effectively match the returns of those market benchmarks at fees that often run only one-tenth of those of active funds.

Skeptics have pointed out that if individual investors—those Wrong-Way Corrigan of the financial world—are rushing into passive funds, then active funds might be due for a resurgence. Others cite the financial analyst Benjamin Graham: "There are no dependable ways of making money easily and quickly, either in Wall Street or anywhere else."

But the net supply of outperformance always is zero; one fund manager can beat the market only at the expense of another who must lag behind it. And owning index funds is neither easy nor quick: You must give up all hope of ever beating the market, resign yourself to a stupefyingly boring portfolio and wait years for the advantages of the cost savings to pile up.

So there isn't any reason—other than human nature—for investors not to put all their money into index funds. Or, if you like, reserve a tiny fraction for managers who are so active that they thumb their noses at market benchmarks.

To Mr. Ellis, the future for many portfolio managers is clear: "Lots of them are going to have to go find something else to do, because the line of work they originally trained for will be fading away."

One obvious destination, he says, is financial planning. Tens of millions of Americans need a financial adviser, but only a few hundred thousand advisers are available—many of whom aren't investing experts. Who better to fill the insatiable demand for financial advisers than former portfolio managers who know firsthand how hard it is to beat the market?

This way, Mr. Ellis says, "investors will get better, more-valuable service from smarter people."

In short, many stock pickers should get out of the business of managing investments and get into the business of managing investors.

— Write to Jason Zweig at intelligentinvestor@wsj.com, and follow him on Twitter: [@jasonzweigwsj](https://twitter.com/jasonzweigwsj)

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Move to passive likely to build still more steam

But any paradigm shift
is seen as a long way off

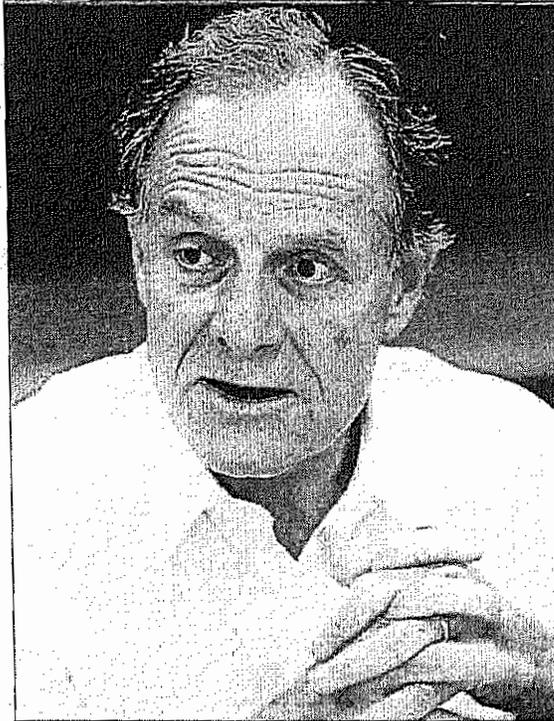
By DOUGLAS APPELL

Active money managers could become victims of their own success at identifying mispriced securities.

And those with the least conviction could be the first to fall off the edge of the investment universe, analysts say.

Active managers have gutted their ability to deliver alpha to the clients paying their hefty fees, setting the stage for an accelerating shift to passive strategies, said Charles D. Ellis, founder of money management industry research house Greenwich Associates. (See related story on page 14.)

In a Sept. 10 interview, Mr. Ellis said active managers as a group have become "so good at what they do" that individual managers are no



CAN'T BEAT IT: Charles C. Ellis believes managers' attempts to outsmart the market are a losing proposition.

longer able to "beat the crowd."

While Mr. Ellis began making that point as far back as 1975, in a Financial Analysts Journal article titled "The Loser's Game," his latest

SEE PASSIVE ON PAGE 34

Passive

CONTINUED FROM PAGE 1

bite of the apple — a July FAJ article, “The Rise and Fall of Performance Investing” — comes as developments such as the rise of factor-based “smart beta” indexes and expectations of a long stretch of meager capital market returns look set to make life tougher for active managers.

The advent of “smart beta” over the past five years, has left asset owners with a more complex set of options than the traditional “barbell” approach, with passive at one end and active at the other, said Peter Ryan-Kane, a consultant and head of portfolio advisory for the Asia-Pacific region, ex-Japan and Australia, with Towers Watson Investment Services, Hong Kong.

As investors gravitate to more cost-effective solutions — whether pure passive or factor-based exposure to value, size or minimum volatility — the market share of active managers should drop, predicted Chia Chin-Ping, MSCI Inc.’s Hong Kong-based head of research for the Asia Pacific region.

The scale of that decline could depend on how quickly active managers reinvent themselves, for example by offering strategies that tactically shift allocations among various factor indexes, he said.

Mr. Ellis said the shift by asset owners to passive from active — both traditional index strategies and exchange-traded funds — is accelerating, even if it remains well short of a paradigm shift.

ETFs driving growth

If statistics provided by the world’s largest money manager, New York-based BlackRock Inc., are a reliable proxy, ETFs have been the bigger engine of passive growth.

For the five years through June 20

Shift to passive may not signal prospects for alpha

The dearth of alpha on tap today — the result of a critical mass of smart, motivated people dedicating their lives to stock picking — should persist even if a wave of passive investing were to sweep a healthy chunk of those people out to sea, two experts say.

Both Michael Sebastian, a Singapore-based partner with Aon Hewitt and head of the Aon Center for Innovation and Analytics, and Charles D. Ellis, founder of money management industry research house Greenwich Associates, say several factors have slashed the proportion of active managers capable of covering their fees over the years. Among those factors are increased competition, technology that makes information more abundant and regulation meant to provide investors with equal access to market-moving news.

If cutthroat competition has powered the market’s efficiency, then a shift to passive investing significant enough to result in a major culling of active managers could be expected to improve the alpha prospects of survivors.

But both analysts contend that a fairly significant move to passive could occur without weakening active management’s “price discovery” muscle, or reversing alpha’s downward spiral.

In a footnote to his July Financial Analysts Journal article titled “The Rise and Fall of Perfor-

mance Investing,” Mr. Ellis wrote that even if 80% of shares listed on the New York Stock Exchange were indexed, indexing would still represent less than 5% of annual trading. “It is hard to believe that even this large hypothetical change would make a substantial difference to the price discovery success of active managers,” he added.

In an e-mail, Mr. Sebastian predicted the trend toward “more efficient and effective price discovery will continue” whether or not the shift to passive investing picks up dramatically. If passive allocations do gain considerable ground at the expense of active strategies in the years to come, it’s likely to be the low-conviction benchmark huggers that are driven out of the market.

“It’s the unskilled manager group that will decline, while indexing and high-conviction, skilled active management rises,” and those skilled managers “will continue to get better at what they do as technology and financial instruments continue to improve,” he predicted.

Others expect a more fluid alpha environment in response to shifts in the balance between the industry’s active and passive segments.

“I’d rather everybody else moves into passive because that would give my managers more scope to find mispricings,” said Elspeth Lumsden, the Melbourne-based head of equities with

Australia’s A\$101 billion (US\$91 billion) Future Fund.

Rather than target a specific mix of active and passive strategies, Ms. Lumsden said the Future Fund team makes judgments on the best way to get exposure for each allocation. The current mix is probably roughly 60% active and 40% passive, with the passive total including allocations to factor indexes as well as futures for the fund’s overlay program, she said.

That passive allocation could edge up should the Future Fund find new factor indexes to allocate to but “we’ve certainly got no plans to actively reduce active management,” which should continue to offer good value “as long as you’ve got the internal team to be on top of your managers ... and really understand the return stream you’re getting (from them),” she said.

Some managers say their ability to add alpha might already be benefiting as a result of attrition following the global financial crisis.

Outperformance by quant equity managers has picked up considerably in the past three or four years, and the fact that the quant space has become a lot less crowded now has contributed, noted Michael Even, president and CEO of Boston-based Numeric Investors LLC.

— DOUGLAS APPELL

trillion in long-term AUM jumped to 23% from 17%, while traditional index strategies rose to 43% from 41%. Active strategies, meanwhile, dropped to 34% of the total from 42%.

In an interview, Deborah Fuhr, managing partner of London-based research and consulting firm ETFGI LLP, said that as of Aug. 31, global ETF assets stood at a record \$2.7 trillion, with record inflows of \$185 billion for the first eight months of the year.

While precise data are not available, Ms. Fuhr noted that by some estimates, smart-beta ETFs account for more than \$300 billion of that total, up from a negligible amount

market returns over the next few years could add further momentum to the pickup in passive allocations, observers say.

In his latest FAJ article, Mr. Ellis said the correct way for asset owners to gauge what kind of value active managers are offering is to compare the incremental returns delivered over and above an index fund with the incremental fees charged. If expectations of low returns in the coming years materialize, the fees those managers command will look increasingly prohibitive, he said.

Michael Sebastian, a Singapore-based partner with Aon Hewitt, and head of the firm’s Aon Center for

ceasingly difficult for active managers to provide alpha net of fees.

According to an analysis of a decade’s worth of eVestment LLC performance data conducted by Mr. Sebastian and Sudhakar Attaluri, a senior consultant with Hewitt EnnisKnupp Inc., less than 2% of U.S.-based managers of active institutional strategies showed evidence of sufficient skill to provide alpha to clients after fees.

In contrast to Mr. Ellis, however, Mr. Sebastian said he believes that still leaves room for a minority of asset owners skilled at selecting active managers to successfully focus on active allocations.

containing big passive allocations to markets deemed highly efficient, such as U.S. large-cap equities, and smaller, active allocations to less efficient market segments will give way to portfolios that are predominantly active or passive.

Asset owners skilled at picking superior active managers should go entirely active — both in allocations to alternatives strategies such as hedge funds or private equity, and to high-conviction, long-only traditional strategies, said Mr. Sebastian. Asset owners with no special skill at picking managers should go entirely passive, he said.

By contrast, Mr. Ellis predicted



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Passive Investment Momentum Continues

May 27, 2014

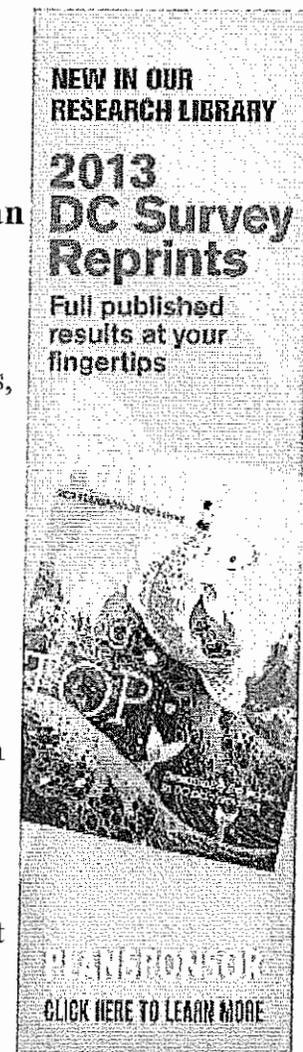
The strong growth of passive investment products shows little sign of slowing over the short term and could signal an important secular trend, according to new research from Cerulli Associates.

Passive mutual fund assets have grown considerably in the last five years, jumping from \$542.1 billion in early 2009 to \$1.7 trillion as of year-end 2014, according to Cerulli's recent report, "The Cerulli Edge: U.S. Monthly Product Trends Edition." Despite a slow start in January, the growth of index strategies has continued this year as passively managed mutual fund flows combined with exchange-traded fund (ETF) flows to reach \$56.7 million year-to-date. By contrast, actively managed funds received \$82.8 million so far this year.

Cerulli researchers point to a number of explanations for the increased popularity of passive mutual funds and ETFs. Put simply, even more than investors' emphasis on mitigating risk, which can push them towards active strategies, the industry-wide focus on lowering investment costs is driving higher allocations to passive management.

Inflows for active strategies still outpace inflows for passive products, but Cerulli says active managers should be increasingly wary as passive investments show signs of picking up additional momentum and eating away at the actively managed asset base. And unlike earlier cyclical fluctuations between active and passive investment style leadership, the ongoing upswing in passive investment usage could be more permanent as investors become increasingly fee conscious.

To compensate for growing inflows to passive investment strategies, active managers are developing new products that do not compete directly with passive strategies, Cerulli says. Numerous providers have released multi-strategy and outcome-oriented products for both retail and



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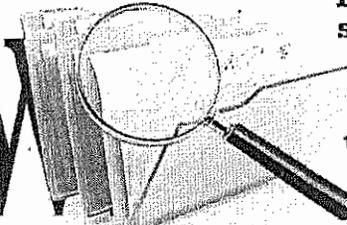
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March 25-29, 2013

Investment News

LPL under scrutiny

The largest independent broker-dealer is again being investigated over the sale of non-traded REITs. Page 2



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Active funds losing ground to passive style

By Jason Kephart

Passive investing has reached a watershed moment.

The second-largest pension fund in the United States is considering a move to an all-passive portfolio while at the same time, the largest brokerage firms are falling over themselves to push passively managed exchange-traded funds.

The California Public Employees' Retirement System's investment committee started a review of its investment beliefs last week, with the main focus on its active managers, according to sister publication Pensions and Investments.

CalPERS oversees about \$255 billion in assets, more than half of which already is



Chris McIsaac: CalPERS' move to examine active managers is a sign of the trend.

invested in passive strategies.

"It's sort of an exclamation mark on a trend that most are aware of," said Chris McIsaac, managing director of the institutional investor group at The Vanguard Group Inc.

Fidelity Investments, meanwhile, has responded to the enthusiasm for passive strategies by doubling down on its agreement with BlackRock Inc.'s iShares unit. Fidelity increased the number of iShares ETFs that

Continued on Page 30

Passive style gains

Continued from Page 1
trade commission-free to its clients to 62, from 30, two weeks ago.

Fidelity's move came just a month after The Charles Schwab Corp. launched an ETF platform that offers investors more than 100 commission-free ETFs.

TD Ameritrade Inc., the third leg of the online brokerage world, has been offering more than 100 commission-free ETFs since 2010.

"We see don't see it as either passive or active, we see it as both. In a low-return environment, fees matter a lot," said Scott Couto, president of Fidelity Financial Advisor Solutions.

"That's getting interest in passive investing over the short term. Over the long term, active management adds a lot of value," Mr. Couto said.

"There will continue to be a growing interest in the passive side because cost matters to investors," said Beth Flynn, vice president and head of third-party ETF platform management at Schwab.

"Virtually all our adviser clients use ETFs in some way, shape or form," she said. "Usage is much lower on the individual-investor side, but growing at a pretty steady and rapid clip."

More than 40% of individual investors plan to increase their use of ETFs over the next year, for example, according to a recent Schwab survey.

TD executives couldn't be reached for comment.

SHIFTING PREFERENCE

Passive investing is nothing new. Vanguard founder John Bogle launched the first index mutual fund in 1975. But the fund world has always been dominated by active management.

A decade ago, 86% of the \$4.4 trillion in mutual funds and ETFs were in active strategies, according to Lipper Inc.

Investors' preference is clearly shifting, though. Active manage-

72% as of the end of last month, and passive funds clearly have all the momentum now.

As investors have gotten back into stocks this year, they have done so largely through passive funds. Passive funds took in \$65 billion in the first two months of the year, while active funds took in \$40 billion.

For anyone who has been watching fund flows over the past few years, the surge in passive strategies shouldn't come as a surprise.

Since 2003, investors have pulled \$287 billion from actively managed equity funds, while investing just over \$1 trillion in passive funds.

Even though the preference for passive strategies has been most dramatic in equity funds, passively managed bond strategies are gaining steam, as well.

Passive bond strategies have had \$260 billion of inflows since the beginning of 2008. Between 2003 and 2007, they had \$73 billion of

"BEING ACTIVE over the past 15 years has not been rewarding."

Geoff Bobroff
Industry consultant

inflows, according to Lipper.

"Indexing has proven to be a very compelling investment strategy, especially for investors with an extended investment horizon," Mr. McIsaac said.

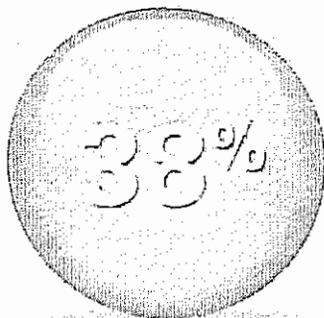
Costs have played a big part. They are, as Mr. Bogle likes to point out, the only thing that an investor really can control, and passive strategies are much cheaper than their active counterparts.

U.S. equity ETFs have an average expense ratio of 40 basis points, compared with an average expense ratio of 134 basis points for actively managed mutual funds, according to a recent Morgan Stanley Wealth Management research note.

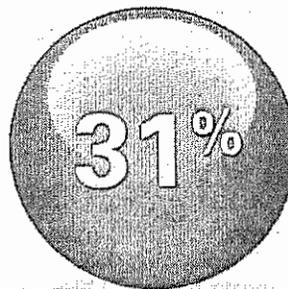
Hard to beat

The percentage of large-cap managers that have outperformed the S&P 500

Over the 10 years ended March 20



Over the five years ended March 20



Over the three years ended March 20



Over all three periods



Source: Morningstar Inc.

GERARDO TABONES

What's more, a number of large-capitalization ETFs charge less than 10 basis points, while the cheapest actively managed large-cap fund charges 50 basis points.

Active managers haven't given investors much reason to stick around.

"Being active over the past 15 years has not been rewarding," said industry consultant Geoff Bobroff.

The percentage of managers beating their benchmark has been shrinking.

Over the past 10 years, just 38% of large-cap-equity managers have beaten the S&P 500. Over five years, it shrinks to 31%, and over three years, it is just 18%, according to Morningstar Inc.

Making things even harder for those trying to pick active managers is that just 9% of large-cap managers outperformed the S&P 500 over all three time spans.

The inconsistency of actively managed returns is what prompted the review by CalPERS.

As P&I reported: "CalPERS investment consultant Allan Emkin told the investment committee that at any given time, around a quarter

of external managers will be outperforming their benchmarks, but he said the question is whether those managers that are doing well are canceled out by other managers that are underperforming."

'EVALUATING MANAGERS'

Rick Ferri, founder of Portfolio Solutions LLC, ran into the same problem while he was working at a brokerage firm early in his career.

"I spent a lot of time and money evaluating managers," he said.

"It was a revolving door for most of them," Mr. Ferri said. "You can't win unless you get very, very lucky."

Mr. Ferri now runs an all-index portfolio for his clients' equity exposure. On the bond side, he still favors active management — when it is cheap.

"Sometimes that's the best way to get market representation," Mr. Ferri said.

The \$39.2 billion Vanguard Intermediate-Term Tax-Free Bond Fund (VWITX) owns 3,854 bonds and charges 20 basis points, for example. The \$3.6 billion iShares S&P National AMT-Free Municipal Bond ETF (MUB), the largest municipal

bond ETF, holds 2,196 bonds and charges 25 basis points.

CalPERS is expected to decide the fate of its active managers in about five months. At this point, it looks as though it could go either way.

Chief operating investment officer Janine Guilot told P&I that 27 preliminary interviews of CalPERS staff members, board members, money managers and external consultants showed a "wide disparity of views" on active management.

Mr. McIsaac isn't ready to write off active management altogether.

"There will come a period of time when active managers will do much better," he said.

That is, if good active management can be found at a low cost.

"It's hard to find both," Mr. McIsaac said.

The market ultimately will have the biggest say in the future of active management, Mr. Bobroff said.

"Is this the end of a trend?" he asked. "It depends where the market is going over the next five years. Your guess is as good as mine."

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MARKETS

Investors Pour Into Vanguard, Eschewing Stock Pickers

By KIRSTEN GRIND

Updated Aug. 21, 2014 11:31 a.m. ET



John Bogle, founder of The Vanguard Group *Reuters*

Investors are pouring money into Vanguard Group, the epitome of the hands-off approach to investing, flocking to funds that track market indexes and aren't run by stock pickers or star managers.

The inflow has pushed the mutual-fund giant to almost \$3 trillion in assets under management for the first time.

The surge is part of a sea change in the fund business in which investors are increasingly opting for products that track the market rather than relying on managers to pick winners. Other firms, such as New York behemoth BlackRock Inc. and Texas-based Dimensional Fund Advisors, are also enjoying an influx of cash.

Vanguard this week is expected to top \$3 trillion in assets, the latest in a series of milestones for the mutual-fund giant. The company got help from two investing legends: Warren Buffett and Bill Gross. Geoffrey Rogow joins MoneyBeat.

Related

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Vanguard got a huge boost this spring when Warren Buffett gave it a public stamp of approval in March.

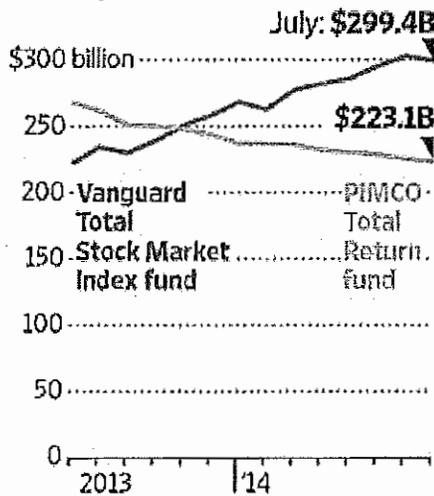
The billionaire wrote in his closely watched letter to shareholders of his company, Berkshire Hathaway Inc., that he believed most people would be well-served by following the investing instructions in his will.

Mr. Buffett, 83 years old and with a net worth of \$66 billion, wrote that he advised his trustee to "put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.)."

Changing Styles

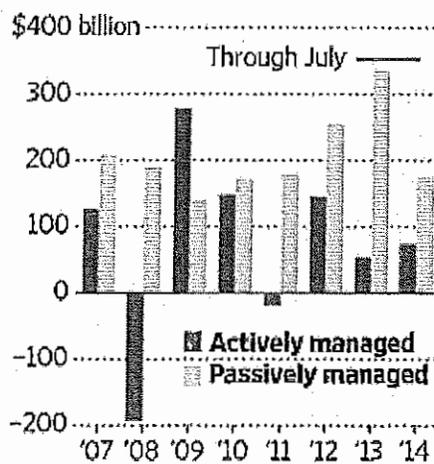
Vanguard now boasts the largest mutual fund in the world thanks to a shift by investors away from bonds and money managers who actively select individual holdings.

Monthly net assets



Source: Morningstar

Annual net flows, stock and bond funds



The Wall Street Journal

In the five months that followed, investors poured \$5.5 billion into the Vanguard fund, or about three times more than during the same period the previous year.

Vanguard, based in Malvern, Pa., credits Mr. Buffett with the surge of money.

Mr. Buffett "mentioned to me that I might be pleasantly surprised by his annual report, and of course I was," said F. William McNabb III, Vanguard's chairman and chief executive, in an interview. He said the company's recent growth shows "the triumph of low-cost investing over all."

In an email to Mr. Buffett, Vanguard's retired founder, John C. "Jack" Bogle, said financial advisers were describing Mr. Bogle as only "the second best salesman at Vanguard."

Mr. Buffett declined to comment.

His recommendation wasn't the only recent milestone for Vanguard. Its Total Stock Market Index fund is now the biggest mutual fund in the world and also surpassed Pimco in the amount of bond fund assets it manages, according to Morningstar.

"They are the king of the hill," said Michael Rawson, an analyst at Morningstar Inc.

Vanguard's ascent is notable because its plain-vanilla index funds are often derided by more adventurous investors who believe in trying to do better than the overall market.

The company is a pioneer in the accelerating shift toward so-called passively managed products like index funds and exchange-traded funds that track baskets of stocks or other assets. These funds typically promise diversification and are relatively inexpensive compared to traditional mutual funds.

It is "a trend that I see continuing on, probably forever," said David Barse, chief executive officer at New York-based Third Avenue Management, which manages \$13.5 billion. He said the challenge for active managers, like his firm, is to identify overlooked investments that don't merely track the broad market.

But he acknowledged that is increasingly a tougher sell, particularly to retail investors.

Investors poured a net \$336 billion into passively managed stock and bond funds in 2013, handily beating the \$53 billion invested in traditional mutual funds of the same type, according to Morningstar. So far this year through July, investors put a net \$177 billion into those passive funds, compared with \$74 billion in actively managed funds.

Phillip Henry, 30, a securities lawyer in Mountain View, Calif., said that in recent months he has moved about \$25,000 into Vanguard's index funds from his former 401(k) provider, the asset manager TIAA-CREF. Mr. Henry said he became convinced that index funds were far superior to actively managed funds after doing research and reading a book by Mr. Bogle. He said cost was a key factor.

"I'm firmly convinced it's the better way to go," Mr. Henry said. "I don't believe fund managers can beat the market."

The average Vanguard U.S. equity index fund has an expense ratio of 0.1% versus 0.7% for competitors and 1.3% for an actively managed stock fund, according to Morningstar.

Traditional stock-fund managers—old-fashioned stock pickers—have been the hardest hit in the wave toward passive investment. Through July, passively managed stock funds have seen a net \$128.4 billion in investor inflows, compared with \$18 billion for traditional stock funds, according to Morningstar.

Bryan Polley, a financial adviser with Allodium Investment Consultants in Minneapolis, with \$210 million of assets under management, said he began moving clients into index and exchange-traded stock funds in recent months and away from actively managed funds.

The S&P 500 is in a five-year bull market and is up an additional 8.6% this year. "It's been very difficult for active managers to beat the index," Mr. Polley said.

The 2008 financial crisis sparked a general disillusionment among investors about traditional stock managers, and some of that has continued today, say analysts and industry observers.

That general sentiment has helped Vanguard. While the firm's index funds aren't actively run by managers, the company as a whole tends to act like a "doting mother," said Mr. Rawson. "They're telling

you what they think you should be doing when a lot of fund companies....ask what you want to do and then do it."

Vanguard's ascendance coincides with struggles at one of its top rivals, Pacific Investment Management Co., which has seen outflows for 15 consecutive months. Pimco's flagship fund, the Total Return bond fund, run by Bill Gross, was for five years the biggest mutual fund in the world, but investors have pulled money amid a stretch of lackluster performance. Pimco's Total Return bond fund now manages \$223 billion, compared with \$299.4 billion for Vanguard's Total Stock Market Index fund. Pimco's spokeswoman declined to comment.

Mr. McNabb said Vanguard doesn't have any internal growth targets and he hasn't paid attention to the firm's recent milestones. The firm will sometimes take actions that seem counterintuitive to growth, like closing off a popular mutual fund to new investors for a "cooling off" period when it believes investors are only attracted to short-term past performance.

Vanguard isn't the only company benefiting from the wave of money flowing into passive products. BlackRock, the world's largest asset manager, with about \$4.6 trillion in assets under management, has seen \$53 billion pour into its iShares' ETF business globally this year through Aug. 18, the largest amount of any fund company, according to the company.

BlackRock is the largest ETF provider. A spokeswoman for the company declined to comment. Vanguard, however, the third-largest provider behind State Street Global Advisors, has seen more investor inflows in the U.S.

—Anupreet Das
contributed to this article.

Write to Kirsten Grind at kirsten.grind@wsj.com

Weekly Commentary by Professor Jeremy J. Siegel

The CALPERS Shocker; The Fed's New "Dot Plot"

Saturday, 11:00 AM EDT, 9/20/2014



Many have said that three highly significant events impacted the market this past week: The FOMC meeting, the Scottish vote, and the Alibaba IPO. But I think a fourth overshadows all: the decision by CALPERS, the 2nd largest pension fund in the U.S., to exit all of its \$4 billion hedge fund positions, claiming that the returns have not justified the costs. Looking at the data, it is easy to see why. According to HFR, the hedge fund tracker, the returns on hedge funds have averaged about *6 percentage points per year* behind a 60-40 stock/bond balanced index fund over the past five years. And even in the crash year 2008, where hedge funds are supposed to shine, they lost 19%, only slightly better than the 22.2% loss of balanced index funds. The upshot is that hedge funds are just a fancy name for high-priced active management, which have been shown in repeated studies to fall significantly behind index funds. Will hedge funds disappear as a result of these developments? Of course not: Hope Spring Eternal among investors that they (or someone they hire) can beat the market. But hedge funds recent performance should give investors reason to pause and reflect on the type of strategy that optimizes their returns.

Front and center with the Fed meeting was the Dot Plot. I was wrong in expecting the Fed to remove the words "considerable time" in their directive, but right in predicting that they will tighten faster than the market expects. In fact the infamous "dot plot", which reveals year-end predictions of FOMC members, was even more hawkish than the June forecasts. The December 2015 expectations for the fund rate rose to 1.25% to 1.50%, far above the 0.77% in the Fed Funds futures markets and the 2016 expectations rose to 2.50% to 2.75%, also far above the 1.86% market level. And now the Fed has added 2017 forecasts for the first time, which shows the expectations of the funds rate at virtually the long-run level of 3.75%. Certainly the yields in the futures market moved up as result of the release of the FOMC directive, but they are still nowhere near the level of the forecasts. The longest fund future is August 2017, and that rose 11 bps from about 2.38% to 2.49, more than 120 bps below the Fed's forecasts.

Who's right: the market or the Fed? In the long run, the market is historically right. I have written extensively that the equilibrium long-run funds rate is far below the near 4% the Fed thinks – in sync with Bill Gross's "New Neutral" of 2% or slightly higher. Yet I think that stronger growth will bring the Fed to this level faster than the market believes, so short-term rates might be pressured in coming months. Stocks clearly looked at the bright side of the Fed meeting: No rapid tightening, and no recession forecast in the next 3 years, and rose to record highs.

Past performance is not indicative of future results. You cannot invest in an index. Professor Jeremy Siegel is a Senior Investment Strategy Advisor to WisdomTree Investments, Inc. and WisdomTree Asset Management, Inc. He is also a registered representative of ALPS Distributors, Inc. This material contains the current research and opinions of Professor Siegel, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. The user of this information assumes the entire risk of any use made of the information provided herein. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

HEARD ON **WALL STREET**

For Hedge Funds, a Troubling Return

By JUSTIN LAHART



The most surprising thing about the California Public Employees' Retirement

System's announcement Monday that it will be exiting its \$4 billion investment in hedge funds over the next year may not be the decision itself, but that it took so long.

In the fiscal year that ended this June, the pension fund's hedge-fund investments returned just 7.1%. That compares with a 12.5% return for the Vanguard Balanced Index Fund, which follows the allocation of 60% stocks, 40% bonds that pension funds have historically followed. In the prior year, Calpers's hedge-fund investments returned 7.4% versus 10.8% for the index fund.

It isn't just Calpers. Hedge-fund tracker HFR's composite index, which measures the equal-weighted performance, after fees, of over 2,000 funds, has been underperforming the passive bond-and-stock portfolio since 2009. During the crisis year of 2008, it lost 19%, only marginally better than the index fund's 22.2% loss. That performance made it a bit harder to accept the idea that hedge funds' ability to offer downside protection justifies the hefty fees they charge—

Please turn to the back page

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THE WALL STREET JOURNAL.

Wednesday, September 17, 2014

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Hedge Fund Investors Facing a Troubling Return

Continued from page C1
typically a 2% management fee and 20% of investment profits.

What has happened to the onetime masters of the investing universe? Hedge funds may have become a victim of their own success. With assets under management tripling to \$2.8 trillion from their 2004 level, according to HFR, the field has become so crowded that it isn't as easy for managers to consistently deliver strong performance. Indeed, just as actively managed mutual funds struggled to deliver returns commensurate with their fees and expenses as they boomed in the 1990s, hedge-fund returns have suffered over the past decade.

Certainly within the broad

universe of hedge funds there are managers who can consistently deliver strong performances. But within an increasingly crowded field, picking them is a skill in itself. That further reduces their allure for big investors like Calpers. Such funds can hire outside managers to do this, and incur additional fees, or develop that expertise in-house, and incur additional costs.

Indeed, Calpers said it wasn't hedge-funds returns, but the costs and complexity of running a portfolio of hedge-fund investments, that drove its decision. Hedge funds represent just a tiny fraction of the \$298 billion Calpers manages, so regardless of whether they performed very

well or very poorly, they wouldn't do much to move the needle. For hedge funds to be worth the effort, the pension fund would have had to dedicate a far larger chunk of its portfolio to them.

Given how big Calpers is, and how crowded many hedge-fund strategies have become, such a move would further cut into hedge-fund returns. That is a particular risk since other pension funds, seeing Calpers as a bellwether, might have followed suit.

Instead, other pension funds may follow Calpers's lead and cut or reduce their hedge-fund exposures. One place that the money might go is to lower-cost strategies that mimic the aggregate returns of various

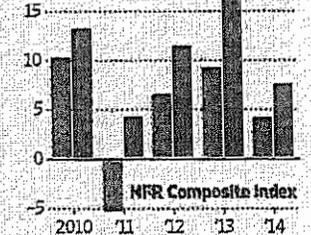
hedge-fund strategies—something that Calpers already has begun doing. These promise to provide institutional investors with index-like investments that can round out the risk profile of their portfolios like hedge funds do—but without the high fees.

Calpers's move is hardly a death knell for hedge funds. There will always be smaller, sophisticated investors with the patience and experience to find great hedge-fund managers. And there always will be others, seduced by the mystique hedge funds offer, who invest in them even though they shouldn't.

But the high-water mark for hedge funds may have passed. Increasingly, investors will

Performance Anxiety

Annual return for hedge funds and a stock-and-bond index fund



Sources: FactSet; HFR
The Wall Street Journal

question why hedge funds charge so much for what they do. Managers who don't have a performance-based answer will be in trouble.

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OPINION

You're Paying Too Much for Investment Help

Burton G. Malkiel

From 1980 to 2006, the U.S. financial services sector grew from 4.9% to 8.3% of GDP. A substantial share of that increase represented rises in asset-management fees. Excluding index funds (which make market returns available even to small investors at close to zero expense), fees have risen substantially as a percentage of assets managed. In my opinion, investors have received no net benefit from this increase in expense ratios.

Index funds have far outperformed the average active manager, and at a much lower cost to the investor.

The increase in fees could be justified if it reflected increasing returns for investors from active management, or if it improved the efficiency of the market. Neither of these arguments holds. Actively managed funds of publicly traded securities have consistently underperformed index funds—by roughly a differential in fees charged.

Passive portfolios that held all the stocks in a broad-based market index have substantially outperformed the average active manager since 1980. Therefore, the increase in fees likely represents a deadweight loss for investors.

There are substantial economies of scale in asset management. It is no more costly to place an order for 20,000 shares of stock than for 10,000 shares. The same annual report and similar filings to the Securities and Exchange Commission are required whether an investment fund has \$100 million or \$500 million in assets. The due diligence required for the investment manager is no different for a large mutual fund than for a small one. Modern technology has fully automated such tasks as dividend collection, tax reporting and client statements. Academic research has documented substantial economies of scale in mutual-fund administration.

In 1980, the equity mutual-fund industry managed less than \$26 billion of assets. By 2010 the equity assets of the mutual-fund industry totaled almost \$3.5 trillion. Substantial economies of scale could have been passed on to individual investors, resulting in lower expense ratios. But those economies appear to have been entirely captured by asset managers. The same finding holds for asset managers who cater to institutional investors.

In 1980, the annual expense ratio for all mutual funds (as measured by Lipper Analytic Services) was 66 basis points. In 2010, the equivalent (asset weighted) ratio was 69.2 basis points. But in 2010 almost 30% of mutual-fund assets were invested in low-cost index funds, which represented an insignificant share of assets in 1980. Thus the annual expense ratios for actively managed funds rose to 91 basis points from 66 basis points. While expense ratios paid by institu-



tional investors are considerably lower than those paid by individual investors—by about 40%—these fees have not fallen over time as a percentage of assets managed.

However, index funds and their exchange-traded counterparts have allowed the individual investor to benefit from scale economies. Exchange-traded funds that track the Standard & Poor's 500 Stock Index or the Wilshire 5,000 Total Stock-Market Index are available to individual investors at expense ratios of five basis points or less.

There is another way of looking at these asset-management fees. Total fund assets increased 135 times since 1980, but the total expenses paid to

equity mutual-fund managers increased 141 times (to \$24,143 billion from \$170.8 million).

Of course, when stated as a percentage of assets, these fees do look low—close to 1% of assets. But compare them with returns produced. If overall stock-market returns average, say, 7% a year, fees of 1% point are actually about 14% of stock-market returns. Mutual-fund fees take up well over 50% of dividend distributions.

Even these recalculations may substantially understate the real cost of active investment management. A more reasonable way to assess the benefits of active management is to measure fees as a percentage of the "excess" returns produced by active

managers over the returns available from low-cost index funds. Overall, these excess returns seem nonexistent.

Why do investors continue to pay such high fees for financial services of such questionable value? Many may incorrectly judge the quality of investment advice by the price charged. Individual and institutional investors may suffer from overconfidence and truly believe that they can select the best investment managers and earn excess returns; despite historical evidence to the contrary.

Outperforming the consensus of hundreds of thousands of professionals at the world's major financial institutions is next to impossible. It has been for decades. Over long periods, about two-thirds of active managers are outperformed by the benchmark indexes. The one-third that may outperform the passive index in one period are generally not the same as in the next period. But investors can benefit from low-cost index funds and their exchange-traded cousins.

The lesson for investors is very clear: You can't control what markets can do, but you can control the costs you pay. The less you pay to the purveyors of investment services, the more there will be for you. The quintessential low-cost investment vehicles are index funds, which should comprise the core of every investment portfolio. The high fees charged for active management cannot be justified.

Mr. Malkiel is the chief investment officer of Wealthfront and serves on the advisory board of Rebalance IRA.

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