

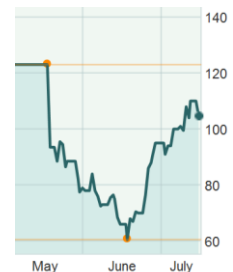
What Are The Disadvantages of Passive Investing?

We spend a lot of time talking with clients about the many advantages of passive investing. We talk most frequently about the following benefits of this model as it is implemented by the investment professionals at Passive Capital Management, LLC:

- **Capturing market returns** and avoiding performance-chasing behavior;
- **Diversification** – the funds we use provide exposure to thousands of stocks across and within asset classes;
- **Discipline** – we help our clients stay invested through all phases of the market cycle, and we periodically rebalance portfolios to their target allocations;
- **Elimination of risks** for which there is no evidence of commensurate reward – stock-selection risk, manager-selection risk, and market-timing risk;
- **Transparency** – each client can view his or her positions online through our custodian at any time;
- **Liquidity** – all of the asset class funds we use are liquid within one day, and ETFs are liquid within three days;
- **Tax efficiency** – our model minimizes unnecessary taxable events;
- **“Tilting”** toward small cap and value stocks to capture the premium historically offered by those asset classes;
- **Affordability** – we provide exposure to the markets through very low-cost funds, and our advisory fees are among the lowest in the business.

With all of these benefits, what is the downside? After all, a key element of our philosophy is that there is no “free lunch” in investing. What is the trade-off for choosing to invest with a passive rather than an active strategy?

The main element of investing that you are giving up is the opportunity to revel in the glory of a short-term win. None of our clients can tell a friend or golf partner that they shorted the LinkedIn (LNKD) IPO at \$120 at the open and got out at \$60 in mid-June. Wouldn't that be a great story to tell at the nineteenth hole? Fortunately, it's also true that none of our clients will be saying that they were *long* LinkedIn at the open and got out in a panic in mid-June, as many investors who paid a premium for access to this limited float surely did. These kinds of market-timing moves require luck, a crystal ball, or both. The famous “[Dalbar study](#)” tells us that most investors underperform the market by gambling on the future in this way,



LNKD (source: WSJ)

and a robust body of evidence tells us that professional managers do little better, but charge considerable fees nonetheless.

What else does the passive investor give up? I suppose another sacrifice is the ability to sign up with the star fund manager of the moment. Might a passive investor sometimes feel like she is sitting on the sidelines as her friends and neighbors invest with the Morningstar™ Equity Fund Manager of the Decade? Aren't we potentially leaving a lot of "alpha" on the table?

Sure. But please remember that alpha (or "Jensen's alpha") can be positive *or negative*. Alpha measures the return produced by the manager rather than the market, for good or ill. The desire for positive alpha is the reason active portfolio managers can command huge salaries. So let's take a look at what would have happened if you had chosen to invest with the newest Morningstar™ Equity Fund Manager of the Decade on the day when this honor was announced -- January 12, 2010.



FAIRX vs S&P 500, 1/12/10 to 7/18/11
(Source: WSJ)

Maybe the sideline isn't such a bad place to be! The better option, of course, is to own the domestic large company asset class at a cost of 0.08% instead of paying over 1.00% for temporary and unsustainable performance.

Is passive investing boring? I don't think so. Seeking out the most sophisticated and lowest-cost asset class funds and implementing an elegantly simple strategy is exciting for me. Helping clients have a successful investing experience is highly rewarding, especially when those clients are reeling from past experiences of bad advice, bad stock or fund picks, or market-timing failures.

Is there a downside? Certainly. You'll need to find something else to talk about at the golf club.

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