Financial Fables

Ely Prudent Portfolios

Kiss Off

GUERDON T. ELY, MBA, CFP®, AIFA®

July 2014

My wife and I, along with a daughter and son-in-law, were in a London pub when a World Cup soccer match between Great Britain and Sweden was about to start. In preparation for the telecast, the waitresses were busy replacing glass mugs with plastic cups -- for everyone but us. When I asked one of them “Why?” she replied, “You’re Americans. You can keep your glasses, but the local football fans tend to get a little excited and throw their glasses at the telly.”

While I never did see anything thrown, I did see a lot of excitement. The first goal generated a roar worthy of the three lions crest on the team’s jerseys. In the celebration that followed, a passionate fan next to my wife grabbed her and kissed her. When I stood to protest, the Brit bear hugged me and planted his stiff upper lip squarely on mine.

Being kissed was not surprising but the source was unexpected. Similarly, Michael Johnson recently wrote in the *Financial Times* that another report documenting the futility of active investing was not surprising “…but the source was unexpected.” That’s because it was a dispassionate British agency, not some passionate advocate for passive investing. And that’s why he claims their research is so “…robust, independent and damning… [And why it] skewers any justification that active fund management of listed assets is worth the candle.” It’s a waste of time and money, he says, since “Ludicrously expensive talent is deployed [by investment firms] in the pointless pursuit of continually trying to outperform one another. Worse, it is a giant negative-sum game in which the savers pay the price, their hard-won capital persistently eroded by recurring charges and fees.”

In his book on prudent investing, *The Prudent Investor Act: A Guide to Understanding*, W. Scott Simon describes this pointless pursuit in more detail. He explains that active investment buy-sell decisions are “…little more than side bets…” on the direction of the stock market. A highly educated and well-trained analyst at one prestigious financial institution “…places a buy bet on the same stock…” another equally well educated and trained analyst at another institution places a sell bet on. And since losing bets are always offset by winning bets, he quotes Steven R. Thorley’s conclusion that, “…simple arithmetic dictates that beating stock-index benchmarks is a zero sum game before costs and a negative sum game after costs.”

So, surprisingly simple arithmetic and mountains of data collected by an unexpected and unbiased source prove that, on average, the additional returns generated by active management are not sufficient to overcome the additional costs. And while some managers will beat the indexes and their peers, it is virtually impossible to identify those managers in advance. As Johnson points out, “a stunningly small number of funds beat their peers on a regular basis, but the crucial point is that at the start of any three-year period, no one knows which funds they will be. Hindsight being useless, this is active fund management’s Achilles heel, and the crux of the debate.”

The debate is over. Johnson concludes that active investment management is “…a web of meaningless terminology, pseudoscience and sales patter…costs are controllable but, by and large, investment performance is not.” So, just as prudent waitresses replaced glass mugs with plastic cups, the British government’s report recommends that prudent investors replace active fund management with “…passive fund management.” It will probably reduce costs and increase performance, but it will not be exciting. Sports is exciting but good investing is not. As Warren Buffett explains “…excitement and expenses are [investors’] enemies.” And that’s why when an investment broker passionately explains the advantages of some great active strategy, you should dispassionately tell him to “kiss off.”

Ely Prudent Portfolios, LLC is a fee-only investment advisory service working with individuals in or near retirement and non-profits. The firm is accepting new clients with a minimum AUM of $1,000,000

ELY PRUDENT PORTFOLIOS, LLC
10 DECLARATION DR., SUITE D
CHICO, CA 95973

(530) 895-0636 OR (800) 560-0636
WWW.ELYPORTFOLIOS.COM
GTELY@ELYPORTFOLIOS.COM