# NO GURUS

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One of the most common mistakes we see people make with their portfolios is seeking a market "guru" to try to beat or time the market. We hear things like it is a "stock picker's market," "asset allocation is dead" or that people need to overweight a specific industry or sector to take advantage of market conditions. These sentiments exist in all market environments but are more frequently expressed when markets decline. No one wants to be "average"; it is ingrained in our psyche to be better than average. Market returns are particularly unattractive when the market declines and emotions are at their most intense. Many have the perception that getting the return provided by the market as a whole is a weak goal, something they don't want to "settle for."

Investing predicates a passage of years and, though not a guarantee, historically has been quite profitable. The longer the time frame, the better the market's record. The primary reason that following a guru is such a low probability approach is that their maneuverings are more akin to speculation than investing. A focus on the short term often can lead to poor decisions. If there was ever a year in which so-called gurus should have thrived, it was 2008. In reality, they did not.

Research firm Standard & Poors has published a "S&P Indexes vs. Active Funds Scorecard" for several years now, always with the same basic result. Here are excerpts of their report through December 2008: "*The belief that bear markets favor active management is a myth. A majority of active funds in eight of the nine domestic equity style boxes were outperformed by indices in the negative markets of 2008. The bear market of 2000 to 2002 showed similar outcomes (as did) the previous five year cycle from 1999 to 2003. The script was similar for non-U.S. equity funds, with indices outperforming a majority of actively managed non-U.S. equity funds over the past five years.*"

Stock market trading as a whole is always a zero sum game *before* fees, expenses, and trading costs, regardless of market conditions. Every buy is offset by a sell. If there are winners, they win at the expense of losers. And trading is **always** a negative sum game *after* costs, regardless of market conditions. This is simple math, not academic theory.

The facts illustrate this. For decades, study after study confirms that most gurus fail to beat their relevant market index or benchmark. This holds true with all types of gurus whether they run mutual funds, separate accounts (also called wrap accounts), newsletters, hedge funds, or they are individuals trading on their own. Studies have shown that in most years, 60% or so fall short of their benchmarks. Obviously just picking superior funds would be good. The problem is over longer periods of time, fewer and fewer beat their benchmarks by less and less. S&P published a "Persistency Scorecard" last updated through 2006. This report illustrated just how few "winners" stay in the top ranks for long. Over the five years ending 2006, a mere 3% of large cap funds, 2.5% of midcap funds and zero small cap funds maintained a ranking in the top 25% in each of those years. Other time frames also yielded results worse than would be expected by random chance.

Despite the daunting odds over time, many people fail to see the potential harm in betting that their managers will top the market. A recent study by Russ Kinnel at Morningstar examined the difference between being in a top quartile fund (best 25%) and a bottom quartile fund (worst 25%) over ten years. It shows just how expensive a less than top quartile manager can be. With large cap US funds, the difference was over 4% and with international funds, the dispersion was 6% per year. Kinnel's point is that if you can get into that top quartile, you are likely leaving your neighbor in the dust. Here's the kicker omitted from the article -- an investment in a related index fund or the benchmark appropriate to each category would have landed in the top quartile or top of the second quartile in all categories examined, meaning investors do not even need to take on guru risk to outperform most other market participants.

Funds actually did even worse than it appears. First, Kinnel points out that his study only considered funds that survived the ten year period. Many funds were folded or merged out of existence, almost always due to poor performance. The S&P studies mentioned take into account this "survivorship bias." This means a considerable number of funds are missing from the bottom end of Kinnel's analysis sample, making an index approach land in the top quartile in almost all cases. Worse still, both Kinnel and S&P studies ignore taxes. Index funds are far more tax-efficient than most other funds, so the ranking of an index fund would be even higher if considered on an after-tax basis. Lastly, let's not forget that these are the results one would have gotten only if one stuck with the fund for the whole ten years. We know from other studies that actual investors do even worse, because they leave lagging funds for recent winners that also become laggards.

Most of the financial services world attempts to get customers to buy into the idea that some guru can deftly maneuver through the markets. Their "advisors" are paid to tout certain managers through various products that have a sales agreement with the firm. Attempting to out smart the market via market timing or trying to pick the best stocks on a large scale is adding risk, not lowering it. This is a risk that does not pay and is easily avoidable.

How risky? There are far more poor performing stocks out there than people realize. Consider the CRSP 1-10 index, which tracks almost all stocks available on the major US exchanges. It lost 36.69% in 2008 while the median return of stocks was a loss of 52.7% according to an article by Dr. Craig Israelson at the University of Missouri. Median means half the stocks lost more than 52.7%.

Don't get us wrong. We do not exclusively use index funds in client portfolios. There are indexes that do not track anything meaningful in our view. Also, there are important asset classes that have no good indexes that track them, and there are fine indexes tracked by lousy index funds. Even the best index funds and exchange traded funds (ETF) can be used in ways that can negate the long term advantages of the index approach.

Unlike most people who call themselves "advisors", we are not burdened by the influence of upper management and we strive to use the best components available. We scrutinize alternatives with a skeptical eye and want to see substance behind a strategy, not just hear an attractive pitch. As a result, we are attracted to products that are consistent in their approach, low-cost, tax-efficient, and disciplined.

We are certain that some managers will have standout years and we completely understand the allure of the guru. As your advocates, however, we don't invest based on allure or purported intuition. Over time, it is clear that depending on gurus to add value is more of a guessing game than a strategy. Guru investing means higher costs, more taxes and most likely weaker results, lowering the odds that you will reach your goals. Minimize or eliminate exposure to guru risks and odds are favorable that you'll do much better than average. In this market, with so many bad ideas and hollow pitches, keeping this in mind is more important than ever.



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