CAPITAL PERFORMANCE ADVISORS, LLC

CAPITAL IDEAS

Bad News, Good News

There is a tremendous body of evidence demonstrating that the capital markets are highly efficient. Even when markets are not perfectly efficient, the evidence demonstrates that the costs of trying to exploit any anomaly or inefficiency have proven to be greater than the likely benefit. Thus efforts to “actively manage” one’s portfolio by selecting the next winning stocks, sectors or asset classes represent a loser’s game — a game that, while not impossible to win, carries odds that are so low that investors are better off simply not playing.

Many investors may become disheartened by this reality, feeling that *any* efforts they take to maximize their portfolio’s returns are in vain. The good news is that, rather than attempting to beat the market, there is a better approach they can adopt that does not exclude them from having a positive investment experience. In fact, if one takes the proper perspective, there is great news imbedded in the Efficient Markets Theory (EMT). The EMT basically states that the current price of any security is likely to be the correct price — otherwise the market would quote a different price. A second major tenet of the EMT is that risk and expected return are related.

These two tenets should be of much comfort to investors. First, the EMT means that investors do not need to know details about a particular stock, sector, or even the economy in general. The market has already incorporated everything that is publicly knowable about the stock, sector, or economy into current prices. Unless an investor has inside information or believes that he or she can somehow interpret the data better than all the other professionals (and non-professionals), there is no likely way to generate abnormal profits.

This means that investors can stop spending (wasting?) their valuable time researching companies, studying economic reports, frequenting the Internet chat boards, reading financial publications that advise which mutual funds or stocks to buy, and watching CNBC or other financial programs (unless they find the knowledge interesting for its own sake rather than as a tool to select investments). The market has already done the work for the investor. It is highly unlikely that additional stock-picking or market-timing efforts will add value.

Instead, we advise investors to adhere to the passive investment approach by taking the following three steps:

1. Adopt a belief in the basis for our capitalist system. The providers of capital must be rewarded with returns for providing their capital, or they will cease to do so.

2. Adopt a belief that risk and expected returns are related. Riskier asset classes must provide higher expected returns over time, or no one would invest in them.

3. Build a diversified portfolio of passive asset class/index funds that meet your unique ability, willingness and need to take risk. Then, just as importantly, establish the discipline to "stay the course" (particularly during times of crisis) by regularly portfolio rebalancing — eliminating any style drift that market movements may have caused by restoring the portfolio's asset allocation to its targets.

Once these tasks have been accomplished, investors can spend their increased free time on whatever they consider the really important things in their life. Instead of watching CNBC, they can spend time with their family. Instead of reading *Money* magazine, they can read a good book. Instead of hours on the Internet, they can go fishing or whitewater rafting or visiting with a friend. Such leisure activities are likely to be far more rewarding, and why we believe that passive investing is not only the winning investment strategy, but also the winning game in life.

As evidence that the EMT provides the formula for the winning investment strategy — passive asset class investing — we submit the following. During the last 75 years, investors who simply invested passively in the total US stock market would have doubled their investments approximately every six and a half years. And they could have done so without any knowledge of individual companies, sectors or the markets. They could have accomplished that amazing feat by simply believing in the capitalist system, in risk and reward being related, and in having the discipline to stay the course, during good times and bad.

This material is derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The content of this publication is for general information only and are not intended to serve as specific financial, accounting or tax advice. To be distributed only by a registered investment advisor. Copyright © BAM Advisor Services, 2001 & Capital Performance Advisors, LLC.