

OVERVIEW OF INDEX FUNDS: THE 12-STEP PROGRAM



Step 1 - Active Investors: What are the traits of active investors? They try to pick winners in stocks, times, managers, or investment styles. But markets are moved by news. News is unpredictable and random. Therefore, the movements of stocks, markets, managers, and styles are unpredictable and random. Markets are also efficient, meaning that news is rapidly reflected in market prices. As a result, active investing is not a viable strategy. The only reliable source of long term returns is from consistent exposure to economic risk factors that have a history of nearly eighty years of positive annualized returns.



Step 2 - Nobel Laureates: Nobel Prizes have been awarded to academics for their analysis of how stock markets work. Their findings are not biased by a need to earn a commission or sell you an IPO, magazine, or newspaper. More than one-hundred years of academic research conclude that index funds are an investor's best investment. But, the great majority of investors have never read these academic studies so they continue as active investors.



Step 3 - Stock Pickers: The primary factor influencing the success of a stock picker is simply luck. In numerous studies, only about 3% of stock pickers beat their benchmark. Most stock pickers invest in stocks that have done well recently, however, those same stocks do poorly in subsequent periods. The performance of stocks is random, just like the news that influences their prices. Therefore, it is not possible to consistently pick stocks that will be top performers in the future.



Step 4 - Time Pickers: When thirty-two market timing newsletters were compared to the S&P 500 index over a ten-year period, not one of them beat the broad market index. The primary reason for this inability to time the market is the high concentration of returns and losses in very few days. In a ten-year period, about 88% of the total gain was highly concentrated in just forty days. It is impossible to pick those forty days in advance. Professors studied 15,000 predictions by 237 market timers and concluded that "There is no evidence that newsletters can time the market." Therefore, it is not possible to consistently pick the best times to be in or out of the market.



Step 5 - Manager Pickers: The S&P 500 Index consistently outperformed 98.5% of mutual fund managers over the last three years and 97.6% over the last ten years, ending October, 2004. In two 30 year studies, the S&P 500 outperformed 97.5% and 94.5% of managers. In addition, only about 8% of the top 25% of managers repeat their performance in the following years. Therefore, it is not possible to consistently pick next years hot mutual fund manager. Index portfolios consistently capture the risk and return of markets, which in a high risk index portfolio has been 14.1% annualized for the last 50 years. (See <http://ifa.com/btp>.) The S&P 500 over that period earned 10.94% annualized.



Step 6 - Style Drifters: Most mutual fund managers play fast and loose with investor's money, as they drift from one recent winner to the next. The fund-stated objective is altered by these style drifters, and one study indicated that 40% of mutual funds drift from their originally stated style. To make things worse for these drifters, style performance rotates randomly and therefore it is not possible to consistently predict tomorrow's winning style.



Step 7 - Silent Partners: There are partners taking a large slice of your investment return that often do so in a very quiet and nearly invisible manner. Over a fifteen-year period, active investors only keep about 50% of the total return earned by their initial investment in taxable accounts. An index funds investor keeps about 85% of the total return by maintaining tight controls over the silent and often invisible partners of high fees, expenses, cash drag, taxes, transaction costs and more. Investor's who minimize the cost of these silent partners will increase their expected returns.



Step 8 - Riskese: Lawyers speak legalese and the best investors speak riskese. A basic understanding of the concepts of risk, return, time, and correlation are essential for successful investing. Most investors instead chase the short-term returns of stocks, markets, managers, or styles and never truly understand the impact of risk, time, and correlation on their returns. The more fluent you speak Riskese™, the higher your risk capacity, corresponding risk exposure, and expected returns.



Step 9 - History: Long term data is required to establish expected returns for different stock market risk factors. We now have almost eighty years of risk and return data on indexes, making them the most reliable and logical investment choice. Since you can not predict the future based on recent events, the study of long term stock market data is the only source of probability distributions of the expected risk and return of various types of investments. As Harry Truman said, "The only new thing in the world is the history you don't know."



Step 10 - Risk Capacity: The Risk Capacity Survey will help you determine your individual and unique risk capacity. Five dimensions of your risk capacity will be thoroughly measured resulting in a score and corresponding index portfolio. These risk capacity dimensions include time horizon, investment knowledge, net income, net worth, and attitude towards risk. This is the single most important step in your investment process resulting in an Investment Policy Statement that will provide the guidelines for your financial future.



Step 11 - Risk Exposure: According to Ibbotson and Associates, one hundred percent of your long-term return levels are explained by your asset allocation of index funds. Once you have determined your risk capacity in Step 10, you will then be directed to one of twenty risk exposures in the form of index portfolios. DFA index funds are used to implement index portfolios in a way that minimize taxes and maximize expected returns among your various investment accounts. A properly constructed index portfolio outperformed the S&P 500 index by 3% annually for the last 50 years at the same risk level and after DFA and IFA fees. (See <http://ifa.com/btp>.)



Step 12 - Invest and Relax: The road to recovery for active investors ends with a recognition that a strategy of buying, holding, and rebalancing a portfolio of index funds is the best way for investors to build wealth. An Index Funds Advisor can design, implement, and maintain a risk-appropriate, tax-managed, and highly efficient portfolio of low-cost index funds for you. After implementing your prudent investment plan, you can kickback and relax.

