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Passive Investing's Performance Advantage

Year after year, a battle is fought in the capital markets between two types of investors — active and passive.

Passive investors seek to match the return of a particular area of the capital markets by holding all, or substantially all, of the securities that compose the desired sector. In the other camp, active investors seek to provide a return that is higher than market benchmarks such as the S&P 500 Index.

Much of the intellectual underpinning of passive investing is derived from the *Efficient Markets Hypothesis*, an academic theory developed by Professor Eugene Fama of the University of Chicago. The theory asserts that current securities prices reflect all available information and expectations. The implication is that active investors will not consistently beat the market over long periods of time, except by chance.

Active managers don't buy into this theory. Every day they challenge the hypothesis through their efforts to pick winning stocks and time the markets.

So, who is winning the battle? How can investors evaluate one approach vs. the other?

The good news is that there is a scorekeeper — the annual S&P SPIVA (S&P Indices versus Active Funds) analysis. The SPIVA scorecard is derived from a sophisticated data set that compares active funds' performance vs. their appropriate benchmarks. It also takes into account that numerous funds go out of business or are merged into others.

Have active managers delivered on their promise of market-beating returns? Most have not, according to the SPIVA study.[1]

The chart on the next page looks at how active stock mutual funds fared in their attempt to beat the market over the five years ending December 31st, 2012. In the U.S., international developed and emerging markets, their results were underwhelming. Approximately 3 out of 4 managers underperformed — they failed to beat their index.

And it's not just stocks. The SPIVA study shows that actively managed bond funds, in nearly all the categories, lagged behind their benchmark indices as well.

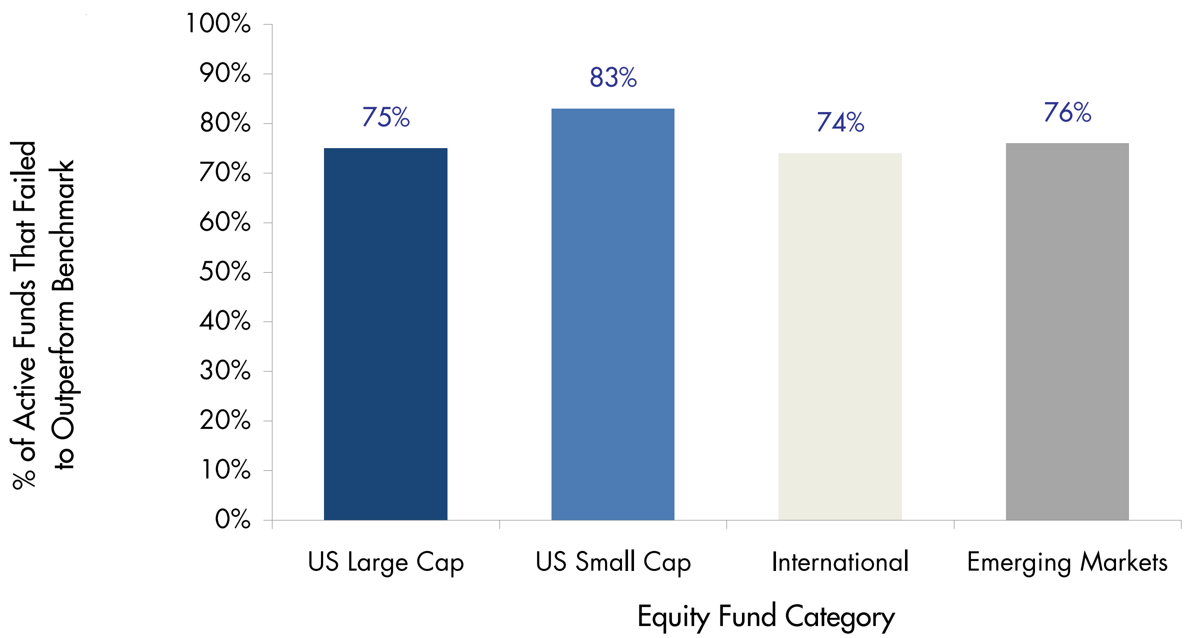
The 2012 SPIVA study is consistent with years of academic research showing that, as a group, active managers underperform the market by an amount equivalent to their average fees and expenses. Vanguard, in their March 2013 research report, *The Case for Index-Fund Investing*, concludes that consistent outperformance of any one active manager has been very rare.[2]

Investors' recent actions show they agree. Morningstar reports that in 2012, $95 billion flowed out of large-cap active U.S. stock funds, while $61 billion flowed into large-cap passive stock funds.[3]

In addition to the performance advantage, passive investing has other benefits relative to active management. Passive portfolios are usually more broadly diversified and can provide greater control over risk in a portfolio. Costs are lower, and tax-efficiency is higher.

For all of these reasons, market-tracking passive funds form the foundation of our investment approach.

Percentage of active public equity funds that failed to beat the index
Five years as of December 2012[4]



Sources

1. Standard & Poor's Indices versus Active Funds (SPIVA) Scorecard Year-end 2012.

2. Vanguard, *The Case for Index Fund Investing*, March 2013.

3. Morningstar Direct℠ U.S. Direct Open-End Asset Flows Update. January 2013. Includes U.S. Open-end and exchange-traded funds. Large cap consists of Morningstar categories large value, large blend, and large growth.

4. Source: Standard & Poor's Indices Versus Active Funds Scorecard, year-end 2012. Index used for comparison: US Large Cap—S&P 500 Index; US Mid Cap—S&P MidCap 400 Index; US Small Cap—S&P SmallCap 600 Index; Global Funds—S&P Global 1200 Index; International—S&P 700 Index; International Small—S&P World ex. US SmallCap Index; Emerging Markets—S&P IFCI Composite. Data for the SPIVA study is from the CRSP Survivor-Bias-Free US Mutual Fund Database.

Disclosures

This information is for educational purposes only and should not be considered investment advice or an offer of any security for sale.

Past performance is no guarantee of future results, and every investment strategy has a potential for profit or loss.

Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Nothing herein constitutes (i) legal, accounting or tax advice, (ii) a recommendation to buy, sell or hold a security or (iii) advice as to whether any investment strategy is suitable for a particular investor.

Rappaport Reiches Capital Management is an investment advisor delivering world-class global investment management and financial planning solutions to individuals and families. As an independent firm, we are beholden only to our clients' best interests.

Our Value Added Indexing℠ approach utilizes passive and index-related portfolios as part of a comprehensive solution to meet our clients' long term goals. The result is a disciplined investment experience based on sound research and planning, rather than forecasts, emotions or trends.