Appendix B:
Become a savvy buyer

A common belief is that there are smart professionals, with resources beyond our imagination, that are more capable of beating the average market return than we are.

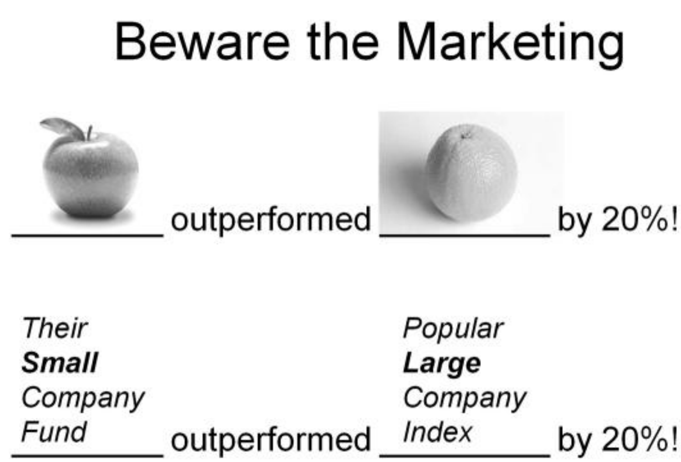
I too know that there are excellent people actively managing mutual funds. But this short book has attempted to show that *after you pay their fees,* your probability of even achieving the average market return is low and gets worse with time.

Keep in mind that companies are *competing* for your investments and each company is trying to *sell* you their products and services. You need to be a savvy buyer. Remember, their marketing is excellent, so this can be hard to recognize.

Test yourself. Suppose this was their sales pitch. Can you see through this?

"We beat the S&P 500 index by 20% last year."

See the problem? This picture will give you a hint:



Yes! You get it. You can only compare apples with apples. You can't compare large company stocks with small company stocks any more than you can compare stocks with bond performance. They are different asset classes with different levels of risk. And when you recognize it from that perspective, you would know to find out more and compare it with the appropriate benchmark (e.g. an index fund of small company stocks for this example).

OK, test yourself again. This next one is going to be harder. Can you see through this?

> *"Our fund beat the S&P 500 index for the past five years."*

Your first reactions are probably good ones—you ask to learn more about risk level and expenses. You are getting good! But keep going. A long track record is pretty compelling! Is this manager truly brilliant?

Simple random luck will make some people appear more brilliant than they really are. I'd like you to consider the following scenario. A thousand individuals are gathered together to participate in a contest. (Coin-Tossing Gurus?) A coin will be tossed and the contestants must guess whether it will come up heads or tails. Contestants who correctly guess the outcome of *five* consecutive tosses are declared winners and each receive the coveted title of "National Coin-tossing Guru of the Year."

Simple statistics tell us we can expect that after the first toss, five hundred participants will have guessed the outcome correctly. The other five hundred will have guessed incorrectly and thus are eliminated from the competition. After the second round, 250 participants will remain; and so on. *After five repetitions we would expect to have thirty remaining participants who would have guessed correctly all five times and earned their guru status!* What probability would you attach to the likelihood that those thirty gurus would win the next coin-toss competition? (Hint: 50%—the same as for you!) I chose a coin-toss example, because we humans tend to give too much weight to recent experience—perhaps like the mutual funds ranked with five stars?

Now how do you feel about the active fund manager that beat the market average five years in a row? Was it superior intelligence? Keep in mind that there are *thousands* of mutual funds.

Or, are we fooled by randomness? Since funds are competing for your investment dollars, I want you to have healthy skepticism about their sales pitches.

Remember, the stock market *average* return is exactly that. If there were no costs involved, the winners that over-performed would exactly equal the losers that under-performed. Because, together they comprise the whole market and earn the "total market return".

Well, *with no costs*—50/50—that sounds pretty similar to the odds in our coin-tossing example doesn't it?

The grim reality is that the odds of beating the market average *after* mutual fund expenses is much worse. That's why the argument for considering index funds is so compelling

"*Costs matter!"* John Bogle constantly shows us. "*You get to keep what you don't give away*."

John Bogle writes in his *Little Book of Common Sense Investing*, "Once you recognize this fact, you can see that the index fund is guaranteed to win not only over time, but every year, and every month and week, even every minute of the day. Because no matter how long or short the time frame, the gross return in the stock market, minus intermediation costs, equals the net return earned by investors."

If you are *still* tempted to choose what looks like a manager with superior intelligence with fees and other costs that are lower than your expected return premium, then consider the market effect of new money attracted into that fund, and the manager needing to repeat that genius the next year by investing 10 to 100 times last year's amount. Those opportunities are quite different!