Index Fund Investing vs. Asset Class Fund Investing

An Educational Resource From
Solid Rock Wealth Management

By Christopher Nolt, LUTCF

Today's investors (and their financial advisors) face a paralyzing problem: Choice.

With tens of thousands of investments to choose from — and more appearing every day — the decisions you face are overwhelming and endless. But we believe all these decisions boil down to two primary choices:

1. Active Management vs. Passive Management

2. Indexing vs. Asset Class Investing

How you address these two decisions can have a substantial impact on your portfolio and its long-term financial success.

Decision 1: Active Management vs. Passive Management

The difference between active and passive investing can come down to one thing: efficiency.

Active management assumes the market isn't completely efficient — that some securities are over- or underpriced and it is possible to figure out which ones they are. Active managers try to beat the market through security selection and market timing. To do this, active managers must take on more risk than the market's inherent risk.

On the other hand, passive managers aim to capture the market's returns, investing without regard for future forecasts. Passive managers seek to avoid unnecessary risks and focus on keeping costs low in order to provide investors with greater potential returns. As the Nobel Laureate in Economics, William Sharpe conclusively demonstrated in a ground-breaking paper:

> "…it must be the case that
>
> 1. before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and
>
> 2. after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar
>
> These assertions will hold for any time period. Moreover, they depend only on the laws of addition, subtraction, multiplication and division. Nothing else is required."*

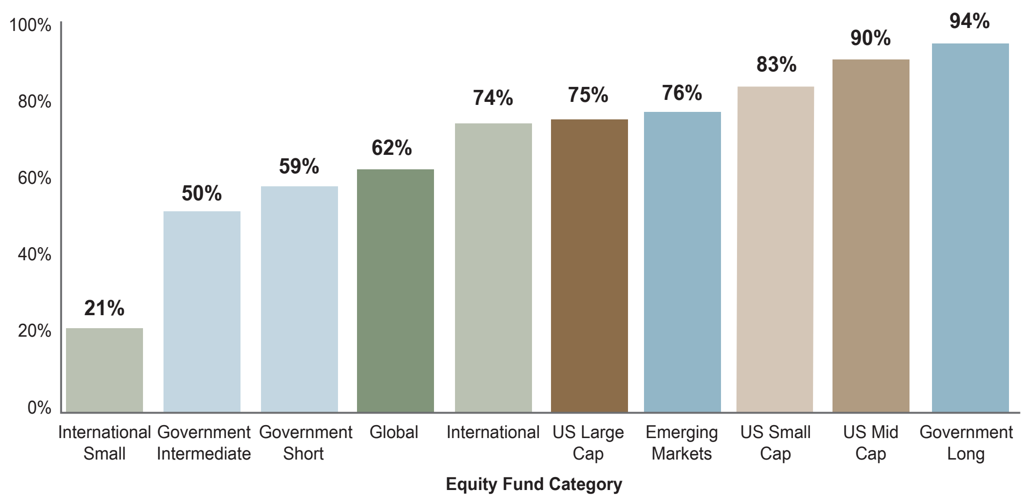
Looked at in the clear light of simple mathematics, after fees and costs are deducted, active management becomes a losing game in which the expected outcome is negative, in which the odds are stacked against the average participant. In other words, while some active managers will win, the majority will necessarily lose. The math is inescapable, so it isn't surprising as the chart below shows, over the last five years, most active managers underperformed their benchmarks.

**William F. Sharpe, "The Arithmetic of Active Management," The Financial Analysts' Journal Vol. 47, No. 1, January/February 1991. pp. 7-9*

Most Active Managers Underperform Their Benchmarks

Percentage of Active Funds that Failed to Beat Their Indices

January 2008 – December 2012



Source: Standard & Poor's Indices Versus Active Funds Scorecard (SPIVA), 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; Emerging Markets — S&P/IFCI Composite; Short-Term Inv. Grade Fixed Income — Barclays 1-3 Year Government/Credit Index. Outperformance is based upon equal weight fund counts. For illustrative purposes only. Index returns do not include payment of any sales charges or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. Past performance is not an indication of future results.

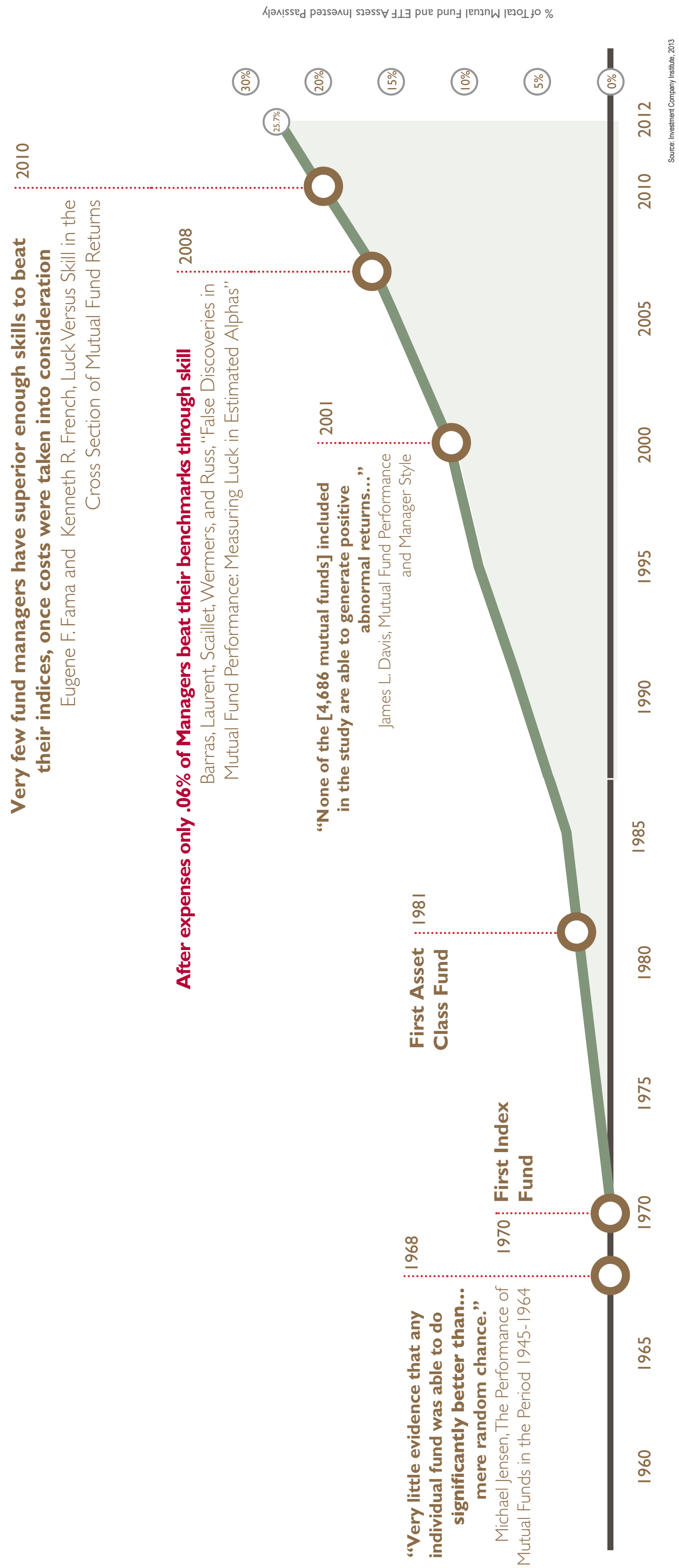
Active Management	vs.	Passive Management
Assumes markets aren't efficient; tries to be predictive.		Assumes markets are efficient.
Relies on security selection and market timing to seek alpha.		Asset classes define security selection.
Manager style drift can compromise portfolio asset allocation.		No manager style drift.
Exposes the investor to above-market risk.		Tries to eliminate all non-market risks.
Frequent trades increase transactions costs and taxes.		Lower costs mean greater potential returns for investors.

Investors Increasingly Trust the Passive Approach

More and more investors are questioning the wisdom of risking their financial futures on underperforming active managers with high fees. Then there is the ever-present risk of style drift, which can jeopardize the overall portfolio asset allocation.

Is it any wonder that passive investing is growing exponentially? Investors added $61 billion to passively managed funds and ETFs in 2012, compared to outflows of $95 billion from actively managed funds, according to Morningstar.

As you can see from the chart to the right, passively invested assets have increased substantially — alongside a number of academic studies which have called into question the historical ability of most active managers to outperform their benchmarks over the long term.



Decision 2: Indexing vs. Asset Class Investing

The traditional approach to passive investing is index investing. With index investing, you invest in a mutual fund or ETF that mimics a commercial index representing an asset class.

While index investing, in our view, is preferable to active management, it has one major problem: Indexes are designed to establish market performance and serve as a benchmark for active management, not serve as investment vehicles.

As a result, index funds have three built-in drawbacks that may reduce their effectiveness.

1. **High trading costs from buying and selling as a "motivated trader"**
   The goal of an index fund is to track an index as closely as possible. That means a fund's manager must buy a security the day it is added to an index. As the Reconstitution Effect chart to the right shows, the end result is that the index manager must typically pay a high price due to the temporary run up in price between the announcement and when it is actually added. Additionally, index funds have no flexibility to exclude or postpone a trade if the pricing is not favorable.

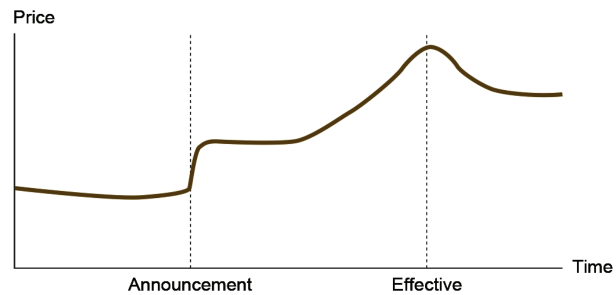
2. **Inefficient asset & irregular class tracking**
   Indexes are typically reconstituted just once a year. If an underlying security migrates to a different asset class (the company grows substantially bigger, for example) it won't be removed from the index or fund until its annual review — creating a disconnect between what investors want and what their portfolios hold.

3. **No flexibility in security selection**
   The index provider determines the securities. Managers aren't free to select the securities that best represent the asset class.

What Is Asset Class Investing?

Asset class investing is a passive investment strategy based on the research of some of the academic community's most innovative and respected thinkers and economists. Rooted in the knowledge that asset allocation has the greatest impact on investment returns, it is designed to carefully control the investments included in each asset class, giving investors truer market returns than similar strategies.

Reconstitution Effect



	S&P 500 Index	MSCI EAFE Index
One Day Return after Announcement (%)	3.2	3.4
Run-Up to Effective Date (%)	3.8	4.5
Decay after Effective Date (%)	-2.1	-2.6

- Stocks typically rise on announcement of inclusion in an index
- Index funds forced to buy high on effective date
- Buying and selling to track index changes reduces tracking error but generates higher transaction costs
- Asset class investing strives to add value by not demanding liquidity on heaviest trading days

In US dollars. S&P 500 data source: Anthony Lynch and Richard Mendenhall, "New Evidence on Stock Price Effects Associated with Changes in the S&P 500 Index," Journal of Business 70, no. 3 (July 1997): 351-83. MSCI EAFE Index data source: Rajesh Chakrabarti, Wei Huang, Narayanan Jayaraman, and Jinsoo Lee, "Price and Volume Effects of Changes in MSCI Indices: Nature and Causes," Journal of Banking and Finance 29, no. 5 (May 2005): 1237-64. For illustrative purposes only. Past performance is not a guarantee of future results.

Which came first, the index or the asset class?

Nobel-Prize Winning Research

In 1952, Professor Harry S. Markowitz published a paper on what would become known as Modern Portfolio Theory. Before Modern Portfolio Theory, investors thought the best way to make money in the markets was to buy just a few high-performing stocks. Markowitz, who earned the Nobel Prize in Economics for his research, showed that investors could maximize returns and minimize risk by investing in diverse portfolios containing many asset classes. To adjust the amount of risk, an investor need only change the proportion of asset classes in his portfolio.

Markowitz's idea was ahead of his time. Computing was in its infancy and there were few practical ways to implement his theory.

Harnessing Modern Portfolio Theory

By the early 1970s, computing technology had advanced, giving two financial innovators, Rex Sinquefield and David Booth, a revolutionary idea. Why not develop portfolios based on Markowitz's discovery using indexes? The men helped pioneer some of the first index funds — Booth at Wells Fargo and Sinquefield at American National Bank.

Index funds proved an immediate success — but Sinquefield and Booth didn't stop there.

Building on a Brilliant Idea

By 1981, the pair were being asked repeatedly by their institutional clients for an alternative to indexing that could deliver truer market rates of return. They knew there had to be a better way. They founded Dimensional Fund Advisors and working with Gene Fama Sr., a renowned professor at the University of Chicago, created Asset Class Investing.

Today Loring Ward uses institutional asset class funds from Dimensional Fund Advisors as the building blocks of our distinctive Asset Class Investing approach to portfolio management. All portfolios are designed by Loring Ward's Investment Committee, which includes Dr. Markowitz as well as Behavioral Finance pioneer, Dr. Meir Statman.

The Asset Class Investing Advantage

Asset Class Investing tries to improve on index investing by offering investors two major advantages:

1. **Truer asset classes — meaning truer investment returns**

2. **Lower costs and higher potential returns thanks to advanced trading and engineering**

How is this possible?

More Accurate Asset Class Tracking

Investors buy an asset class because its risk and return is part of a carefully planned asset allocation. If an investment doesn't accurately reflect the desired asset class, it can throw off an entire investment strategy. As a pioneer in Asset Class Investing, Dimensional makes asset class accuracy a top priority, empowering its managers to swap out securities whenever necessary to maintain true asset class representation. The result is a fund that is much more faithful to its asset class than an index fund that adjusts only annually.

Asset Class Consistency

Over time, securities within an index can migrate from one asset class to another, e.g., from small company to large company. Since many indexes are reconstituted only once a year, their characteristics can be significantly diff erent eleven months after their reconstitution date. Because of this, an index that purports to represent a certain asset class may not offer thorough, consistent exposure to the underlying risk factors. This can be seen in the chart on the next page that shows the Russell 2000 Index and the Center for Research in Securities Prices small cap index (CRSP 6-10 Index).

Asset Class investors are able to maintain "pure" asset class exposure. Because Asset Class Investing is not tied to a specific target index, money managers can utilize investor cash flows into and out of the portfolios to hold the necessary securities for each asset class.

Flexible Trading to Enhance Efficiency

With Asset Class Investing, managers can also choose the most appropriate investments from the whole universe of securities in an asset class — not just the ones included in an index. Managers can also exclude IPOs, financially distressed and bankrupt companies and illiquid stocks that don't truly represent the class. Managers can also draw from a wider universe. For example, while there are approximately 4,500 small-cap stocks in the U.S. to choose from, most small-cap index funds and ETFs limit themselves to the 2,000 small-cap stocks of the Russell 2000.

Flexible Trading to Enhance Efficiency

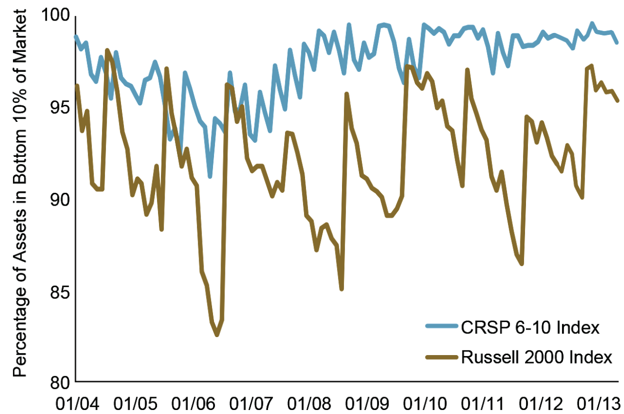
Because asset class funds aren't tied to an index, managers have the flexibility to decide when to add a security to the fund. That means managers aren't forced to buy a stock the day it becomes part of an index — when its price is likely to be high. Instead they trade carefully and patiently in an effort to minimize transaction costs. They are also free to capitalize on block trading and securities lending whenever possible.

Independence from index tracking means lower trading costs, which can mean that investors see higher returns.

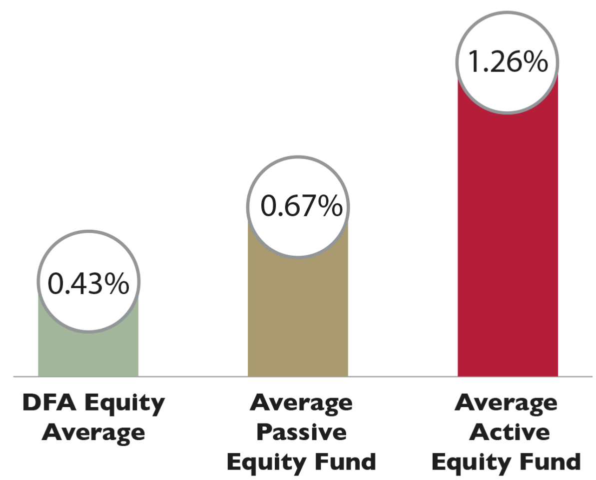
As you can see from the chart on the right, the average expense ratio of a DFA Fund — about .43% is significantly lower than the .67% average of passive funds and substantially lower than the 1.26% average for actively managed funds.

Consistency of Asset Class Exposure

Percentage of Assets in Bottom 10% of Markets	Russell 2000 Index	CRSP 6-10 Index
June 30 Averages (reconstitutions month)	96.30	96.61
May 31 Averages (11 months after reconstitutions)	88.42	97.24



Month-end values from January 2004-December 2012. Russell data © Russell Investment Group 1995-2012, all rights reserved. CRSP data provided by the Center for Research in Security Prices, University of Chicago. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.



Source: Morningstar 2013

Index Investing	vs.	Asset Class Investing
Strategy determined by commercial index		Strategy defined by academically researched asset class
Requires the purchase of securities to match index regardless of price		Avoids buying high-priced securities when index reconstitutes
Index class drifts from target over the year		Asset class holds truer throughout the year
Higher transaction costs from trading		Uses advanced trading and engineering to minimize transaction costs

The Ultimate Decision

In the end, only you (working closely with your financial advisor) can decide what is the best approach and investment vehicle for your individual situation.

However, we passionately believe that most investors can benefit from the sophistication, truer asset class returns and lower costs that can come from adopting a strategic Asset Class Investing approach.

This means you no longer have to spend all your time focused on trying to outguess the market or pick the right managers. Instead, you can address what matters most — enjoying your life secure in the knowledge that you have a prudent plan in place for achieving your long-term goals.

Chris Nolt is the owner of Solid Rock Wealth Management, Inc. and Solid Rock Realty Advisors, LLC, with offices in Bozeman, Montana and Fountain Hills, Arizona. Solid Rock Wealth Management and Solid Rock Realty Advisors are dedicated to helping people effectively grow and preserve their wealth. We use a comprehensive planning approach with a team of financial professionals, which addresses retirement planning, investment planning, estate planning, tax planning, charitable giving and risk management. Our wealth preservation strategies are designed to help our clients reduce taxes, increase retirement income and maximize the amount of wealth they pass on to their heirs and favorite charitable organizations.

Solid Rock Wealth Management

Solid Rock Wealth Management is an independent, fee-only registered investment adviser. We offer globally diversified portfolios of no-load, low-cost institutional asset class mutual funds and exchange traded funds. Are portfolios are diversified among as many as 15 asset classes and market sectors and are comprised of holdings in roughly 12,000 companies in 45 different countries. Our model portfolios range from conservative (100% fixed income) to aggressive (100% equities) and are designed to achieve optimal returns for your level of risk tolerance.

Solid Rock Realty Advisors

Solid Rock Realty Advisors assists investors who are seeking secure income producing real estate investments. We specialize in office buildings leased to the U.S. Federal Government and primarily work with investors who are purchasing properties through a 1031 tax-deferred exchange. These fee-simple real estate properties offer long-term leases guaranteed by the full faith and credit of the U.S. government with competitive cap rates and professional property management.

Chris Nolt, LUTCF

Chris grew up in Lewistown, Montana. He received a Bachelors degree in business from Montana State University in 1987 and entered the financial services industry in 1989. For over 25 years, Chris has been helping people reduce taxes, invest wisely and preserve their wealth. Chris has earned the designations of Certified Retirement Financial Advisor and Life Underwriter Training Council Fellow.

For more information or to request other Wealth Guides, call 406-582-1264 or send an email to: chris@solidrockwealth.com

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