Just recently, I was reading an article from Larry Swedroe which *"discussed"* the "Surprising Results From S&P's Latest SPIVA Analysis." To wit:

> *"Over the 15-year period, on an equal-weighted (asset-weighted) basis, **the average actively managed U.S. equity fund underperformed by 1.4% (0.74%)per annum.** The worst performances were small caps, with active small-cap growth managers underperforming on an equal-weighted (asset-weighted) basis by 1.99% (0.90%) per annum, active small-cap core managers underperforming by 2.43% (1.82%) per annum, and active small--value managers underperforming by 2.00% (1.71%) per annum. So much for the idea that the small-cap asset class is inefficient and active management is the winning strategy."*

As Larry concludes from that analysis:

> *"S&P?s SPIVA scorecard provides persuasive evidence of the futility of active management."*

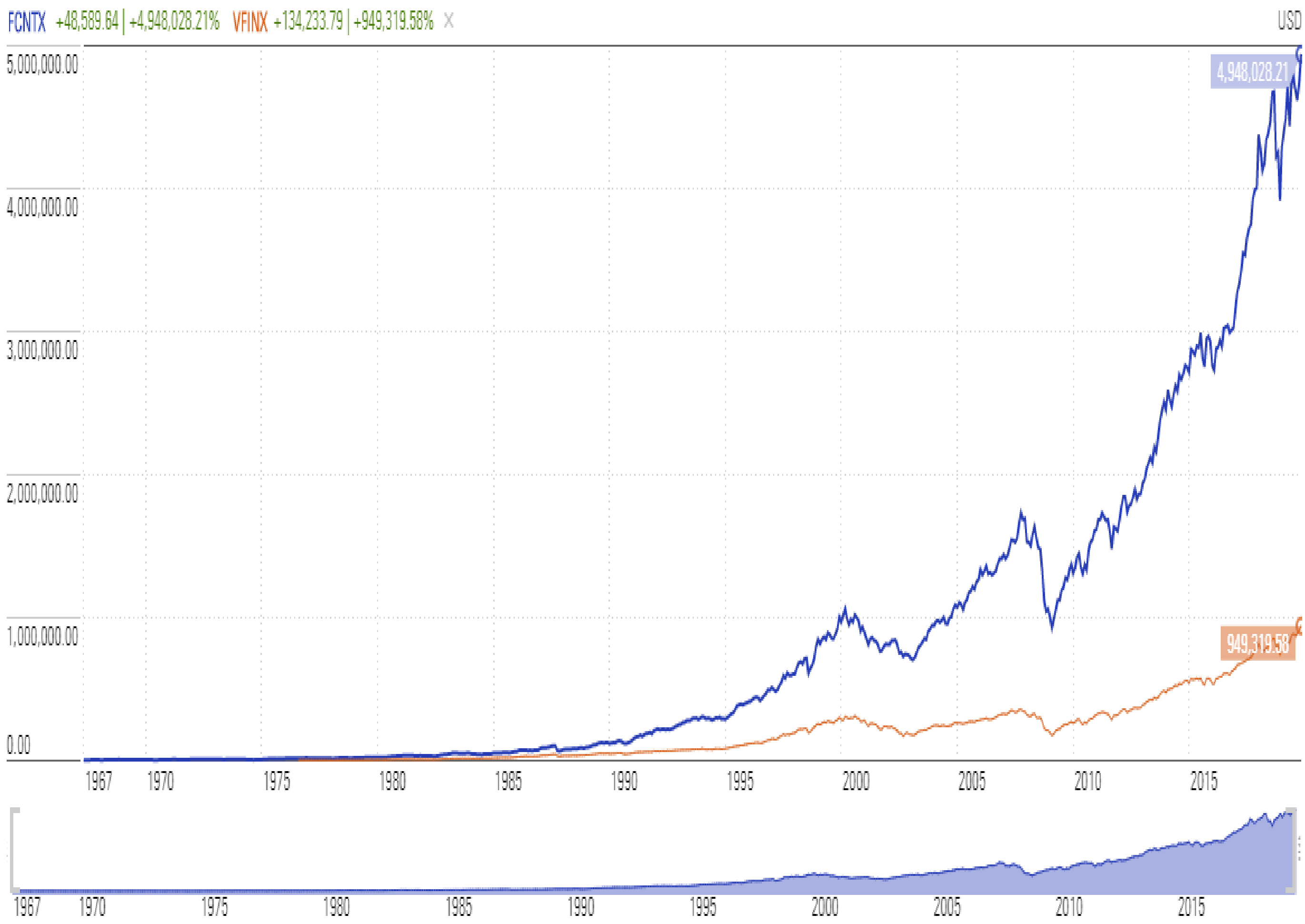
See, according to Larry, it is clear you should just passively index in funds and everything will be just fine.

If it were only that simple.

We Are Supposed To Be Long-Term Investors

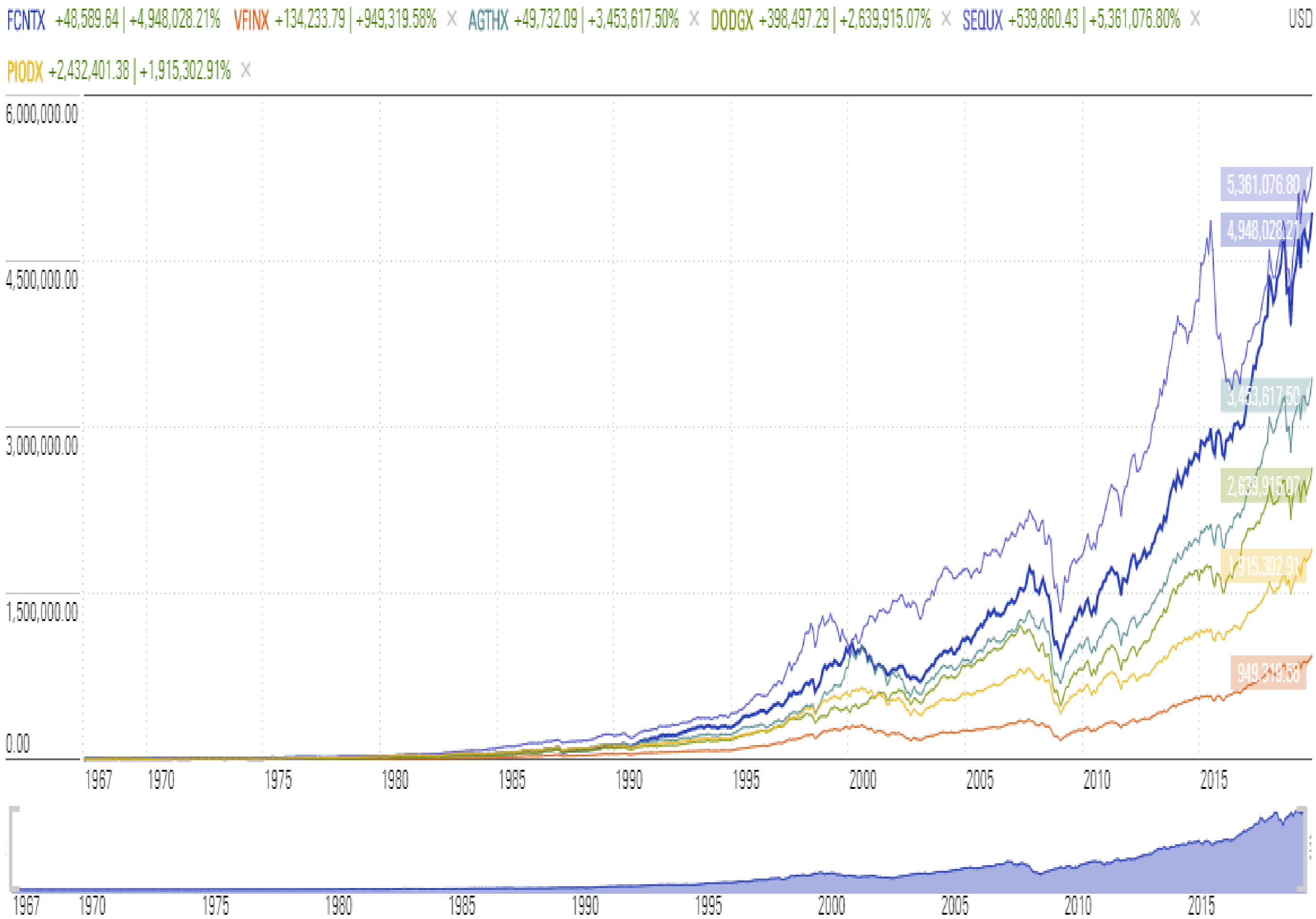
In any given short-term period, a manager of an active portfolio may make bets which either outperform or underperform their relative benchmark. However, we are supposed to be long-term investors, which suggests that we should focus on the long-term results, and not short-term deviations.

The following chart of Fidelity Contra Fund versus the Vanguard S&P 500 Index proves this point. Which fund would you have rather owned?



(Source: Morningstar)

Finding funds with very long-term track records is difficult because the majority of mutual funds didn't launch until the late *"go-go 90's"* and early 2000's. However, I did a quick look up and added 4-more active mutual funds with long-term track records for comparison. The chart below compares Fidelity Contrafund, Pioneer Fund, Sequoia Fund, Dodge & Cox Stock Fund, and Growth Fund of America to the Vanguard S&P 500 Index.



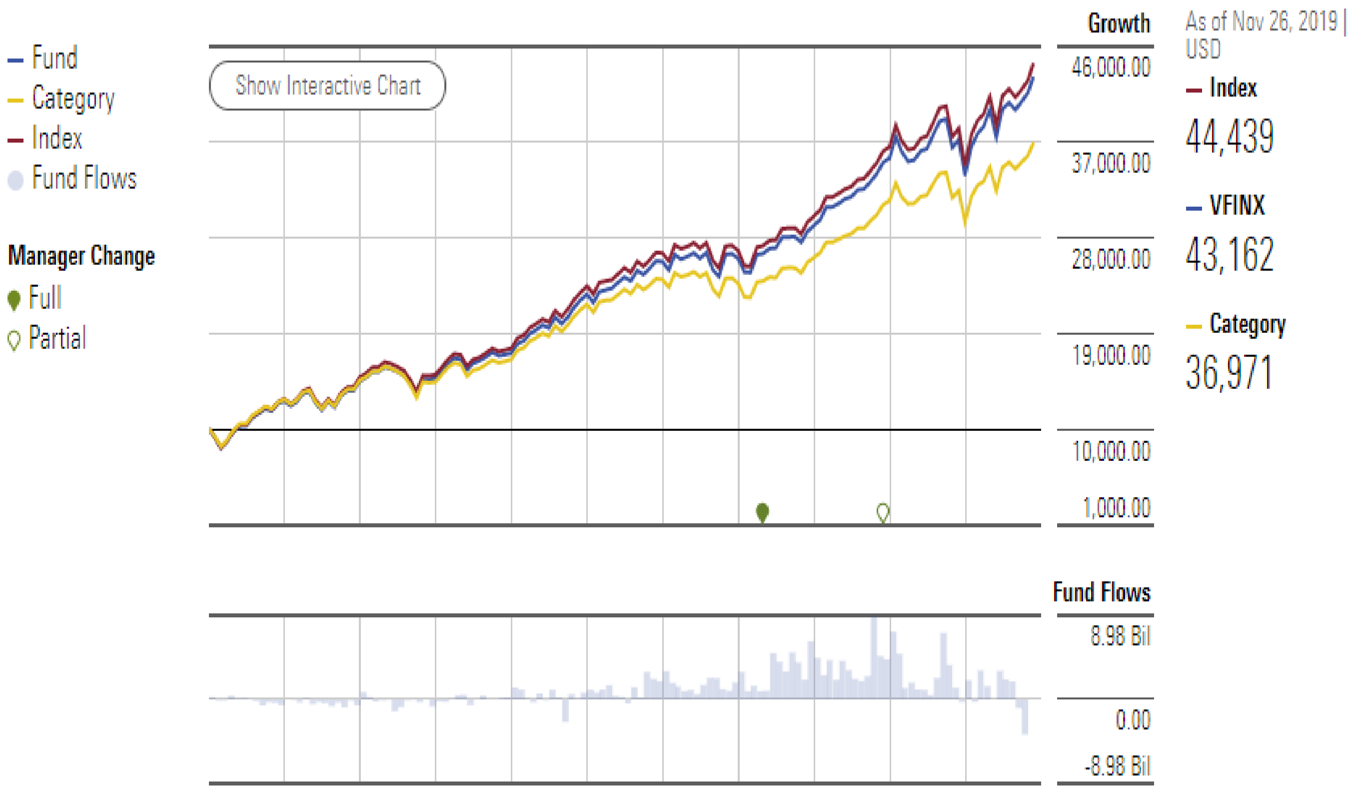
(Source: Morningstar)

I don't know about you, but an investment into any of the actively managed funds over the long-term horizon certainly seems to have been a better bet.

Even Index Funds Can't Beat The Index

Do you want to know what fund did NOT beat the index according to Morningstar? The Vanguard S&P 500 Index fund.

Growth of 10,000



Total Return %	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD
Fund	26.49	14.91	1.97	15.82	32.18	13.51	1.25	11.82	21.67	-4.52	27.43
+/- Category	-1.68	0.91	3.24	0.86	0.67	2.55	2.32	1.45	1.23	1.75	2.06
+/- Index	-1.95	-1.18	0.47	-0.60	-0.94	0.27	0.33	-0.24	-0.02	0.26	-0.27

How is it that a fund that is supposed to purely replicate an index, failed to exactly match the performance of the index.

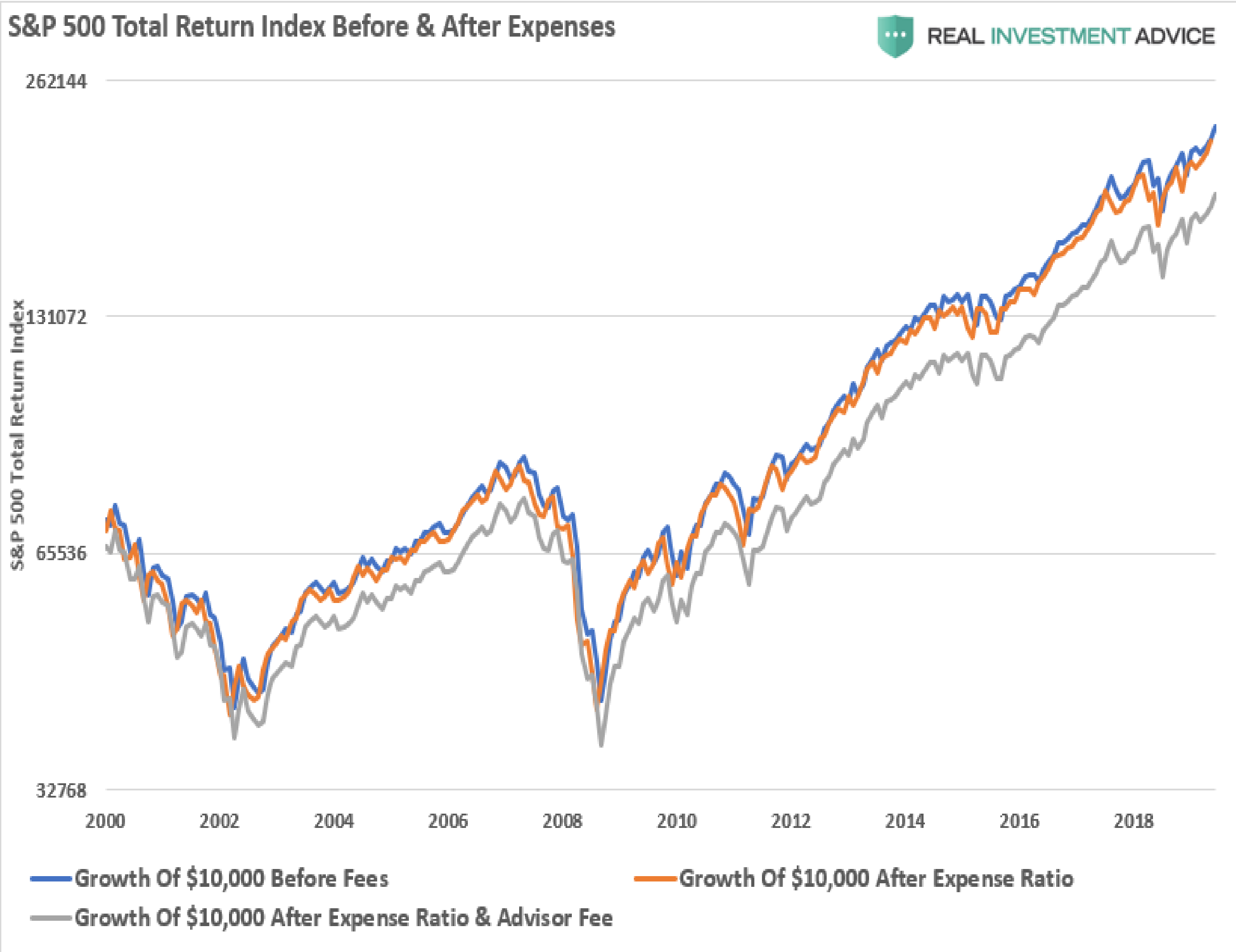
Simple.

Fees, taxes, and expenses.

Unfortunately, in the *"real world"* where people actually invest their *"hard earned savings,"* their overall returns are constantly under siege from taxes, previously commissions, fees, and most importantly - taxes.

An *"index,"* which is simply a mathematical calculation of priced securities, has no such detriments.

The chart below is the S&P 500 Total Return Index before, and after the same expense ratio charged by the Vanguard S&P 500 Index Fund. Since most advisers don't manage client money for free, I have also included an *"adviser fee"* of 0.5% annually.



Of course, if your adviser is simply indexing for you, then maybe the real question is exactly what are you paying for?

The Differences Between You And An Index

Which brings us to why you, nor any investment product that exactly mimics the S&P 500 index, can actually match it, must less beat it.

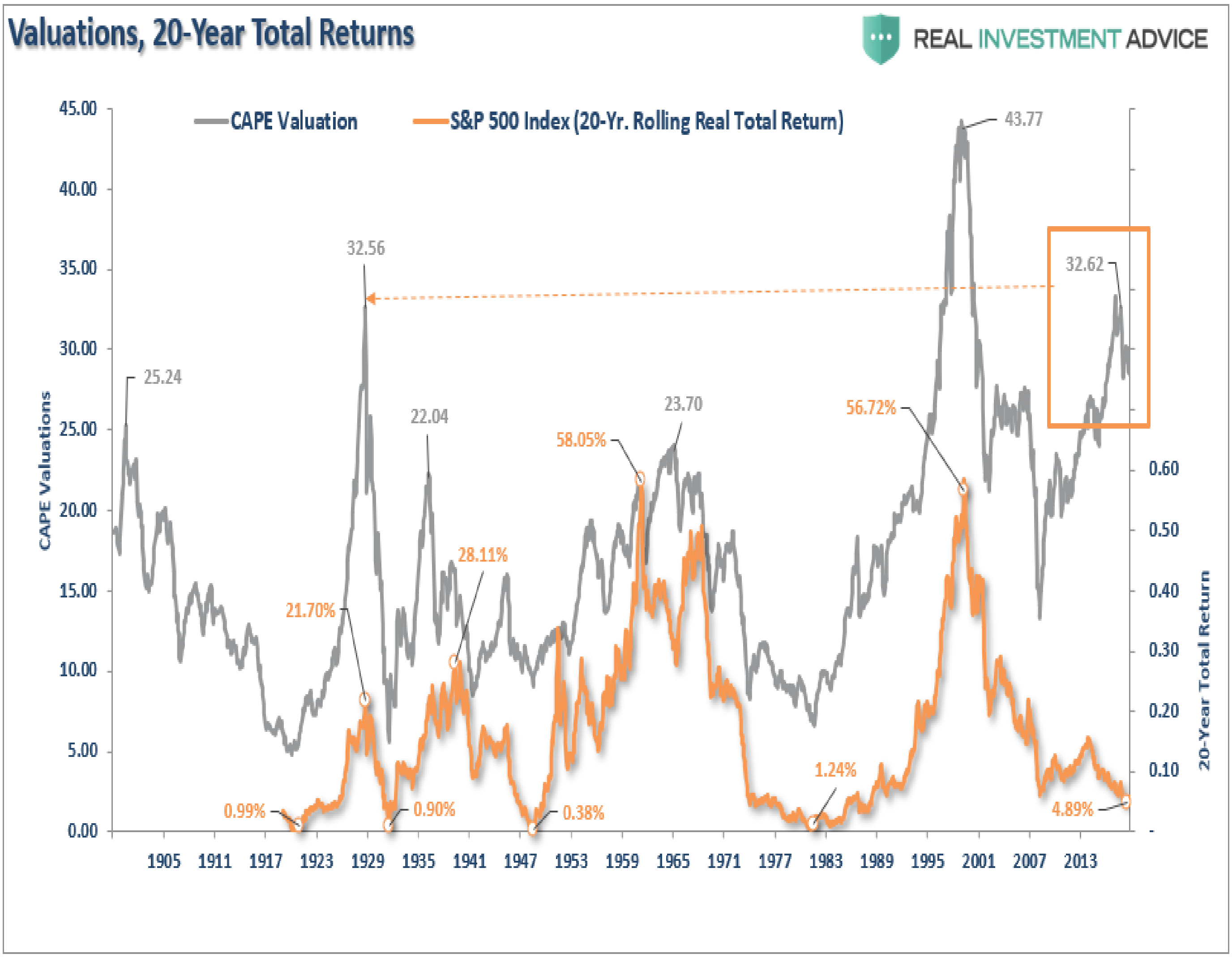
While Wall Street wants you to compare your portfolio to the 'index' so that you will continue to keep chasing an index, which keeps money in motion and creates fees for Wall Street, the reality is that you and an index are very different things. This is due to the following reasons:

1) The index contains no cash,

> *If you maintain cash for expected expenses, taxes, or any other reason, your performance will lag the benchmark index.*

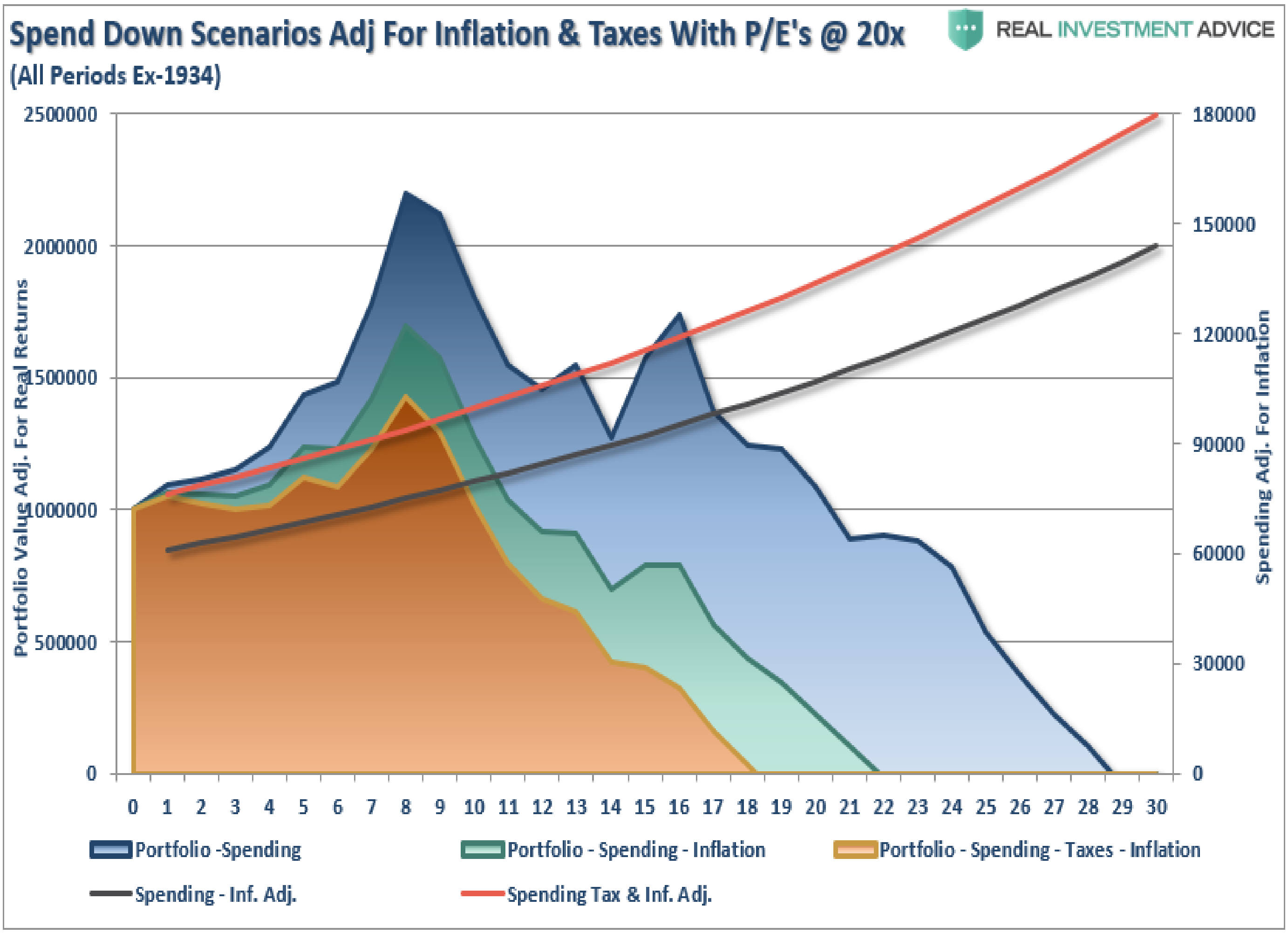
2) The index has no life expectancy requirements ? but you do.

While it may sound great that if you just hold an index long-term you will generate 8-10% annual returns, the reality is that your investment horizon between accumulation and distribution fall within one *"full-market"* cycle. Start on the wrong end of a cycle *(high starting valuations)* and the end result will be far less than advertised.



3) The Index does not have to compensate for distributions to meet living requirements.

At the point in life when you begin withdrawing money to live on, performance is affected by the withdrawals against the value of the portfolio. ***[(Read more here)]***



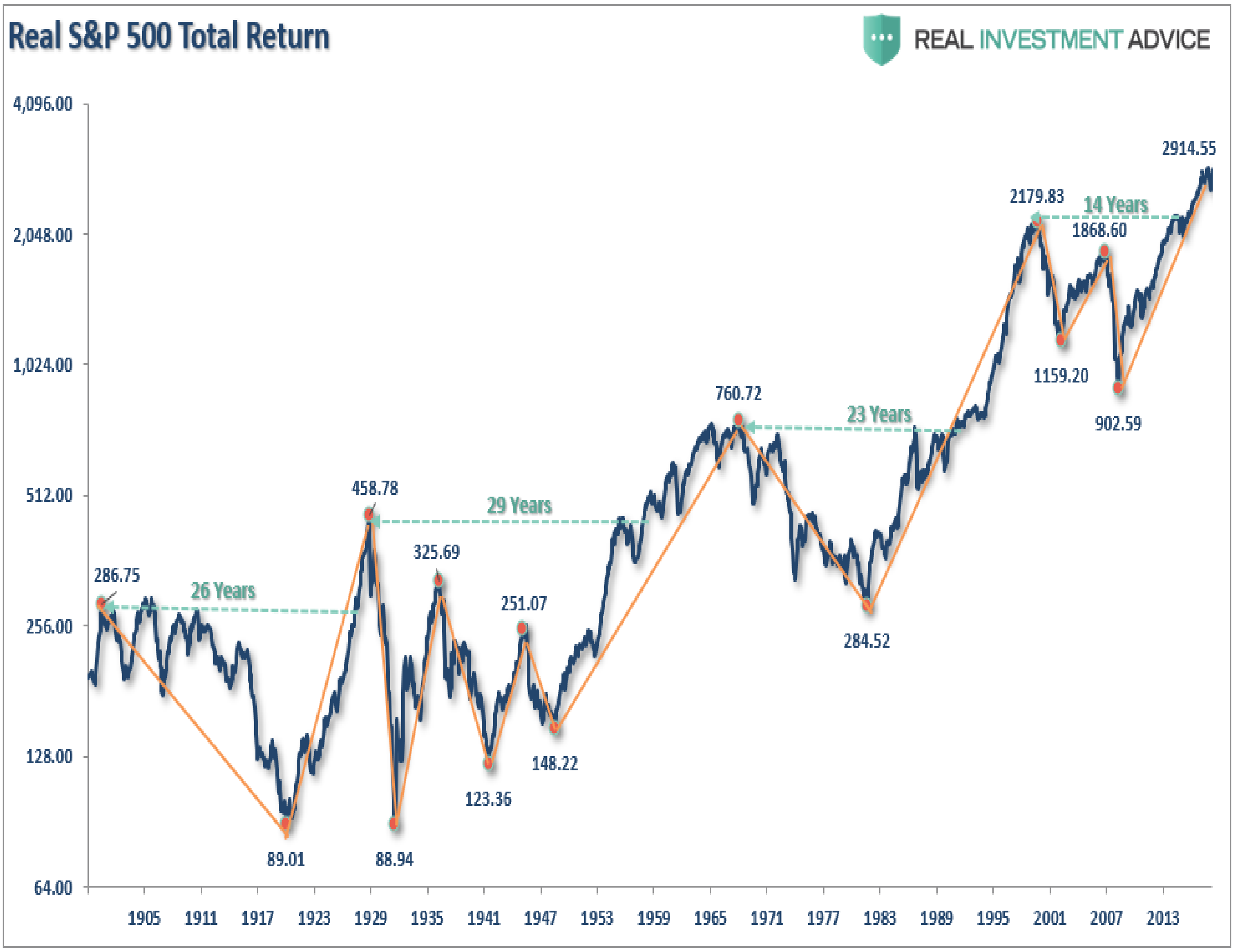
4) The index requires you to take on excess risk.

Cullen Roche once penned a salient point:

> *?Benchmarking is a pernicious thing in financial circles.* ***Not only because it disconnects the way the client and a fund manager understand the concept of ?risk?, but also because the concept of benchmarking seems to be misunderstood.?***

Risk is rarely understood by investors until it is generally too late.

Chasing the S&P 500 index requires you to have your portfolio fully allocated to equity risk, at all times. This vastly increases the "risk profile" of the portfolio which may not be optimal for investors approaching, or in, retirement. ***(Read more here)***



5) It has no taxes, costs or other expenses associated with it.

As noted above, an index does not have to pay taxes on realized gains and dividends, does not have management fees, or other expenses which must be covered. All of these items will lead to underperformance from one year, to the next, versus an index.

6) It has the ability to substitute at no penalty.

In an index, if a company goes bankrupt, the index simply takes it out and substitutes another stock in its position. The index value is then adjusted for the "market capitalization" of the new entrant and the index resumes. However, in your portfolio, given you only have a "finite" amount of capital, when a company goes bankrupt, or losses the majority of its value, you have to sell that stock at a loss and buy the replacement with whatever is left or add more capital.

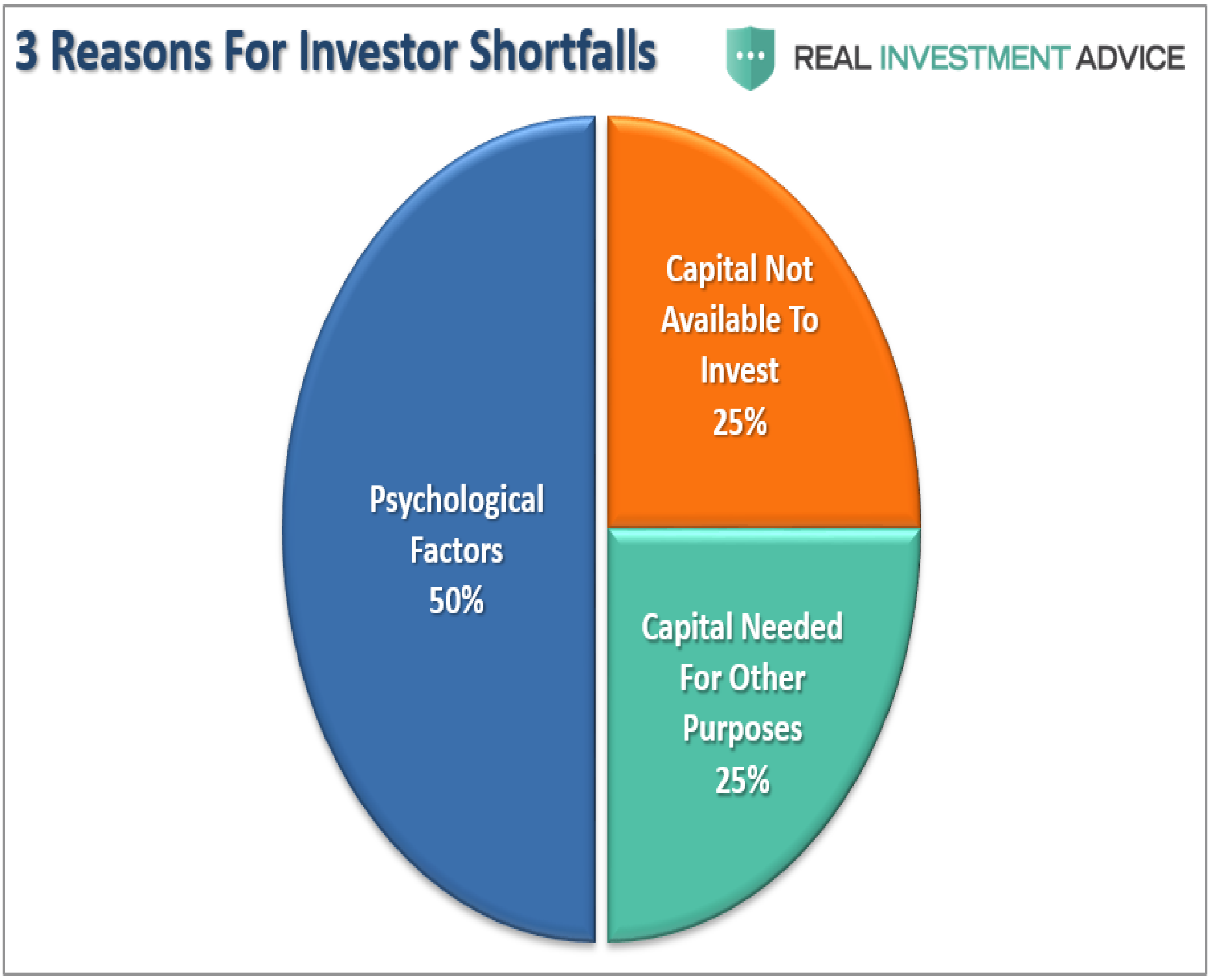
It's Your Brain, Man

Unfortunately, investors rarely do what is *?logical,?* but react *?emotionally?* to market swings. When stock prices are rising, instead of questioning when to *?sell,?* they are instead lured into market peaks. The reverse happens as prices fall. First, comes *"paralysis,?* then *?hope?* that losses may be recovered, but eventually *"capitulation"* sets in as the emotional strain becomes too great and investors *?dump?* shares at any price to preserve what capital they have left. They then remain out of the market as prices rise only to *"jump back in"* about mid-way to the next market peak.

Wash. Rinse. Repeat.

Despite the media?s commentary that *?if an investor had ?bought? the bottom of the market,?* the reality is that few, if any, actually ever do. The biggest drag on investor performance over time is allowing *?emotions?* to dictate investment decisions. This is shown in the Dalbar Investor Study which showed *?psychological factors?* accounted for between 45-55% of underperformance. From the study:

> *?Analysis of investor fund flows compared to market performance further supports the argument that investors are unsuccessful at timing the market. Market upswings rarely coincide with mutual fund inflows while market downturns do not coincide with mutual fund outflows.?*



In other words, investors consistently bought the *?tops?* and sold the *?bottoms.?* You will notice the other two primary reasons for underperformance was related to a lack of capital to invest. This is also not surprising given the current economic environment.

The Only Question That Matters

There are many reasons why you shouldn't chase an index over time, and why you see statistics such as *?80% of all fund underperform the S&P 500.?* **The impact of share buybacks, substitutions, lack of taxes and trading expenses all contribute to the outperformance of the index over those actually investing real dollars who do not receive the same advantages.**

More importantly, any portfolio that is allocated differently than the benchmark to provide for lower volatility, create income, or provide for long-term financial planning and capital preservation will underperform the index as well. **Therefore, comparing your portfolio to the S&P 500 is inherently *?apples to oranges*? and will always lead to disappointing outcomes.**

> *?But it gets worse. Often times, these comparisons are made without even considering the right way to quantify 'risk'. That is, we don?t even see measurements of risk-adjusted returns in these 'performance' reviews. Of course, that misses the whole point of implementing a strategy that is different than a long only index.*
>
> *It?s fine to compare things to a benchmark. In fact, it?s helpful in a lot of cases. But we need to careful about how we go about doing it.? - Cullen Roche*

For all of these reasons, and more, the act of comparing your portfolio to that of a *?benchmark index?* will ultimately lead you to taking on too much risk and into making emotionally based investment decisions.

But here is the only question that really matters in the active/passive debate:

> ***"What's more important - matching an index during a bull cycle, or protecting capital during a bear cycle?"***

You can't have both.

If you benchmark an index during the bull cycle, you will lose equally during the bear cycle. However, while an active manager that focuses on *"risk"* may underperform during a bull market, the preservation of capital during a bear cycle will **salvage your investment goals.**

Investing is not a competition and, as history shows, there are horrid consequences for treating it as such. So, do yourself a favor and forget about what the benchmark index does from one day to the next. Focus instead on matching your portfolio to your own personal goals, objectives, and time frames. **In the long run, you may not beat the index, but you are likely to achieve your own personal investment goals which is why you invested in the first place.**