When Being Average Wins…

We live in a time when being average can often be looked down upon. We are told that we need to strive to be 'above average' and win at everything we do.

Much of the investment world is similarly obsessive about 'beating the market' and being 'above average'. It seems to be a never-ending mantra everywhere you look.

Advertisements from any fund house manage to explain why they are, or have been voted, the best!

Yet we all know that on a day-to-day basis, pension managers, fund managers and investment strategists advocate a balanced diverse portfolio.

We also know the reality is that if you hold a balanced and diversified portfolio or index funds or ETFs that track a specific basket of underlying investments such as the S&P500 or the FTSE All-share indices, then you can expect to achieve average market returns.

Now I know that this is unlikely sound exciting so far, and it's no wonder in all honesty, but bear with me.

It's very clear that average usually doesn't sell too well. Nobody looks for an average accountant or an average cardiac surgeon. Nobody is excited by an average examination result or the prospects of eating at an average restaurant.

However, Index funds are the exception.

What The Research Shows

Studies, which researchers have been churning out since the early 1970's, have repeatedly shown that in the long term, index funds perform better than the majority of actively managed mutual funds.

In a commentary spurred by one of the many studies documenting the advantages of index funds, Institutional Investor Magazine appeared huffy about a report's conclusions that index funds are superior. "Fair enough," the publication wrote, "but didn't we already know that?"

We can see that the writers and editors within the myriad financial trade publications understand the index advantage, and so do the finance professors at a whole host of notable, academic establishments and universities around the world that specialise in the world of finance, from the many documents that have been published on the subject.

However, the average person trying to figure out how to invest for his or her future doesn't - Maybe I can change that!

As a Reminder - What is an Index Fund?

Typically, they provide only average market returns, what's so attractive about index funds?

To appreciate what they offer, you must understand how they work.

The job of an index fund is to closely track its respective benchmark, whether that's a large-cap index like the S&P500, a small-cap index like the MSCI UK Small Cap Index, or indeed any other index.

An index fund manager will invest in all or a representative sampling of the securities contained in a particular stock or bond index.

The abundance of index-based mutual funds and ETFs allow investors to build diversified portfolios anywhere along the risk spectrum.

Indexing is quite different from actively-managed mutual funds, where managers try to pick only the assets they think will hit home runs (for the American baseball fans) or hit a few 6's (for the cricket-loving British).

But as we all know, trying to hit the big home run or a six can be a very risky business!

Index Funds also have a Cost Advantage...

Active fund managers also generate more costs for fund investors, due to their greater trading activities and research. These costs typically erode returns.

The best index and passively managed funds pass along low expenses to investors, which give them, (on a cost basis at least) a built-in performance advantage over actively managed funds.

Over an investor's lifetime, the cost difference between investing in an average-priced actively managed fund and an average-priced index fund could be significant.

This provides a good example;-

Compare the Vanguard S&P 500 index fund (which tracks the S&P 500) with an actively managed, but widely praised fund, the Fidelity Contrafund, which does not track an index, but has similar objectives (US Large Cap exposure).

Each fund has a 'turnover rate', which is the percentage of the fund bought and sold in a year. Additionally, the cost of that is roughly 0.5% of the buying or selling price for each transaction.

The Vanguard S&P Index Fund has a turnover rate of 3%. The Fidelity Contrafund's (one of history's best actively managed funds) turnover rate of 29%. You then need to add that the expenses for the index fund, which are 0.04%, whilst the actively managed fund has expenses of 0.74%.

This means that the Contrafund needs to have a growth rate that exceeds the difference in turnover rate between the two funds (0.29 - 0.03 = 0.26), and the difference in expense ratio (0.74 - 0.04 = 0.70).

When you combine these two differences, you see that the Contrafund must out-perform the Vanguard Index Fund by (0.70 + 0.26 = 0.96%) almost 1% per year.

1% may not sound like a lot, but when you consider compounding over the lifetime of an investment, this is a lot.

To get an idea about that, compare the growth of £100,000 over 30 years at a fixed growth rate of 8% per year and at a fixed growth rate of 7% per year. (These calculations were done on Investopedia's future value calculator, but it is simple arithmetic, independent of fund performance.)

- 8% growth rate after 30 years on £100,000 = £1,006,265.69
- 7% growth rate after 30 years on £100,000 = £761,225.50

Difference: $245,040.18

The 1% you gave up in higher costs will cost you almost a quarter of a million pounds over 30 years on £100,000.

This is exactly where being 'Average' wins.

Chasing 'above-average' returns relative to your risk tolerance is not only more likely to increase the volatility of your portfolio, but incur significant additional trading costs, whether you select an actively managed, aggressively traded fund, or a selection of individual assets.

This type of portfolio management will inevitably mean increased turnover, with the associated costs, and of course, there is also the question of market timing, whether by you or the fund manager. (More information about market timing can be found in my article about it here).

There is a lot to be said for the lower cost, lower turnover strategy of careful longer-term investment in ETF's, and other assets which essentially follow the market, rather than speculating on a portfolio of 'potential out-performers'.

There will always be 'rock-star' investors on social media, telling us all we can make superb returns easily.

The reality is that this comes with cost and huge risk. It's my advice to relax, stick to your goals, go with the market and don't try to beat it - You'll win in the end!