Don’t Assume Beating the Market Is Easy

The majority of investors use active strategies for a single reason: to beat the market. There are other reasons, of course, to handpick securities (or pay a fund manager to do so), such as realizing a higher stream of portfolio income or reducing volatility. Today, though, I want to focus on what you should consider when trying to beat the market.

The financial industry has done a great job making beating the market seem easy. Go to just about any financial media outlet (traditional or social) and you’ll find plenty of chatter claiming index funds are for suckers. What you often won’t find is a frank discussion about the long-term results actually realized by a large group of investors or fund managers.

There is a good reason for this: The numbers aren’t good. Consider the performance data published in our 2014 Guide to the Top Mutual Funds. Just 35% of funds with 10-year track records beat the S&P 500 index on a 10-year annualized basis. In other words, you had nearly a two-thirds chance of trailing the S&P 500 over the past 10 years if you bought an actively managed fund. The actual odds are worse because funds that folded over the last 10 years are excluded (“survivorship bias”) from the current guide and taxes are excluded from the return calculations.

The performance hurdle is not just limited to mutual funds. Barry Ritholtz, who writes The Big Picture Blog, says an active trader has to beat the S&P 500 by 25% annually to come out ahead. The large margin primarily reflects the impact of taxes. The active trader pays short-term taxes, and these costs add up. The long-term passive investor, conversely, pays little in taxes until he or she retires and makes withdrawals at a potentially lower tax rate.

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