Tim Slattery, an advisor friend of ours, starts out a meeting with a prospective client by stating the following:

“Our investment philosophy is 100% driven by logic, with one exception. We’re asking you to take one thing on faith: capitalism will make us money over time. If you don’t believe that you shouldn’t hire us and you should not own stocks. Because if you don’t believe capitalism will make you money over time then the stock market is just a gambling casino. It’s purely a speculative venture.”

Capitalism creates wealth in many different ways. For example, you can assess all the risks and then invest your time, money, and brains into opening a local coffee shop. Or you can invest in the global public securities market and rely on others to assess the unique risks of their businesses and build wealth that is reflected in rising stock prices and, hopefully, dividends. How you “invest” in these securities markets is the critical issue.

Most investors purchase mutual funds run by money managers who buy and sell a concentrated portfolio of, say, 50 stocks. It’s considered good diversification if you own many of these actively managed funds with different investment styles. Welcome to the gambling casino.

The table below shows that over the last 15 years only 42% of U.S. actively managed stock funds have survived. Would you consider a 58% chance that your fund either merges with another one or is liquidated (almost always to hide bad performance) a gamble on the viability of active management?

Over the last 15 years only 39% of actively managed funds stayed true to their investment style. If, as the empirical evidence suggests, returns are driven by style, isn’t this 61% failure rate considered a gamble?

Over the last 15 years only 15% of all U.S. stocks funds managed to outperform the market. Should a 85% failure rate be considered a gamble?

Finally (not shown), only 10% of funds that were in the top 25% in performance at the end of 2013 remained in that top quartile a year later. Four years later, only .87% were still top-quartile. Is this lack of performance persistence not a gamble?1

This is why traditional active management should be consider an uncompensated risk by fiduciaries, such as advisors and trustees. Some risks are worth taking and others simply aren’t. Capitalism creates the opportunity. You need to decide how to most wisely exploit that opportunity.

With so much empirical evidence supporting efficient market theory, the availability of highly diversified index and asset class funds, and a better understanding of investment risk (as well as how emotion and behavior affect decisions), investors can invest in capitalism rather than gamble with it. Asset class investing is the answer.

According to the Ad Council, since the “Friends Don’t Let Friends Drive Drunk” advertising campaign in 1983, “more than 70% of Americans exposed to the advertising have acted to prevent someone from driving drunk. As a result of the campaign, the term ‘designated driver’ is part of American culture.”

Maybe you should be the financial designated driver for family, friends, and colleagues by steering them away from active management. After all, after you rejected the low odds and uncertainty of that addiction, aren’t you less stressed and more confident of your financial future?

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**Results After 15 years (ended June 2017)**

<table>
<thead>
<tr>
<th>Fund Category</th>
<th>Comparison Index</th>
<th>Survivorship</th>
<th>Style Consistency</th>
<th>% Outperformed by Benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Domestic Funds</td>
<td>S&amp;P Composite 1500</td>
<td>42%</td>
<td>39%</td>
<td>85%</td>
</tr>
<tr>
<td>All Large-Cap Funds</td>
<td>S&amp;P 500</td>
<td>36%</td>
<td>27%</td>
<td>93%</td>
</tr>
<tr>
<td>All Small-Cap Funds</td>
<td>S&amp;P SmallCap 600</td>
<td>51%</td>
<td>45%</td>
<td>94%</td>
</tr>
</tbody>
</table>

Source: S&P Index Versus Active (SPIVA) report, S&P Dow Jones Indices LLC, CRSP. Data as of June 30, 2017. Table is provided for illustrative purposes. Past performance is no guarantee of future results.

1. SPIVA Persistent Scorecard
The curve of the active management path represents the emotional ups and downs most investors experience with the approach. Greater uncertainty, fear, stress, lack of clarity, complexity, high costs, constant changes, poor relative performance, and other negative attributes are among the reasons long-term investors are increasingly turning to indexing and asset class investing and away from active management. The path to success with indexing and asset class investing is hardly ever as smooth as portrayed here. Asset class investing requires a new—some would say radical—way of thinking about risk and return, and the inevitability of market cycles will always create doubt and uncertainty. Confidence builds over time and should lead to uncommon discipline and self-control. This is the unique challenge of indexing, which is often undertaken by “do-it-yourselfers” with inadequate knowledge and no professional assistance with the confidence and discipline challenge. Market timing (usually of the buy high/sell low variety) is too often the result. Preventing these costly “detours” is Equus’ greatest opportunity (and our greatest value) with clients.
Now and Then

Dave Goetsch, Executive Producer of The Big Bang Theory, reflects on his investment experience in the recent market downturn and contrasts his new perspective with memories of the 2008-2009 financial crisis.

Seeing all the recent headlines about the sudden downturn in the stock market has transported me back to February of 2009, when I was close to despair. It’s striking how different I feel now.

In February 2009, the stock market was down around 50% from its high, and everyone seemed to feel like the sky was falling. I was familiar with this state of panic because my relationship to the financial markets was that I didn’t trust them.

They were always going up and down in ways no one could predict, and I couldn’t trust those folks who said that they could anticipate what was going to happen. So when the market went down, I went down with it—sinking into a depression, knowing there was nothing I could do.

What a difference nine years make. I haven’t changed because the stock market rebounded. I changed because I learned that there was a different way to think about investing.

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I was a mess nine years ago. Now, my outlook is totally different. The markets haven’t changed; they still go up and down. The difference is, I don’t anymore.

I’m not sure I should admit to being a huge fan of The Big Bang Theory, but there you go. I met Dave at a CEO Forum sponsored by Dimensional a couple of years ago and was struck by how this incredibly talented artist has so passionately embraced asset class investing. He has inspired me to try to inject more humor into what is clearly a serious business of building and preserving our clients’ wealth. This month’s “centerfold” is an attempt I hope you will appreciate.

*S&P data © 2018 S&P Dow Jones Indices LLC.