

GETTING ACTIVE WITH PASSIVE INVESTING

*Notes on **The Only Guide to a Winning Investment Strategy You'll Ever Need***

-Larry Swedroe, St. Martin's Press, New York, NY, 2005 (323 pages)

Overview

Mr. Swedroe, a principal and Director of Research at Buckingham Asset Management, has written four investment books. This 2005 update to his original manuscript by the same name (published in 1996 by Truman Press) incorporates the many financial innovations, new passive investment vehicles, and changes in the tax law that had come onto the scene in the intervening eight years. As the author puts it, however, "...one thing that has not changed is its basic message: While active investing (stock picking and market timing) provides the small hope of outperformance, the odds of success are so low that the prudent approach is to be a passive investor. It is the surest way to enable you to achieve your financial goals."

The book has three major parts. Part One seeks to explain why investors continue to pursue active investment strategies, in spite of the large volume of studies (many of them highlighted) that would seem to prove its ineffectiveness. Swedroe also writes in this section about the many costs of active management, which collectively make it nearly impossible for an active manager to stay above the median market return consistently for a sustained time.

Part Two of the book is largely an academic treatise dealing with the Efficient Markets Hypothesis (EMH) and Modern Portfolio Theory (MPT). The basis of research culminating in Miller, Markowitz, and Sharpe being awarded the Nobel Prize in economics, these are the underpinnings of the case for passive management. Because of their importance, they are explained by Swedroe in layman's terms.

Finally, Part Three offers a step-by-step guide to making Modern Portfolio Theory "...work for you..." by showing the reader how to build and maintain a portfolio suited to his or her individual needs. This includes an excellent demonstration of how additional layers of diversification can enhance or keep constant a portfolio's returns while actually reducing its risk, or volatility. There is also a well-thought-out set of screens for determining appropriate asset allocations. Finally, Swedroe speaks to the issue of index funds versus the alternatives and provides a handy formula for rebalancing a portfolio.

This report will offer a few of pages on what I see as the major take-aways from each of the three parts of the book, with particular emphasis on the practical, actionable implementation steps in Part Three.

Part One- "The Loser's Game: The Game Wall Street Wants and Needs You to Play"

Mr. Swedroe begins with a discussion of the reasons he feels many investors continue to pursue active asset management. He states: "Considering that one academic study after another has demonstrated that well over 90 percent of returns are determined by asset-

allocation decisions, one has to wonder exactly why individual investors and the majority of professional money managers spend virtually all of their time trying to pick stocks and time the market.”

Among the theories he offers are:

1. Our education system almost totally ignores the fields of finance and investments leaving the public (even the educated public) largely vulnerable to the advertising hype that is used to promote active management.
2. Our all-American work ethic dictates that in investing, as with all else in life, all the hard work of researching stocks and markets must surely produce superior results. Swedroe responds that this is not so in a truly efficient market. Sighting the fact that the majority of active managers – presumably all hard workers – consistently underperform the market, he counsels us “...not to confuse efforts with results.”
3. Our naturally optimistic nature encourages us that we can be the ones to pick the managers who will outperform. A corollary is the sense that we have somehow given up control without active management. Swedroe counters that with the asset allocation decision still in our hands, we do in fact remain in control.
4. Our natural instinct to enjoy a game of chance is very strong. The author exhorts us not to confuse games (which are OK in moderation) with the serious business of investing for the future.
5. Our need to have scintillating stories for the next cocktail party. It is great fun to tell friends about the mutual fund pick you made that turned you into a wizard of Wall Street; it's a lot less sexy to talk about the consistent 1% to 2% in cost savings you enjoy, year in and year out, by passively investing.

In seeking to explode the theory that active portfolio management can beat the market on a consistent and sustained basis, Swedroe cites over the next 30-some pages an exhaustive series of studies to demonstrate that the opposite is true. Having personally spent many hours pouring over Morningstar data bases on mutual fund performance in an effort to identify consistently high returns with low volatility and reasonable costs over a number of time periods, I was struck by several of the studies which showed that those with the best records, even over long periods of time, were almost invariably among the worst performers in subsequent time periods of similar length. Swedroe concludes, why would we pay for all that active management when the results appear to be largely random?

Part Two- Efficient Markets and Modern Portfolio Theory

This middle portion of Swedroe's book, he takes us through the Efficient Markets Hypothesis (EMH) and its huge implications for investors with respect to the key areas of (1) availability of advantageous information, (2) costs of investing and, (3) correlation of risk and returns. He then exposes the reader to the five factors that determine the vast majority of expected returns from a diversified portfolio. Finally, Mr. Swedroe discusses volatility and how reducing it through diversification can increase portfolio returns.

The Efficient Markets Hypothesis (EMH) explains, according to the author, why active management seldom beats its benchmarks: “Current market prices reflect the total knowledge and expectations of all investors, and it is highly unlikely that one investor can know more than the market does collectively. For this hypothesis to hold true, one condition must be met: any new information must be disseminated to the public rapidly and completely so that the prices instantly adjust to new data. If this is the case, an investor can consistently beat the market only with the best of luck.”

Relative to adjustments in public information, the author cites a study of the stock and bond markets. In this study, bond markets were found to adjust prices within forty seconds of release of new information; the stock markets adjusted nearly as quickly. Therefore the true window for profiting from this new information is extremely narrow.

With respect to the reams of analysts’ research on particular companies and their market prospects, Swedroe counsels investors not to confuse “information” with “knowledge they can exploit.”

He goes on to suggest that the notion of finding securities that the market has ‘mis-priced’ is flawed. His argument: in an efficient market, the current price is the point of equilibrium between buyers and sellers with the same information and the same intellectual capacity to process that information and reach a buy or sell decision. As most markets are dominated by large institutional investors, each with its own team of Harvard MBAs doing the analysis, it is illogical to conclude that one will identify a pricing ‘mistake,’ absent insider information, which we all know to be illegal.

After discussing what he sees as the absence of truly actionable information about which securities will perform better, the author turns his attention to market timing. In recent years, the popular press has become intensely focused on interest rates and the Federal Reserve’s efforts to moderate the economy by controlling interest rates. The market’s short-term reaction to vague language in notes to Fed meetings is the subject of great scrutiny and wide reporting.

Underlying all of this riveted attention is presumably the notion that a shrewd money manager can guess the direction of the market and the timing of impending movements. Being able to successfully “time the market” has somehow become thought of as a reward for diligent observation and vigilance. Your humble book reviewer has been asked many times by financial planning clients whether now might be a good ‘time’ to get into this emerging markets fund or out of that bond fund.

To those who would time the market, Swedroe points to a 25-year study of forecasts made by economists. His conclusions (paraphrasing) are that (1) economists can not predict the turning points in the economy (46 out of 48 predictions missed the turning point), (2) economists’ forecasting skill was about as good as guessing (economists at the Fed itself and the Congressional Budget Office had records that were worse than pure chance), and (3) there are no economic forecasters who consistently lead the pack in accuracy.

The lesson for investors (and financial planners): find an appropriate asset allocation, a low-cost passive investment vehicle, and the self-discipline to stay the course. Stop worrying about where interest rates and the economy are headed. Have faith in your asset allocation decisions for the long run.

The next two chapters focus on three kinds of investor costs: trading costs, operating costs, and tax costs.

One of the 'conventional wisdoms' of investing is that active management can be beneficial in less efficient markets. This is superficially logical because in small-cap and emerging markets, for example, with less freely flowing information about companies and markets, there is more advantageous information for active managers to find and exploit.

Zeroing in on trading costs, however, as one focuses more on the small-cap markets, while there is less information (and therefore less efficiency), trading costs are correspondingly higher. The result: while a shrewd and focused money manager may find a brief competitive information advantage, the cost of exploiting any such advantage is many times greater. This is so because in this less efficient market, the trading cost (spread between bid and offer) is on average 4%, as opposed to .12% in large-cap. This is over 30 times greater.

When discussing trading costs, Swedroe writes that one must also consider turnover. The average actively managed mutual fund, according to the author, has an average annual turnover rate of about 100%. For passively managed funds, turnover is more like 30%. Therefore, when comparing small-cap mutual funds, the former would likely incur 4% annual trading costs ($1.00 \times .04$), whereas the latter's cost would be 1.2% ($.30 \times .04$). Note that these trading costs are in addition to the funds' operating expense ratios. They must be taken out of investors' returns.

Operating expense ratios are another major component of the equation. Sighting studies by Vanguard founder, John Bogle, and William Reichenstein, Swedroe concludes the difference in bond funds' long-run returns were almost entirely explained by differences in their expense ratios.

With respect to stock funds (or managers of separate accounts, for that matter), operating expense ratios have come down owing to market pressure in recent years. However, your book reviewer's research in the Morningstar Principia database found that the 37 large cap blend index and ETF funds shown have average gross expenses of .47%. By contrast, the 157 actively managed funds that appeared on the list averaged 1.18% in gross expenses. This is roughly a .71% expense handicap the active managers must overcome to beat their passive competitors. And this is without consideration of the higher trading and tax costs of actively managed funds.

The final major cost element Mr. Swedroe discusses is taxes. Mutual funds must, by law, distribute realized gains to shareholders. These distributions of capital gains, dividends and interest are taxable events for fund holders, unless held in a qualified account.

Logically, an actively managed fund that has the average 100% annual turnover will distribute roughly three times as much in taxable capital gains as a passively managed fund with a 30% turnover. The after-tax return implication for investors, according to a study cited by Swedroe, is another 1.9% lost relative to the benchmark return.

Summarizing the crucial area of costs of active portfolio management, the author asks the reader to be mindful that: (1) superior information (or the more astute analysis of it) are not likely to lead to advantageous security selection or market timing and (2) the higher costs of trading, operating expenses, and taxes create a very high hurdle for an active manager to clear before she can add value relative to her benchmark index.

Mr. Swedroe next turns the reader's attention to what he calls the most important factor for investors to consider: risk. The author begins with an explanation of why risk and return are correlated. The basic mathematics of finance is that a company's stock is "worth" the present value of returns expected in the future. Comprised of some combination of dividends and capital gains, those returns are in turn driven by expected future profits.

As students of finance will readily recognize, present value is calculated by applying an interest rate (or 'discount factor') to incomes expected in the future and discounting them to their 'present value.' How high the discount rate is depends on how risky the future income appears to be. The present value of the stock goes up as the discount rate goes down. At the same time, the value goes up as the time until the income is expected to be received goes down.

Therefore, the riskier the company (and its future income) is, the higher the discount rate used and therefore, the lower the market value of the stock. As we would expect, the small companies are considered riskier so investors demand more return from them (a higher discount rate) which in turn makes their shares worth less. The same is true for 'value' stocks, whose characteristics normally include more leverage and more uncertainty about future incomes.

Swedroe makes special note that more risk and higher expected returns does not make the stock better or worse than a lower risk, lower return stock. It just has a different risk return profile. The fact that the different asset classes have different risk and return characteristics is what allows investors to fine tune their portfolios to position themselves for the amount of each that suits their needs and temperament. They do this by shifting the allocation among the asset classes to get to the balance that's right for them.

The author points out that the bond market values fixed income securities in much the same way. The present value (current price) of a bond is based on the riskiness of its future interest and principal payments. Similarly, other asset types (international securities, commodities, and real estate) all have distinct risk/reward characteristics. Of perhaps greater interest to investors is that changes in the movement of the prices of the different asset classes have been shown to be more or less correlated, thus engendering the

opportunity for investors to mix uncorrelated assets in order to reduce risk while raising returns. Swedroe takes up this major benefit of diversification in the next chapter.

In this last chapter of Part Two, Mr. Swedroe brings together many of the previously-discussed attributes of an efficient market to develop his “Five-Factor Model” to fashion a diversified portfolio that can maximize returns for a given level of risk.

The discussion of the model starts with the Three-Factor Equity model. Each is briefly described below:

1. Risk factor 1 is exposure to the overall market. The average annual equity risk premium (amount by which equity has rewarded its investors beyond the risk-free Treasury bill return) has historically been about 6%.
2. Risk factor 2 relates to the market capitalization of the company. Most readers will anticipate that the smaller the company, the higher the expected return. Historically, the small company risk has rewarded investors by about 2.5% above the return on large companies.
3. Risk factor 3 is exposure to inherently riskier value stocks. These historically have returned a 3.5% premium relative to growth stocks.

Swedroe then turns to the Two-Factor Fixed-Income Model:

4. Risk factor 4 is maturity. Longer-term bonds have traditionally paid their owners about 1.6% risk premium.
5. Risk factor 5 is default risk. Swedroe points out that while corporate bonds to carry higher coupons than government bonds, the risk premium has been historically close to zero. This is because the actual default costs and higher expense ratios have pretty much neutralized the difference. I found the absence of any further in-depth discussion of this to be one of the book’s few soft spots.

Determining the expected return of a portfolio of the above asset classes then becomes a simple calculation of the weighted average of the average expected returns of each class.

If the first two major tenets of Modern Portfolio Theory are the efficient markets hypothesis and the correlation of risk and return, the use of diversification to simultaneously boost returns and dampen volatility is the third.

As a segue way to Part 3’s discussion of building a portfolio, Swedroe finishes Part 2 with a simple but powerful illustration of how it is possible to decrease the risk of a portfolio while actually increasing its return. He sets forth the case of two portfolios observed over a twenty year holding period. The first has average annual returns of 15% and a standard deviation of 35%. The standard deviation is a statistical measure of volatility. It tells us how much ‘dispersion from the mean’ to expect – in this case, statistically, returns will range between -20% and +50% in 13 out of ever 20 year period (i.e. 2/3rds of the time).

The second portfolio has average annual returns of 12% but a standard deviation of just 15%, meaning its returns will range from -3% to +27% 2/3rds of the time. The surprising result of the comparison of these two is that the compounded growth rates of the two are the opposite of what one would expect: the second portfolio returned an 11% compound return to investors, while the first returned just 9%. A \$100,000 investment in the one with the lower average annual returns would have delivered \$257,000 more to its owner!

The lesson is of course the importance of diversification. Swedroe concludes with three general recommendations:

1. Buy low-cost, no-load passively managed mutual funds instead of individual securities.
2. Create a portfolio of funds that is diversified across several asset classes.
3. Include international funds in the portfolio.

Part Three-Play the Winner's Game: Make Modern Portfolio Theory Work for You

Mr. Swedroe breaks this final section of the book into discussions of (1) six specific steps for building a diversified portfolio, (2) a methodology for a constructing a model portfolio, (3) the three main types of passive funds, (4) care and maintenance of the portfolio, and (5) implementation of the strategy. My notes will attempt to extract the actionable points for ready application by the user.

Six Steps for Building a Diversified Portfolio

While the three recommendations that concluded the last section of the book were quite general in nature, the author now becomes more specific. He outlines four things we need to do to achieve maximum returns with minimal risk:

- a. Use of only passively managed mutual fund.
- b. Use of high expected return asset classes of small and value companies.
- c. Elimination of long maturities from fixed income holdings.
- d. Addition of global diversification.

To illustrate how these practices work in building out the portfolio, Swedroe takes us through six steps starting with a control portfolio of just 60% S&P 500 index and 40% Lehman Government/Credit bond index. We then move through the addition of the other asset classes sequentially, observing the impact on the expected return and risk of the portfolio as a whole with each subsequent change.

Step I: 'Globalizing' the portfolio by splitting our 60% equity into 20% EAFE Index (Europe, Australasia and the Far East) and 40% S&P 500 costs us slightly in return as we drop from 12.3% to 12.2%, but the volatility (standard deviation) goes down from 11.0% to 10.6%.

Step II: Now adding small company equity by taking another 20% from our S&P 500 fund and investing it in a U.S. small company fund boosts our overall return to 13.4% while keeping volatility at 10.6%.

Step III: U.S. value stocks are brought into the mix by taking 10% each from the S&P 500 and the U.S. small company funds and allocating them to the U.S. large value and small value, respectively. Our expected return for the portfolio has now grown to 13.8% while risk has notably remained at 10.6%.

Step IV: Next is the addition of exposure to small stocks and value stocks within our international allocation. This is done by splitting our 20% in the EAFE index into 10% each in the International Large Value and International Small company categories. The result: returns climb to 14.8% while risk actually drops to 10.5%.

Step V: Shorten the average maturity of our fixed income portfolio by swapping the Lehman Brothers bond index for a Two-Year Fixed Income fund. The overall allocation remains at 40%. The result of this last step: overall expected return eases back from 14.8% to 14.5%. However, portfolio volatility falls from 10.6% to 9.9%. A minor concession on return gets us a very positive effect on risk.

Step VI: Further diversify the portfolio by adding an allocation to real estate in the form of a real estate investment trust (or REIT fund). This final step takes our return down again, but only slightly, to 14.3%. At the same time, we have eased the volatility back to just 9.4%.

While moving through the above steps, Swedroe also calls to our attention the change in the “Sharpe Ratio” that each step causes. A measure of the efficiency of a portfolio, the Sharpe Ratio tells us how much better (or worse) the mix will do for us than an investment in risk-free one-month Treasury bills, on a risk-adjusted basis. Calculated as the asset return minus the risk-free return, divided by the asset standard deviation, our Sharpe Ratio increased by 53% as we moved through the six steps in the process. Next, Swedroe takes up the building of a model portfolio with allocations tailored to an investor’s individual risk level.

Constructing a Model Portfolio

The 60/40 equity/fixed income allocation of assets in the above example is a fairly typical allocation for a moderate investor. However, it is just one example. There is no one right answer. Each of us must objectively assess our unique need for returns, tolerance for risk, and time horizon to develop a sharper vision of an asset mix that will be most appropriate. Swedroe offers a series of useful exercises to help make that assessment and sharpen the vision.

The author starts with a foundation of four models, distinguished by their core allocations of equity and fixed income. They include: (1) Conservative – 40/60, (2) Moderate – 60/40, (3) Moderately Aggressive – 80/20, and (4) Aggressive – 100/0.

He then takes up the allocation to international equities, pointing out first that a purist would have us allocate 50% to this category, as international markets comprise about 50%

of the global equity markets. Swedroe notes that his tests show a 40% allocation to international produced the highest Sharpe Ratio (i.e., the most efficient returns on a risk-adjusted basis). Recall that international returns were very close to those of U.S. markets. However, because they are not perfectly correlated with domestic stocks, they smooth the ride and bring down volatility significantly, without hurting returns: hence their important contribution to risk-adjusted efficiency.

However, there is an issue of investor psychology that must come into play, according to Swedroe. Investors in every country seem to be inherently more comfortable with their own domestic markets. The risk is that, in tumultuous times, a heavy allocation to foreign equity may spur a panicky sell-off at exactly the time when focus and discipline are most called for. Therefore, the author sets as a baseline allocation 30% of the total equity portfolio, with the caveat that those who genuinely feel less susceptible to the psychological risk should consider going higher. The resulting recommendation for international as a percentage of total equity: 12% for Conservative, 18% for Moderate, 24% for Moderately Aggressive, and 30% for Highly Aggressive.

Mr. Swedroe then takes up the question of risk assessment. He starts by dividing the question into three branches:

1. the willingness to take risk.
2. the ability to take risk; and,
3. the need to take risk.

For each, the author suggests practical measurements.

The “Stomach Acid Test” tries to get at the investor’s ability to withstand the temptation to abandon his or her asset allocation strategy in a bear market. It asks how much of a loss can you not only tolerate, but be willing to buy into. Swedroe suggests the following guidelines for maximum equity exposure based upon the answer to that question:

Willingness to Take Risk

<u>Maximum Tolerable Loss</u>	<u>Maximum Equity Exposure</u>
5%	20%
10%	30%
15%	40%
20%	50%
25%	60%
30%	70%
35%	80%
40%	90%
50%	100%

You may be willing to take a certain level of risk, but do you realistically have the ability to do so? Swedroe suggests this is a function of your investment horizon, the stability of your earned income, and your need for liquidity in the near term.

Regarding your investment horizon, the author offers the following guidelines:

Ability to Take Risk

<u>Investment Horizon</u>	<u>Maximum Equity Allocation</u>
0-3 Years	0%
4 Years	10%
5 Years	20%
6 Years	30%
7 Years	40%
8 Years	50%
9 Years	60%
10 Years	70%
11-14 Years	80%
15-19 Years	90%
20 Years or longer	100%

If earned income is stable (e.g. a tenured professor), you would be able to accept more risk. If you are a commissioned sales person in a struggling industry, you should take less.

The liquidity test involves identifying, at a detailed level, your near-term cash needs. The first step is to carve out six months of living expenses and put them in a fixed income account with little or no credit or maturity risk. Next, you would list major cash needs, including the target dates and estimated costs. These would include vehicle replacements, tuition, or a wedding. The allocation should follow the guideline above based on the number of years until needed.

Your advisor or you should have some sort of worksheet that will allow you to enter your goals and the amount year by year. The spreadsheet should then do the calculations as to how much equity, fixed income, and cash equivalent you will need. It can also tell you how long the maturities on the fixed income component should be.

Finally, Swedroe addresses the need to take risk. Your financial planner should be able to project the amount of return required to meet your stated goals. If it turns out that you do not need to take the risk that your answers to the various risk tolerance tests implies that you can, you may then decide whether you want to incur the additional risk to see if you can grow your wealth.

On the other hand, if you are faced with the situation in which it appears you will not be able to reach you stated goals based on expected returns from the asset allocation indicated by your risk tolerance, you face some more difficult choices. These are generally to (1) cut back on the goals, (2) extend the time until they are needed, (3) cut back now and save more, or (4) clench your teeth and take the additional risk. For most of us, the best decision is #3. Bight the bullet now and find a way to save more.

Having to this point developed our basic asset allocation model, the author next focuses on allocating between taxable and tax-advantaged accounts. The key drivers of these decisions, according to Swedroe, are the ordinary income tax treatment of interest and short term capital gains, as well as the way in which tax-deferred accounts "...convert long-term capital gains on equities into ordinary income upon distribution." Your reviewer has created the chart below to summarize the author's guidelines in this important area:

Allocating Assets Between Taxable and Tax-Deferred Accounts

<u>Type of Asset</u>	<u>Taxable Accounts</u>	<u>Tax-Deferred Accounts</u>	<u>Notes</u>
Taxable Fixed Income		X	Interest taxed as ordinary income
Municipal Bonds	X		Generally free of income tax
Core Domestic Equity	X		Lower rates on dividends & long term capital gains; step-up in basis at death lost if in qualified account; tax loss harvesting; gains would be taxed as ordinary income at distribution if held in tax-deferred
International Equity	X		Same as above for Domestic Equity plus potential foreign tax credit
REITs		X	Particularly tax inefficient
Small-Cap Domestic Equity		X-Roth	Highest expected return asset held in Roth- never subject to taxation on withdrawal

If fixed income must be held in a taxable account, Swedroe suggests municipal bonds, unless the investor is in a particularly low tax bracket. If the portfolio is all equity, the portion held in qualified accounts should be the most tax inefficient. This would generally mean those that are actively managed. Conversely, tax managed and or passive, low-turnover funds should be held in taxable accounts. Generally, lifestyle or balanced funds are not tax managed.

Passive Investment Options

Having provided the tools to establish a customized allocation and guidance on where to hold the different assets, the author turns his attention to the three types of passive investment vehicles: index funds, passive asset-class funds, and exchange-traded funds (ETFs). All three offer the advantages of low costs, low turnover, and tax efficiency. Index funds may be preferred in tax-deferred accounts over ETFs because they can be purchased without trading costs. In a taxable account, ETFs may have the advantage because they trade like stocks, giving the investor the discretion as to the timing of capital gain distributions.

Swedroe states that passive asset-class funds are like index funds in that they buy and hold stocks that have similar asset class characteristics. However, they have the latitude to set different criteria for the way the index is constructed (e.g. equal weight instead of market cap weight) and when stocks are bought and sold (can delay selling a stock that has changed asset classes until a more advantageous time).

Maintenance- Rebalancing and Tax Management

Over time, as the various asset classes in a portfolio change in value by different percentages, its risk and expected return will be altered too. Also, if there are assets being held in actively managed accounts (e.g. a 401(k) which offers only these types of funds), the manager may have been guilty of 'style drift.' This is the use of assets that are not consistent with the advertised style and approach. Style drift can obviously also put one's portfolio out of balance. Swedroe points out that it is crucial to rebalance periodically for the portfolio to meet our objectives. He offers us the following guidance on rebalancing:

- Be aware of tax implications if working in a non-qualified account.
- Be aware of transaction costs- another argument for passive, no-load funds.
- Use any regular additions to the account to build up those segments that need to be restored to their original proportions.
- For those investors who balk at selling winners and buying yesterday's losers, rebalancing is a risk management tool, not a tool designed to increase returns.
- Doing so, we are actually buying low and selling high.
- Rebalance with each new fund addition and quarterly otherwise.
- Employ the "5/25 % Rule" which states that we should rebalance whenever an allocation has strayed more than 5 percentage points from its original allocation, or by 25%, whichever is less.

Respecting the second major part of account maintenance, tax management:

- Choose tax-efficient vehicles to start with.
- Check for tax loss harvesting opportunities quarterly and do so whenever the tax benefit exceeds any transaction costs.
- Reinvest the proceeds with an eye on any rebalancing needs but above all, avoid the wash sale rules.
- Do not wait until the end of the year. The opportunity may no longer exist.
- Choose the highest cost-basis purchases to sell first to minimize gains and maximize losses.

- Watch out for and avoid short-term gains.
- Do not purchase shares immediately prior to the date of record for a dividend.
- Do not buy within 30 to 60 days of the ex-dividend date.
- If you have held a fund more than a year, check and see what estimated distributions are planned for the coming year that include short-term capital gains. If there will be, consider selling before the ex-dividend date.

Implementing Your Strategy

Swedroe urges all investors to develop an Investment Policy Statement (IPS), to serve not only as a guide to their actions, but also as a source of discipline and a counter weight to emotion.

After listing all assets and liabilities, we are guided to take the following steps:

1. Take the liquidity test and establish cash reserves.
2. Construct a ladder projecting major cash needs for the next twenty years to determine the minimum amount for fixed income.
3. Take the Stomach Acid test and choose a basic model portfolio allocation.
4. Compare fixed income allocations from the liquidity and Stomach Acid tests; choose the higher of the two.
5. Conduct the Need to Take Risk test. Compare the fixed income result with those of the prior tests and choose the most conservative. If the resulting expected return is inadequate to achieve all financial goals, choose among:
 - a. Lowering, delaying or eliminating one or more goals.
 - b. Increasing saving by reducing current consumption.
 - c. Accepting the incremental risk after an objective decision the extra wealth is worth it.
6. Put the goals in writing.
7. Create the asset allocation:
 - a. Specifically list the percentage of assets to be allocated to stocks and bonds.
 - b. Establish allocations for the individual asset classes.
 - c. List the ranges within which the allocations may vary before rebalancing must occur (Swedroe suggests the 5/25 percent guideline).
8. Identify which assets will go in taxable as opposed to tax-deferred accounts.
9. Determine the investment style (hopefully, passive, per Swedroe) and write down procedures and controls that will ensure proper monitoring and adjustments.
10. Set out a schedule of events and activities:
 - a. Monthly- Review statements to ensure all assets and transactions are shown.
 - b. Quarterly- Review for rebalancing and tax loss harvesting to be done. Have the advisor or custodian provide a current asset allocation report. Review this IPS for reinforcement and to make any necessary changes.
 - c. Annually- Do a complete review of:
 - i. Rebalancing opportunities
 - ii. Tax management opportunities

- iii. Changes in time horizon, personal situation (life events), tax laws, or academic research on financial issues that impact the IPS.
- iv. Estate Planning opportunities.
- v. Personal spending and saving or withdrawals to compare with 'plan'.

11. Sign the IPS, along with the advisor.

The last part of the third section of the book includes short discussions of the importance of starting to save early in life (illustrations of the power of compounding, etc.) and how to select an investment advisor. Swedroe suggests that a good advisor should provide the education necessary for success, a winning strategy, and the discipline to stick with the strategy. The author offers a lengthy set of questions to ask would-be advisors. Finally, he offers the opinion that one should never use a commission-based advisor (potential conflict of interest) and that fee-only advisory services typically cost between 1% and 2% of assets per annum. Those with over a million dollars to invest should expect to pay between .5% and 1%. These fees are for investment advice. Full financial planning, which may involve insurance, estate, and or tax planning may or may not be included. If financial planning beyond investments is to be done, there is often a separate fee for that planning.

Summary

In 12 pages, Mr. Swedroe summarizes his arguments. In keeping with the structure of the book, there is first a recounting of the explanations of market efficiency, the ineffectiveness of active managers' efforts to exploit any inefficiencies they do encounter and to time markets, and the serious damage and costs to investors of pursuing active management strategies. The author then spends a couple of pages on retelling the story of the Efficient Markets Hypothesis and Modern Portfolio Theory. Finally, he briefly reiterates the strategy for building and maintaining an effective portfolio. You will recall this is based on passive management, use of some higher risk asset classes to boost returns, diversification to smooth volatility, and structuring an allocation after taking the stomach acid, liquidity, need to take risk, and time horizon tests. He closes by mentioning the importance of an Investment Policy Statement, regular checkups, and rebalancing.

There are then nine appendices that discuss a range of topics from Monte Carlo simulations to use of commodities.

Your humble reviewer apologizes for the lengthiness of these notes on Mr. Swedroe's book. However, I feel it is one of the best statements of the case for an efficient markets-based passive management strategy that I have read. It was particularly helpful for the clarity it brought to difficult topics, the head on response to active management's proponents' arguments, and the many useful tests, guidelines, and step-by-step instructions for creating an investment plan. If you made it this far, thank you for staying with it!