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Points of interest:

- Investors in managed portfolios pay a variety of fees and expenses in an effort to get market-beating returns.
- The cost of active investment management is growing because fewer investors are sharing in the cost.
- Smart investors have left the game and use low-cost index funds instead

The price of active investing: would you believe $100 billion?

American mutual fund investors are spending a lot of money in a vain quest to beat the market, says famed finance professor Kenneth R. French of Dartmouth.

French has made public preliminary results from his detailed study of the costs investors pay to own actively-managed funds whose goals are to beat the U.S. stock market.

The estimated annual cost so far is $100 billion, French says. And, to make it worse, the evidence suggests that the average investor falls behind the market.

The smart investors are the ones who buy simple index funds that charge modest fees to replicate the stock market's results, he adds.

Mutual fund investors are paying billions of dollars each year in a fruitless quest to beat the stock market, a new study shows.

Costs aplenty

French's study looks at funds that invest in U.S. stocks. He included open-end funds—most commonly used by individual investors— along with closed-end funds and exchange-traded funds.

He included the fees and expenses of the funds, the transaction costs for trading, and other costs.

In order to find the cost of active management, he totaled all of the costs and then subtracted the cost of investing in a passively-managed index fund. The difference was the cost investors paid in their attempts to beat the market.

The estimated annual dollar cost for 2006, the last year covered by the study, was $99.2 billion, and it is assumed that amount grew to at least $100 billion last year.

This compares with an estimated annual cost of $7 billion back in 1980.

The price tag grows

It is ironic that the cost of active management keeps growing, even though market developments since the 1980s have served to reduce some of the typical costs of investing.

Today's mutual funds can take advantage of discounted commissions and smaller bid-ask spreads, while investors pay small direct sales charges on mutual fund sales.

French contends that the costs of investing make this less than a zero-sum game. In a zero-sum game each person's losses or gains are matched by another person's losses or gains.

This, French says, would be the case in the investment markets if there were no costs. But the $100 billion annual price tag associated with active investing means

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More investors drop out of the game and use index funds

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that it is really a negative-sum game. The costs reduce the pie that is divided among all of the investors who participate, he says.

Adding final insult to injury, the cost of active investing is growing because many players have opted out and begun using index funds, French said.

That means the group of investors who bear the costs of active management has gotten smaller, giving each one a large share of the expenses.

French says that the portion of the stock market invested in indexed funds has grown to nearly 18% since 1986.

Use index funds

There is an easy answer: use index funds and passively-managed asset class funds.

Winning investors stick to index funds.

Investors in these funds are assured that they will earn what the market earns, minus a small cost paid to the fund.

Such a no-brainer strategy will also help the investor to beat the great mass of active investors who are constantly in search of a winning formula or a winning portfolio manager. Also, this strategy eliminates the pain of underperforming the market.

When should you take social security

A crucial retirement planning decision for many workers involves deciding when to begin Social Security benefits.

Anyone can begin collecting as early as age 62, but that means the retiree receives a permanent reduction in benefits that can reach 30% or more.

Retirees can also wait until normal retirement age, which currently ranges from 65 years and 10 months to 67 years, depending on the year they were born.

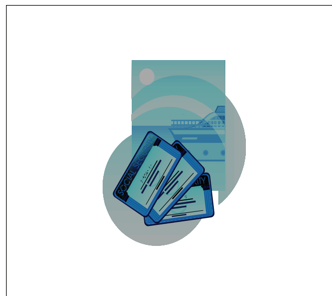
Or, if they choose to keep working or just want to delay Social Security, they can wait until age 70 and get a benefits increase of about 8% for every year they wait to take Social Security after normal retirement age.

Choices, choices

There are some general guidelines. First, if you are still working, it makes sense to put off collecting your benefit. If you claim a benefit between age 62 and your normal retirement age, then benefits are reduced by $1 for each $2 you earn over $13,560.

Although you won't face that reduction due to earned income after full retirement age, you still may get taxed on your benefit, and the higher your other earnings, the more Social Security will be taxed.

If you are retiring as early as 62 and feel you can't make ends meet without the benefit, you might want to think long and hard about retiring that young: you may not be financially ready to take the plunge.



Deciding when to take your Social Security benefit is a function of your income, age, and outlook on your health and longevity.

Or, if you are retiring early but don't need the benefit, you may want to put it off for as long as possible so that you will eventually get a larger lifetime benefit.

How long will you live?

If you knew when you were going to die, your decision would be much easier. Someone who will die relatively young would do better to take Social Security at 62. Even though the benefit would be reduced, they would collect more payments.

However, if you live into normal old age you would collect more lifetime benefits by delaying Social Security until normal retirement age or beyond. For instance, you would have to live past about age 78 to justify delaying the benefit until 66. Keep in mind that actuarial tables show the average 65-year-old will live until age 82 for males and 85 for females.

Social Security has a handy calculator you can use online at: http://www.socialsecurity.gov/OACT/quickcalc/when2retire.html.

"If you are retiring early but don't need the benefit, you may want to put it off for as long as possible."

The pros can't predict markets, and you probably can't either

The next time you make a prediction about the stock market or the economy, write it down. Check back a year or two later and see how it worked out: on average, you are bound to be disappointed.

Studies of the forecasting success of the best and brightest on Wall Street and among economists have found that even the pros have a dismal record in forecasting. If they can't do it, why do we think we can?

For instance, the Federal Reserve Bank of Philadelphia has for years tracked the forecasts of inflation by professional economists.

Past is prologue

They consistently find that economists are pretty good at telling us what has recently happened, but are not good at predicting the future. Their predictions of inflation rates generally appear to be merely a function of recent inflation rates.

Other studies show that the average bond trader incorrectly forecasts the direction of yield changes and that stock analysts cannot forecast the trend in operating earnings.

One of the psychological factors involved in bad predictions is overconfidence. Studies have shown that we are not "well-calibrated" when making estimates.

Too often, we make an estimate based on a range and the actual answer lies far outside our range.

Studies have shown that stock analysts' predictions are not very accurate.

Test yourself

Try it yourself. Answer the following questions with a range (like 50 on the low end and 100 on the high). You should have confidence that 98% of the time the correct answer will fall within your range.

- What is the length of the Nile River?
- How many books are in the Old Testament?
- What is the diameter of the moon in miles?
- How deep is the ocean in feet?

Here are the answers: the Nile is 4,132 miles long, there are 39 books, the moon's diameter is 2,160 miles, and the deepest known part of the ocean is 36,198 feet down.

Don't feel bad if you didn't get them all right: on a longer test, most professional forecasters failed.

"Economists are pretty good at telling us what has recently happened, but are not good at predicting the future."

Friendly advice, the richer rich, & more

Many employees seek advice on investing in their employers' retirement plans from their own brand of "experts": friends and family.

A new survey of retirement plan participants by Spectrem Group, a consulting firm in Chicago, found that 44% seek free advice from people they know, rather than paying to see an independent advisor.

The survey found that it wasn't just the cost of advice that bothered employees: even when their companies offered free access to advisors, only 23% took advantage of the service.

Rich get richer

One out of every 10,000 American families has income over $10.7 million, according to a recent study by Thomas Piketty of the Paris School of Economics and Emmanuel Saez of the University of California.

What's more, their share of national income has quadrupled since 1980. At that time the top earners took home 0.87% of national income; by 2006 their share increased to 3.89%, the highest since 1916.

Peer pressure

Even more than losing money, investors fear that they will miss out on what their peers are doing, according to a new study by researchers from Stanford and Duke universities.

They found that investors "herd" around high flying investments, which enables them to feel like they are not left out of a winning strategy.

In fact, losing doesn't hurt as much in this case, as long as peers are also losing money.

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How heavily should a retiree invest in the stock market?

Common sense seems to tell those who are in or approaching retirement that they should cut back on their investment risk.

After all, they will have to rely on it for income and feel they can't afford to lose it. One rule of thumb says that you should subtract your age from 100 and the remainder is the percentage that should be invested in stocks.

A retirement nest egg should be weighted more heavily toward stocks.

By that measure a 70-year-old should invest only 30% of a portfolio in stocks.

Research into retirement income generation in recent years has turned these common sense ideas on their heads.

Although the stock market can be risky in the short term, the studies say that a retiree's biggest worry is keeping up with inflation. Over the long term, supposedly "safe" fixed income investments do not tend to keep up with inflation, especially after taxes are paid on interest. The stock market does keep up.

A new study by Consumer Reports magazine and the investment research firm Ibbotson Associates looked at the performance of a wide range of stock and fixed income portfolios over the past 66 years.

The study adjusted returns and annual withdrawals for inflation.

It found that an all-stock portfolio handily beat an all bond portfolio, providing an average of over $750,000 in extra retirement income on a portfolio that begins retirement at $500,000.

This result held up no matter which 20– and 35-year market cycle was chosen, meaning that it did better even in periods that included severe bear markets.

An all-stock portfolio may be impractical for many retirees, both because they may panic during market declines and also won't have an alternative source for withdrawals.

Consumer Reports suggests an 80/20 or 70/30 stock to bond mix instead.