It is widely known that the substantial majority of investment managers fail to beat a passive investment in the S&P 500 (when measured over any reasonable investment time horizon).

For professional capital allocators this is both an irrefutable and inconvenient insight. It is an insight that is so inconvenient in fact, that most active investors, myself included, prefer to proceed on the premise that they are part of the minority that can consistently beat the S&P 500, at least over the medium to long term.

Why is the S&P 500 so hard to beat?

I believe there are several reasons, some of which are well understood, and a few that have been given less attention but are no less important.

Important Caveat: The following comments are not a recommendation to buy the S&P 500 today (15th Nov 2016). There are times when the entire market is overvalued, and this could well be one such time. At current levels, medium term forward returns from holding the S&P 500 are likely to be well below its long-term average. This doesn't detract from our broader discussion on the excellent long term performance of the S&P 500.

I believe the S&P 500 has the following positive attributes when compared to most active managers:

Low Cost: This is perhaps the clearest advantage accruing to a passive S&P 500 investor. Market beating gross returns generated by good capital allocators are, in most cases, more than absorbed by the higher costs of active management.

US Capitalism is Effective: Capitalism and shareholder value have their opponents, but a better system (for investors) has yet to emerge. Respect for property rights, and in general, a clear focus on shareholder value are common characteristics of the companies which comprise the S&P 500. The disciplines of market transparency, potential takeovers and shareholder activism all conspire to keep the focus on shareholder value.

Quality & Diverse Industry Capture: The S&P 500 captures a formidable combination of quality companies and industry diversity.

<u>Tax Free & Low/No cost re-Balancing:</u> Constituents of the S&P 500 change. The stated gross return of the S&P 500 makes no allowance for the fact that in practice there are friction costs associated with portfolio churn. The 'friction free' index return is theoretical only and doesn't exist in practice (though some of the largest index funds are getting close).

<u>Limits Losses:</u> I have written before about the "miserable math of mistakes". A 50% loss requires a 100% return to compensate. Avoiding large losses is a pre-requisite to wealth preservation. The typical S&P 500 company is diversified and lowly leveraged. Losing companies eventually fall out of the S&P 500 resulting in a soft form of automatic stop-loss protection.

<u>Keeps Winners:</u> How many ten-baggers have you enjoyed? I am embarrassed to admit that I have not had any (so far). In my case the reason is that I have been too eager to 'lock-in' gains well before achieving a multi-bagger, relying perhaps too much on the old adages that one never went broke taking a profit and that one should always leave something for the next guy. The problem with my approach is that, by definition, I could never achieve a ten-bagger.

Of the total returns that accrue to the stock market, those returns are disproportionately earned by a small number of companies.

Winners contribute disproportionately to total stock market returns. While avoiding losses is a good start, to build a great track record, one also needs to own <u>and keep</u> winners. A holder of the S&P 500 automatically keeps their winners, and this, it turns out, is a big, and in my view underappreciated, feature of why the S&P 500 is so hard to beat.

There is one further nuance that is worth highlighting. With all the accolades supporting index investing there is a key assumption that is fundamental to the index investment case and it is this: Index investors buy and hold the index through thick and thin. This may be theoretically true but it is frequently not behaviourally true. When it comes to investments in active funds, the average returns to investors are much lower than the average returns produced by those same active funds. The difference is down to poor market timing. Investors don't stick with fund managers. They sell after poor performance and buy after good performance which guarantees a result that is worse than what the funds produce. If investors time active funds badly, why would they be any better at sticking to a passive S&P 500 investment? And if you don't stick with your S&P 500 investment then you are not keeping your winners.

L Endersen – 15th November 2016