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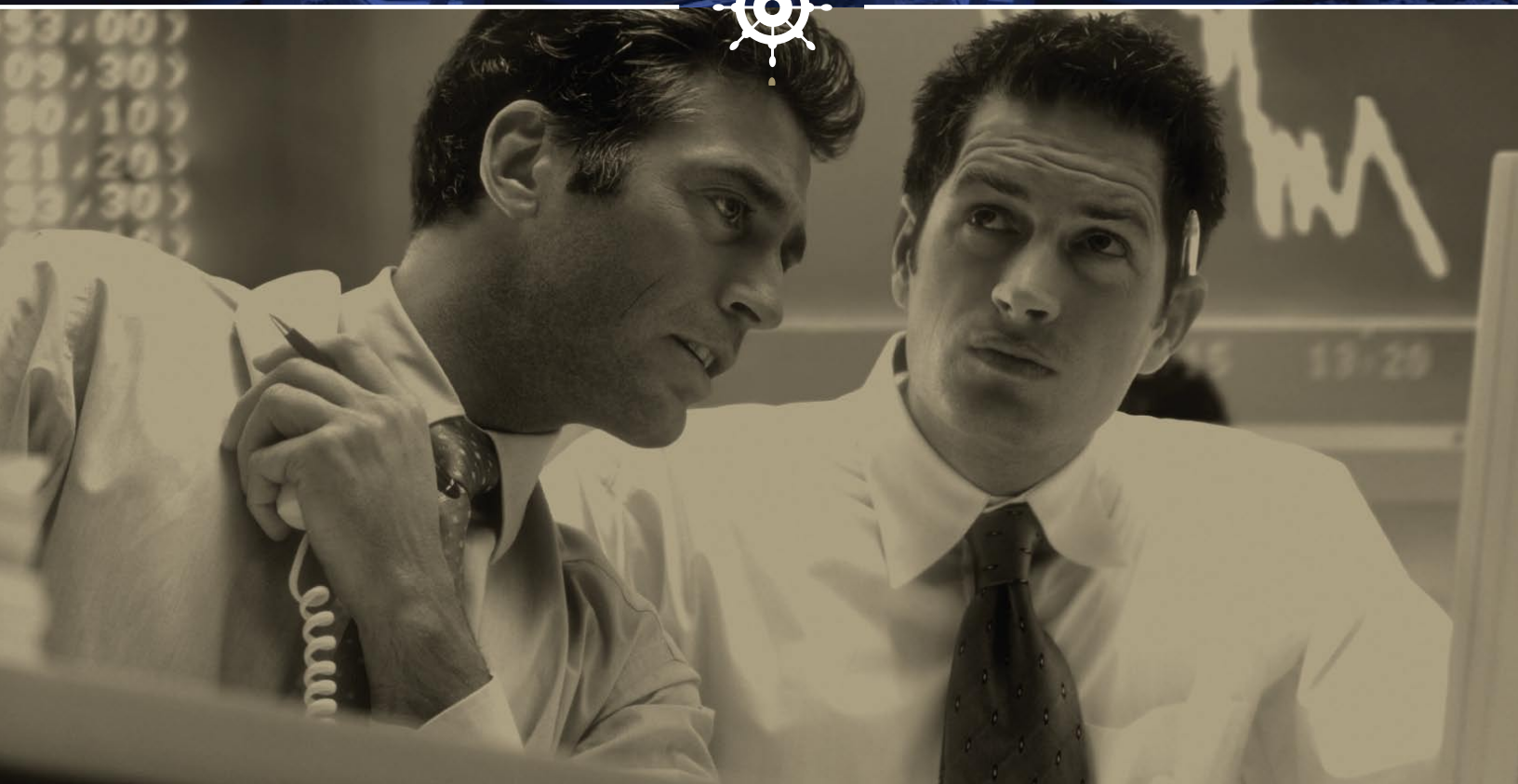
Passive over Active

The Superior Investment Management Choice



Introduction

Investors Face Two Investment Strategy Options

Given the choice of investing your savings based on the success of thousands of global companies run by experienced business managers or investing based on one investor's ability to pick the stock or mutual fund that is better than average, which would you choose?

The first option – an investment in a broad, diversified basket of stocks having similar characteristics – is **Passive Management.** The goal of this investing technique is to capture asset class (market) return. Passive investing does not mean the investor is "doing nothing." Any trading that occurs is guided by a well thought-out plan. Such an investment plan is reviewed periodically to see if it is meeting its goal.

On the other hand, the second option – the process of attempting to outperform the market – is an investment strategy known as **Active Management.** This investment approach requires constant attention and expertise and can be sabotaged by emotion.

Successful investing requires you to choose the one strategy that will have the higher probability of meeting your personal goals.

Historical Basis of Passive vs. Active Management Debate

Discussions of market efficiency have been around for a long time. George Gibson, author of *The Stock Markets of London, Paris and New York* (1889), wrote that when "shares become publicly known in an open market, the value which they acquire may be regarded as the judgment of the best intelligence concerning them."[1] In 1900 Louis Bachelier, a French mathematician, became one of the first to write about market efficiency in his Ph.D. thesis, *Theory of Speculation.*[2] He concluded that the mathematical expectation (expected return) of the speculator is zero. Those historical studies of market efficiency laid the foundation for the academic arguments about Passive versus Active investment.

On average, Active investment managers do not have the ability to consistently pick companies' stock that will outperform the market.

A more modern school of thought called *Decision Making Theory* tells us that the collective wisdom of thousands is better than the judgment of one or even two people. While one rare individual may have superior judgment, the overwhelming majority will not. Active investment managers are no exception to the rule. On average, they do not have the ability to consistently pick companies' stock that will outperform the market. The alternative is to eliminate Active management judgments in picking selected stocks and instead focus on collecting the return from all the available stocks. The odds of success are high because, one, there is no faulty judgment of just one person and, two, company CEOs work to make their companies profitable, thus providing return to investors over time.

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Providing Clarity in the Debate

While we at Voyager Capital Management, LLC do not expect to end the debate, we hope to provide clarity in the following sections of this report.

To encourage your understanding of the key discussion points:

- Section 1, Page 03:
  Passive and Active Defined provides a primer on the basics of investing and on key characteristics of Passive and Active investing.

- Section 2, Page 05:
  Passive and Active Debated highlights the characteristics of each style.

- Section 3, Page 17:
  Money: How It Grows, Where It Goes describes a framework for building the portfolio of thousands of global companies.

Section 1:
Passive and Active Defined

How the Market Works

In this section we will review:

1. **Mechanics of Stocks and Pricing**, explaining how stocks generate return for investors.
2. **Diversification of Risk with a Mutual Fund**, explaining the resulting lower risk.
3. **Players in the Game**, discussing how market prices are set.
4. **Market Efficiencies**, tying together stock return, players in the game, and how you, the investor, can benefit.

Mechanics of Stocks and Pricing

Expecting a company to grow and profit, investors purchase ownership interest via the company's stock. The stock purchase price is critical because when an investor pays above fair value, the investor's potential to profit is at risk.

A stock's price is a result of the expected profit (dividend), the potential growth of the dividend, and the discount rate (short-term risk-free rate), a calculation that is used to turn future dividend payments into a current value. For example, receiving $100,000 today is equivalent to getting $12,333 each year for 10 years, assuming a discount rate of 5%.

Investors expect a return, but no return is completely certain.

Each investor creates his own opinion of the expected dividend and growth of the dividend. This individual calculation of potential leads to stocks' changing hands at different prices as one investor feels the stock is overpriced while another believes that it is underpriced. Investors expect a return, but no return is completely certain, being dependent upon dozens of factors such as company management, consumer tastes, product pricing, and competitors. One additional factor is a stock's Price-to-Earnings Ratio (P/E). In the long run, the P/E is very stable and does not affect fair value; however, in the short run the P/E has fluctuated dramatically. As investors purchase stocks regardless of their earnings, the P/E can rise drastically, as in the Tech Bubble of 2000.

Stock Price = (Dividend + Dividend Growth) / Discount Rate

For example : $5 = (2.5% + 7.5%) / 2%

Diversification of Risk with a Mutual Fund

To minimize risk of buying a single stock, investors purchase mutual funds, which are investment vehicles that hold multiple stocks, bonds, real estate, commodities, and other securities. As of October 2009, Morningstar's database contained 7,647 unique mutual funds.[3]

In general, Active funds are much more expensive than Passive funds.

Within this universe of mutual funds, most are Actively managed. A mutual fund will have a professional manager who selects the investments. For this service, funds charge investors fees that may include an expense ratio, front and rear loads, and 12b-1 fees. While fund fees vary dramatically, in general Active funds are much more expensive for the investor than are Passive funds. While Active funds are less risky than a single stock , the funds will have more risk than Passive funds because Active funds generally hold fewer stocks.

Players in the Game

Stock, mutual fund, and other investment prices are set by bidders and sellers. The price at which the seller agrees to sell and the buyer agrees to buy represents the investment's fair value. Hundreds of millions of people around the globe set fair value each day. Most developed countries have electronic stock exchanges allowing speed and efficiency at relatively low trade-execution costs.

Market Efficiencies

Almost every investor who wishes to trade can do so. Thus, the markets and market pricing are constantly in motion, driven by investors' perceptions.

Investors have so much information today that stock prices are efficient. In a 1965 published thesis, Dr. Eugene Fama, currently a professor of finance at the University of Chicago Booth School of Business, held that market prices reflect all known information and react instantaneously to new information.

More recently, behavioral economists have proposed a new theory that human emotion causes prices to drift from fair value. Though this theory may be true over shorter periods – usually emotionally driven events like the unexpected resignation of a Federal Reserve Chairman – in the long-run markets continue to act efficiently.

Section 2:
Passive and Active Debated

Complexity of Issues Prolongs Debate

The reason that the Passive versus Active debate has remained alive for so long is that the issues are complex.

Because the choice between the two is so critical to your long-term success, we have carefully deconstructed the topics to highlight five key issues:

1. **Human Nature and Mental Accounting Bias**
2. **Market Timing**
3. **Stock Picking**
4. **Failure of Past Performances to Indicate Future Performance**
5. **Necessity of Controlling Costs**

Human Nature and Mental Accounting Bias

Humans are thought to have two driving emotions: love and fear. If you remember the character Spock from *Star Trek*, you will remember that the character showed very little emotion – neither love nor fear. Instead, he used logic to guide his behavior.

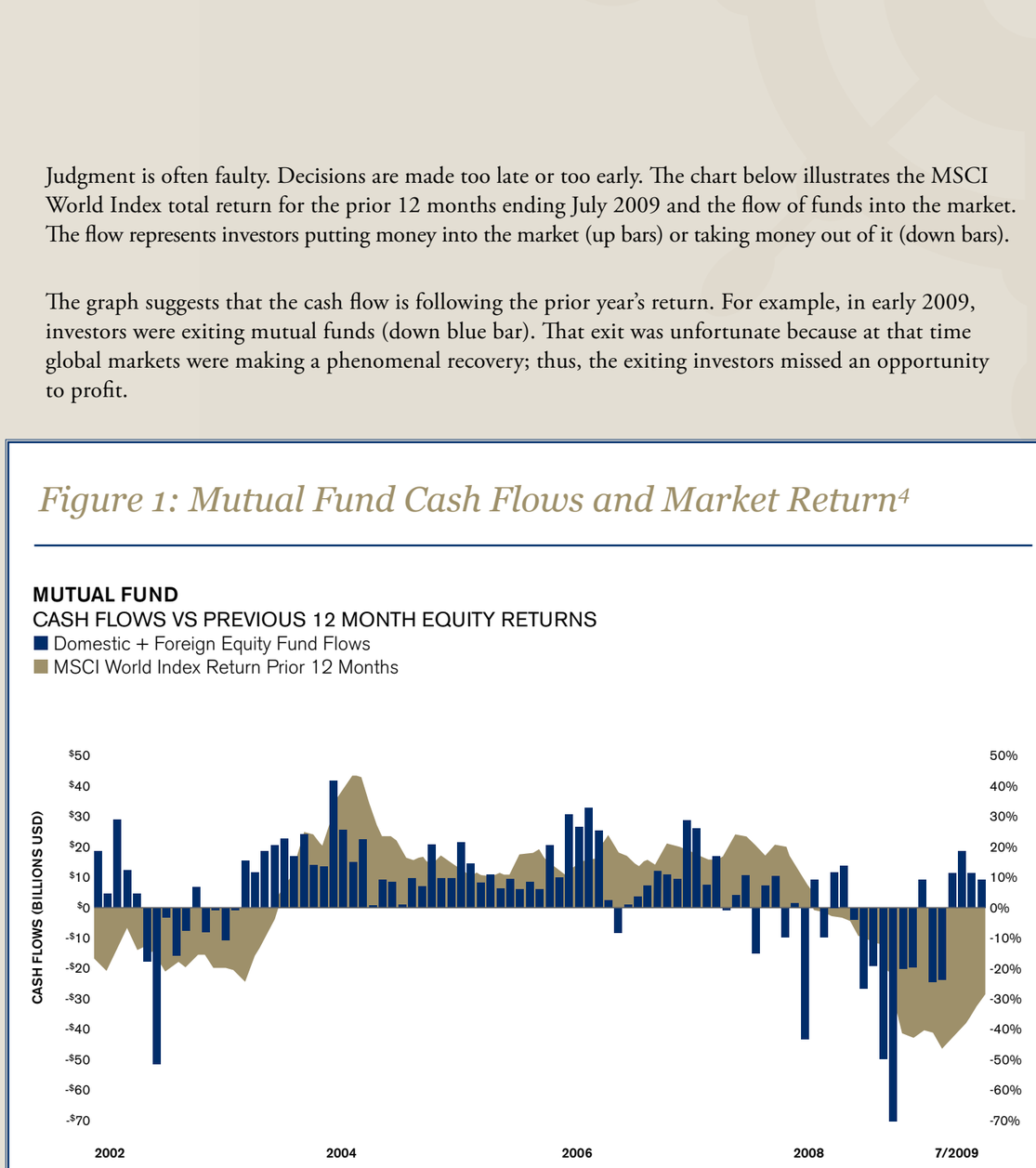
Unlike Spock's decision-making process, our own is affected by emotions that can lead to very poor investment decisions. History is full of human mistakes ranging from the Tulip Mania of 1637 to the Housing Bubble of 2007. Humans love to profit but fear the loss. Greed is excessive love of profit. New behavioral research demonstrates that we have many cognitive biases, including our desire to avoid loss. Charles Ellis's *Winning the Losers Game*, an investigation of human preference to avoid loss, tells the tale that winning is about making fewer mistakes than your opponent makes.

Passive Characteristics	Active Characteristics
Investors choose an index or asset class; thus, the investment will have a large number of securities having the characteristics of the index.	Active investments will by design deviate from the index. The investment manager will select the securities based on his/her tools, strategies, and emotion.

Judgment is often faulty. Decisions are made too late or too early. The chart below illustrates the MSCI World Index total return for the prior 12 months ending July 2009 and the flow of funds into the market. The flow represents investors putting money into the market (up bars) or taking money out of it (down bars).

The graph suggests that the cash flow is following the prior year's return. For example, in early 2009, investors were exiting mutual funds (down blue bar). That exit was unfortunate because at that time global markets were making a phenomenal recovery; thus, the exiting investors missed an opportunity to profit.

Figure 1: Mutual Fund Cash Flows and Market Return[4]



Marketing Timing

Market timing is the process of buying and selling based on predicting future price movements. The strategy involves analyzing market trend and projecting past market behavior as likely to repeat. An example of timing is technical analysis in which traders chart past price patterns and trade based on rules developed around patterns.

Passive Characteristics	Active Characteristics
Investors do not make judgments on the future price movements. Rather, a desired index or asset class exposure determines the holdings.	Active investors will change the portfolio characteristics in an attempt to beat the market.

History has proved that Active investment managers continually fail to add value through market timing techniques. The reasons for the failure are that past patterns may or may not repeat themselves and, if a pattern does repeat, the timing is uncertain. Market timing requires investors to be correct three times: when to get into a position, when to get out of a position, and when to get back into a position.

Active investment managers continually fail to add value through market-timing techniques.

The figure below helps illustrate the difficulty in market timing. Each color represents an asset class. From even a casual observation, the colors show no discernable pattern: one asset class may be a winner for a couple years, and then drop toward the bottom. To see for yourself, choose one color from the top row and notice where it appears in other years.

Figure 2: Asset Class Returns Over Time[5]

Asset-Class Winner and Losers

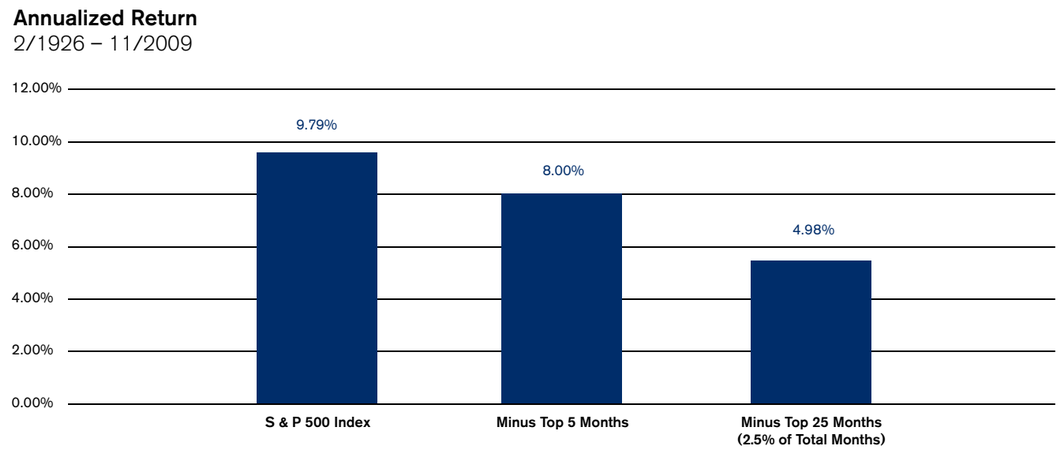
- Small stocks
- Large stocks
- International stocks
- Long-term government bonds
- Treasury bills

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Highest return	8.1%	37.6%	23.0%	33.4%	28.6%	29.8%	21.5%	22.8%	17.8%	60.7%	20.7%	14.0%	26.9%	11.6%	25.9%
	3.9%	34.5%	17.6%	22.8%	20.3%	27.3%	5.9%	3.8%	1.6%	39.2%	18.4%	7.8%	16.2%	9.9%	1.6%
	3.1%	31.7%	6.4%	15.9%	13.1%	21.0%	-3.6%	3.7%	-13.3%	28.7%	10.9%	5.7%	15.8%	5.5%	-36.7%
	1.3%	11.6%	5.2%	5.3%	4.9%	4.7%	-9.1%	-11.9%	-15.7%	1.4%	8.5%	4.9%	4.8%	4.7%	-37.0%
Lowest return	-7.8%	5.6%	-0.9%	2.1%	-7.3%	-9.0%	-14.0%	-21.2%	-22.1%	1.0%	1.2%	3.0%	1.2%	-5.2%	-43.1%

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

A study of the S&P 500 Index returns illustrates that missing just a couple months out of all the history of the S&P 500 Index (2/1926 – 11/2009) could lead to dramatically lower returns. Missing just the top five months reduced the annualized return by 1.79%. Missing the top 25 months meant a real reduction of 4.81%, or 49.1% in relative terms. Giving up almost half of annualized return is a high price to pay for the practice of market timing.

Figure 3: The Cost of Missing a Market Move[6]



Even Peter Lynch, the retired portfolio manager of the legendary Fidelity Magellan Fund, acknowledges the difficulty of successful stock picking and market timing. He devotes an entire chapter of *Beating the Street* (1993) to the inner dialogue of a panel known as the Barron's "roundtable," a yearly gathering of thoughts from about a dozen "experts" asked to predict in January what the market will do in the coming year. Lynch pokes fun at the entire premise of this roundtable, an opinion he is entitled to because he himself was a roundtable member for a number of years while heading Fidelity Magellan. Unfortunately for investors who foolishly accept and act upon the roundtable's predictions, the roundtable is most often wrong. Attempting to beat the market is generally an unrewarding experience, even for the "experts."

Stock Picking

Stock picking is an Active technique in which some individual(s) or possibly a computer program chooses a security that is expected to perform above the market.

The selection process will also exclude securities better avoided. The challenge with stock picking is that someone or something is forecasting future return. Recall from the discussion in Section 1 that return is a result of dividends and dividend growth in the long run and is affected by emotion in the short run. Can anyone or anything possibly predict the emotional factors driving future market returns or future dividends? We think not. The evidence supports our position.

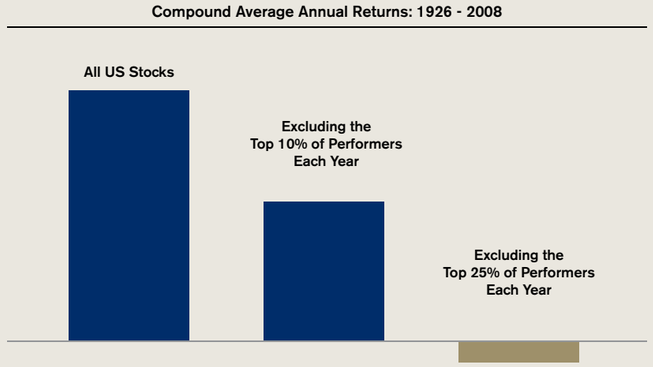
Stock picking is costly.

The figure below illustrates that stock picking is costly. During the 1926–2008 period, the U.S. Total Stock Market rose 9.4% per year. If an investor had missed the 10% best performers, he would have given up 3.4% return per year and earned only 6.0% per year. Missing the top 25% of winning S&P 500 stocks also resulted in a loss to the investor. The true challenge is that unless you are extremely lucky, you cannot possibly know the winners in advance.

Figure 4: Stock-Picking the U.S. Total Stock Market Index[7]

Missing Opportunity

- Strong performance among a few stocks accounts for much of the market's return each year.
- There is no evidence that managers can identify strong performers in advance - and attempting to pick such performers may result in missed opportunity.
- Investors should diversify broadly and stay fully invested to capture expected returns.



If you cannot pick the winners, can you pick the losers? John Rogers of Chicago-based Ariel Investments offers a useful illustration of the challenge in distinguishing skillful money managers from lucky stock pickers.

Rogers suggests that the appropriate test of an activity where skill is rewarded is the extent to which a participant can lose on purpose. He decided to have some fun with this insight and asked 71 staff members of his investment firm to pick 10 stocks that would underperform the market for the second quarter of 2009. Only 19 succeeded, meaning that 73% tried to lose on purpose but failed. The average return of these picks was 30%, compared to a total return of 15.93% for the S&P 500 Index.[8] Yes, those 19 would have made money had they bought their picks, but making money was not their intention. They nominated the stocks as "losers," so they get no credit. That performance and that return are better than going to Vegas, but stock-picking is difficult, both for winning stocks and for losing stocks. People are not good at picking either way.

Individual investors fail to outperform the index – a pattern that persists over time.

An annual study by Dalbar, Inc., calculates the investment success of actual stock and bond investors, a calculation that indirectly measures their market-timing and stock-picking ability.

We compared Dalbar's data on stocks to the performance of the S&P 500 Index and on bonds to the BarCap Aggregate Bond Index, a broadly diversified, high-quality bond index. Individual investors failed to outperform the index – a pattern that persists over time.

The same pattern exists outside the United States in markets considered less efficient, including the merging markets where 90% of the funds failed to outperform the index and foreign stocks with an 87% failure rate for the period July 2004 to June 2009.

Figure 5a: S&P 500 Stock Index Return vs. Investor Equity Return[9]

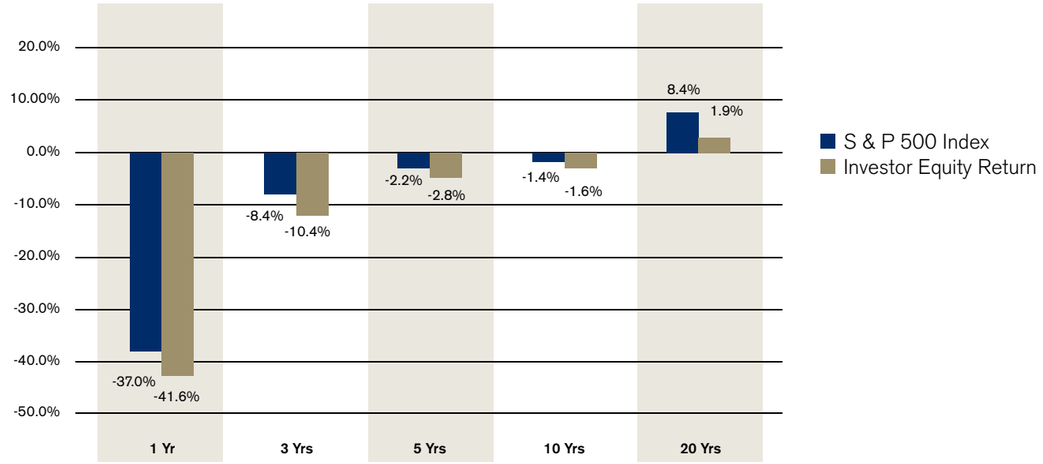
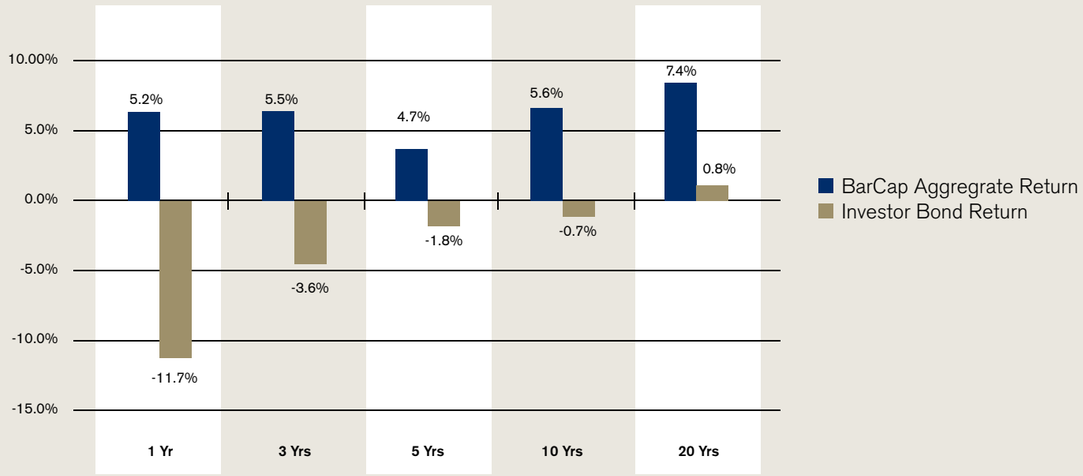


Figure 5b: BarCap Aggregated Bond Index Return vs. Investor Bond Return[10]



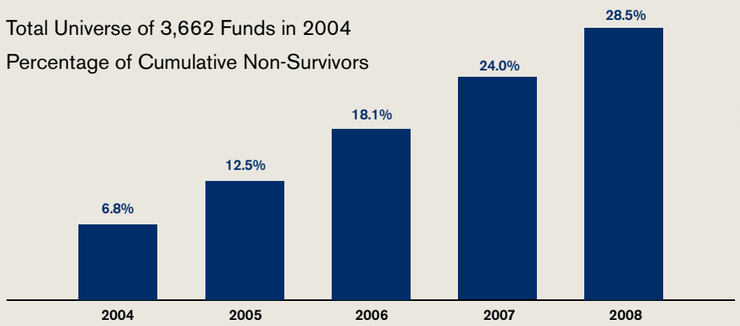
Failure of Past Performances to Indicate Future Performance

Investors make a terrible mistake in judgment when they choose to buy a mutual fund based on past performance. First, many funds disappear due to poor performance or fund companies' merging one fund into another. In fact, from 2004 through 2008, only 71% (2,619) of Actively managed equity funds survived the 5-year period. (See Figure 6.)

Figure 6: Non-Surviving Equity Funds[11]

Non-Surviving Equity Funds
Actively Managed US Equity Funds 2004 - 2008

Total Universe of 3,662 Funds in 2004
Percentage of Cumulative Non-Survivors



On average, 5.7% of the actively managed equity fund universe disappeared each year.

During 2004, 6.8% of the fund universe disappeared. By the fifth year, 28.5% of the fund universe (1,043 funds) had disappeared.

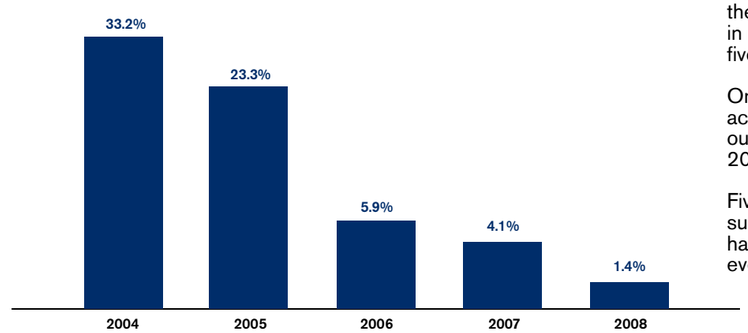
Reasons for non-survival likely included closure due to poor investment results.

Second, most funds do not outperform their category benchmark. (A benchmark is a standard against which the performance of an individual security or group of securities is measured. It is usually based on published indexes of securities of the same or similar class. However, customized ones may be used to suit a particular investment strategy.)

Figure 7: Failure to Consistently Outperform[12]

Few Consistent Equity Fund Winners
Actively Managed US Equity Funds 2004 - 2008

Surviving equity funds that beat their category benchmark consistently.



Surviving funds did not outperform their respective category benchmark in most years or over the entire five-year period.

Only about one-third (33.2%) of actively managed US equity funds outperformed their benchmark in 2004.

Five years later, only 1.4% of the surviving funds (38 out of 2,619) had outperformed the benchmark every year.

In the five-year period under study (Figure 7), recent winners did not reliably repeat their outperformance. In fact, just under a third (33.2%) of the funds beat their benchmark in 2004. In 2005, only 23.3% had beaten the benchmark in 2004 and 2005. For the five-year period, only 1.4% had outperformed the benchmark every year. The bottom line is simple: the odds are greater that winners will not repeat than that they will. Finding the 1.4% that beat their benchmark is like finding a needle in a haystack.

Where do we turn for investment information on past and future performance? Research by *Journal of Financial Planning* (December 2009) indicates that most investors rely on major publications such as *The Wall Street Journal* and *USA Today* as well as television and the Internet.[13] These media tell us what has already occurred.

The media might also make predictions about future performance. The challenge is that the media's motivation is to keep themselves in operation – self-preservation. In the process of selling papers, gaining

advertising dollars or doing whatever is necessary to keep the doors open, the media often omit the dull and boring factual information. While you would like these sources to help you find the next winner, your success is not their primary motivation.

Like the media, brokers/dealers provide clients with investment information, but again the primary motivation is to reward the company and not the buyer because these professionals must sell investments (to you) to earn a living. Isn't it likely they will push a product that gives them a high return? They will tempt you with this logic: "Fund So-and-So made XX% for the last five years. It's a top fund. You should buy this winner!" Remember, fund performance is random, and past performance is not a reliable indicator of future success.

Necessity of Controlling Cost

Regardless of the Passive-Active debate, we cannot predict or control market movements. While we do know that the U.S. Total Stock Market has provided a return of 9.4% per year over the long run, we are not certain what the return will be from year to year. However, one thing is certain: the more you must spend to get investment return, the lower your return will be. The process of keeping your costs to a minimum should be managed carefully.

Multiple fees and costs threaten investors' return. Consider the following[14]:

- The **expense ratio** is an annual fee that the investor pays to the fund company to cover the expenses of running a mutual fund. The average expense ratio of all funds in the Morningstar database as of October 2009 is 1.3%. In contrast, the expense ratio associated with *index funds* that are buy-and-hold is 0.4%.

- The **load** expense is paid by the investor to the fund company. The investment company then pays the salesmen or brokers. The reason loads exist is to compensate brokers for selling the product. A front load is an expense paid when you buy the fund, and a rear load is paid if you exit the fund prior to the end of the penalty period. The length of the penalty period will vary as explained in the mutual fund's prospectus, a legal description of the fund. The rear load decreases each year until it no longer applies, but penalties exist if money is withdrawn during the penalty period. Of load-only funds, the average front load is 4.8% and rear load is 2.5%. If we include the no-load funds, the average load expense drops to 1.5%. While some index funds do have loads, investors should avoid these funds because no-load options are available.

- In addition to the front- or rear-load fees, fund companies may charge a **12b-1** fee, which is money that fund companies use to market their funds. Of funds with 12b-1 fees, the average fee is 0.6%. (Note: The average 12b-1 fee, derived from a combination of all Active funds including those with no 12b-1 fee, is 0.4%.)

- **Trading costs** are those costs associated with buying and selling securities. Institutional stock traders can trade stocks at almost no cost while individuals will typically pay a few dollars per trade. Trading cost is also known as commissions. Foreign-stock trading cost is higher than cost in the U.S. Fixed-income (bonds) instruments generally do not have a commission. However, their trading cost is hidden. (See bid-ask spread, following.)

- **Turnover costs** are those associated with the volume of transactions (buys and sells) in a mutual fund. Excluding index funds with loads and 12b-1 fees, index funds will have a low annual turnover, typically 17%. The Active funds typically have 105% turnover. The costs associated with turnover must be estimated because actual data are not available. The general rule of thumb for stocks and bonds is that the turnover cost is 0.5% for each complete portfolio turnover. So, for a mutual fund with 100% turnover – all the stocks leave the portfolio in one year – the cost is 0.50%. The typical turnover cost of the index fund is 0.09% (0.17% times 0.5%) per year while the Active fund cost is 0.53% (105% times 0.5%) per year. The Active fund owners on average paid almost six times more in turnover costs than the typical index fund owner paid.

- **Bid-Ask Spread** is a hidden cost, therefore difficult to measure. Bond-trading costs vary widely. For example, Vanguard will go directly to a bond issuer and buy bonds for no cost while an individual may pay indirectly though the **bid-ask spread**[15]. The bid-ask spread is the difference between a security's bid (buying) price and the ask (selling) price. An individual's bond bid-ask spread is as wide as 3-4% of the value of the bond. In general the bigger the bond position, the lower the cost. Liquid stocks such as the S&P 500 stocks have very small bid-ask spreads. Traders are in and out of these securities on a daily basis. Emerging Market and Microcap stocks will have larger spreads.

- **Market Impact cost** is the cost of a transaction based on the size of the transaction versus the available investment in the marketplace. For example, a significant market impact would occur if an investment house sold 10% of the outstanding shares of a stock at one time. Since most players understand market impact, they trade in ways to avoid this cost. For our purposes, we can ignore market impact.

- **Tax cost** is the expense that comes due every April 15. The IRS places a potentially higher tax burden on short-term capital gains and ordinary income such as bond income than on long-term capital gains. Since Actively managed funds tend to have higher turnover and more short-term capital gains, the tax burden will be generally greater than with a buy-and-hold, Passive strategy.

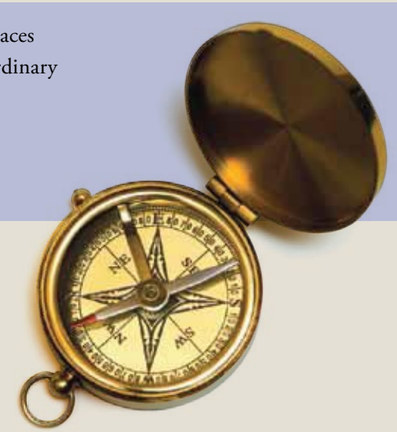


Figure 8 below compares the typical annual return and expenses of a buy-and-hold, Passive strategy compared with those of Active management. Over the last 20 years ending 2008, the S&P 500 Index experienced an annual return of 8.40%. However, an investor cannot own an index, but can instead own an index fund. The Passive investor would have experienced expenses of approximately 0.50%; thus, the Passive investor's after-expense, or net, return would have been approximately 7.90%. (We ignore the tax cost due to the difficulty in calculating the impact because each investor will have a different tax experience.)

According to the Dalbar study (Figure 5a), the annual return of the average stock investor was 1.90%. The Active investor's return already includes costs of loads, 12b-1, and other expenses. In comparison, the individual Active investor's return would likely be 6.0% (7.90% minus 1.90%) per year lower than the Passive investor's return!

Figure 8: Typical Annual Return and Expenses for Passive vs. Equity Investors[16]

Income and (Expense)	Passive Investor	Active Investor
Gross Return	8.40%	1.90%
Total Expenses*	(0.50%)	Included in Return
Net Return (before tax)	7.90%	1.90%

*Estimated Expenses		
Expense Ratio	(0.40%)	(1.30%)
Load	(0.0%)	(1.50%)
12b-1	(0.0%)	(0.40%)
Trading Cost	(0.01%)	(0.01%)
Bid-Ask Spread and Turnover	(0.09%)	(0.53%)
Market Impact Cost	(0.0%)	(0.0%)
Total Expenses	**(0.50%)**	**(3.74%)**

Nobel Prize winner William Sharpe wrote a compelling article, *The Arithmetic of Active Management*, explaining that market return will be the weighted average of returns on all market securities.[17] Passive investors will receive market returns (minus expenses). Active investors will also have market returns after their expenses because for each winner there will be a loser of equal magnitude. The Sharpe theory implies that the Active investor's return should have been market return (8.4%) minus total expenses (3.74%) or 4.66%. The Active investors' net return was 1.90%, or 2.76% worse than implied by the Sharpe theory. It is likely that the worse-than-expected performance is due to investors' chasing winning trends, thus buying winners after the performance had peaked.

The majority of investors, though wrong, believe that their judgment is better than average.

Although the case has been made for Passive management, people continue to desire control over their environment. The majority of investors, though wrong, believe that their judgment is better than average. The question that they need to ask is: What is the cost of being wrong – of not being better than average? Over a 30-year period using the data from Figure 8, $100,000 could be expected to grow to $979,000 using a Passive strategy as compared with only $176,000 in an Active strategy: an $803,000 difference.[18]

Section 3:
Money: How It Grows, Where It Goes

With the cost of Active management so high, the better alternative for your investment strategy is Passive management. A major finance theory, *Modern Portfolio Theory*, provides a framework for using Passively managed funds to construct globally engineered, buy-and-hold portfolios. However, the theory has several faults when applied to the individuals. For example, the theory assumes that the investing time horizon is infinite, but individuals do not have forever to invest. To mitigate the faults, a newer framework is developing to assist investment advisors in creating portfolios for clients. Advisors are learning that clients' liabilities (financial obligations) should affect the investment strategy. For example, the 40-year-old investor can choose to be more aggressive than a 65-year-old investor because more time is available to recover from a bear market.

Because having piles of money is not in and of itself a worthwhile goal, investors have to think about what they need or desire to do with their hard-won returns. The concept **Post** *Modern Portfolio Theory* teaches that individuals think of their wealth as existing in various "risk buckets." At Voyager Capital Management, LLC, we discuss these four buckets: **Safety, Lifestyle, Life Goals, and Long-Shot**.

- The **Safety Bucket** provides a cushion of available funds for everyday expenses and emergencies.
- The **Lifestyle Bucket's** investments are expected to provide cash flow for purchases that meet your personal goals. For example, some clients prefer driving small, gas-efficient cars while others prefer luxury automobiles.
- The **Life Goals Bucket** provides funds for longer-range, more significant expenses such as college for kids or grandkids and elaborate travel. Whatever your goals, this bucket is designed to provide the necessary funds.
- Finally, the **Long-Shot Bucket** may one day buy you an island or any far-reaching personal goal.

The assets that fund each bucket will likely have an increasing level of risk. The Safety Bucket will be invested mostly in bank accounts, money market funds, and CDs, and funded from your employment during your working years and, during retirement, from your Lifestyle and Life Goals buckets. Your Lifestyle and Life Goals buckets contain a portfolio of buy-and-hold, globally diversified investments to maximize your return for your acceptable level of risk. The Long-Shot Bucket might contain a hedge fund, your personal business, or even "play money."

Specifically, "play money" is money you are willing to trade, lose, or gamble away. Trading is not Passive investing. While the evidence points to the superiority of Passive over Active management, for those who still resist, we recommend that they satisfy that need by keeping a minor amount of play money for trading while concentrating the bulk of their assets in a globally engineered, buy-and-hold investment portfolio.

Turning our attention from the enticements of playing with money back to the more serious matter of deciding what approach to use in investing for needs and goals, we can sum up the advantages of Passive Management.

In Conclusion

Passive Management – an investment strategy in which investors gain asset class exposure – is superior to Active Management. While Active Management attempts to beat the market, the evidence points to its failure due to humans' inability to (1) accurately predict future return, (2) time the market, (3) pick stocks, (4) predict winning funds, and (5) keep expenses low. In contrast, the Passive Management approach lifts from investors the burdens of decisions: what to buy and why; what to pay and why; when to buy or sell and why, and even how. Passive investors with a focused, understandable plan can avoid the stresses of emotion played out in the markets. Instead, those investors can have confidence because they will have bought the entire market, with low costs and expenses, all inside an appropriate globally diversified, buy-and-hold portfolio best suited to meet their investment goals and risk tolerance.

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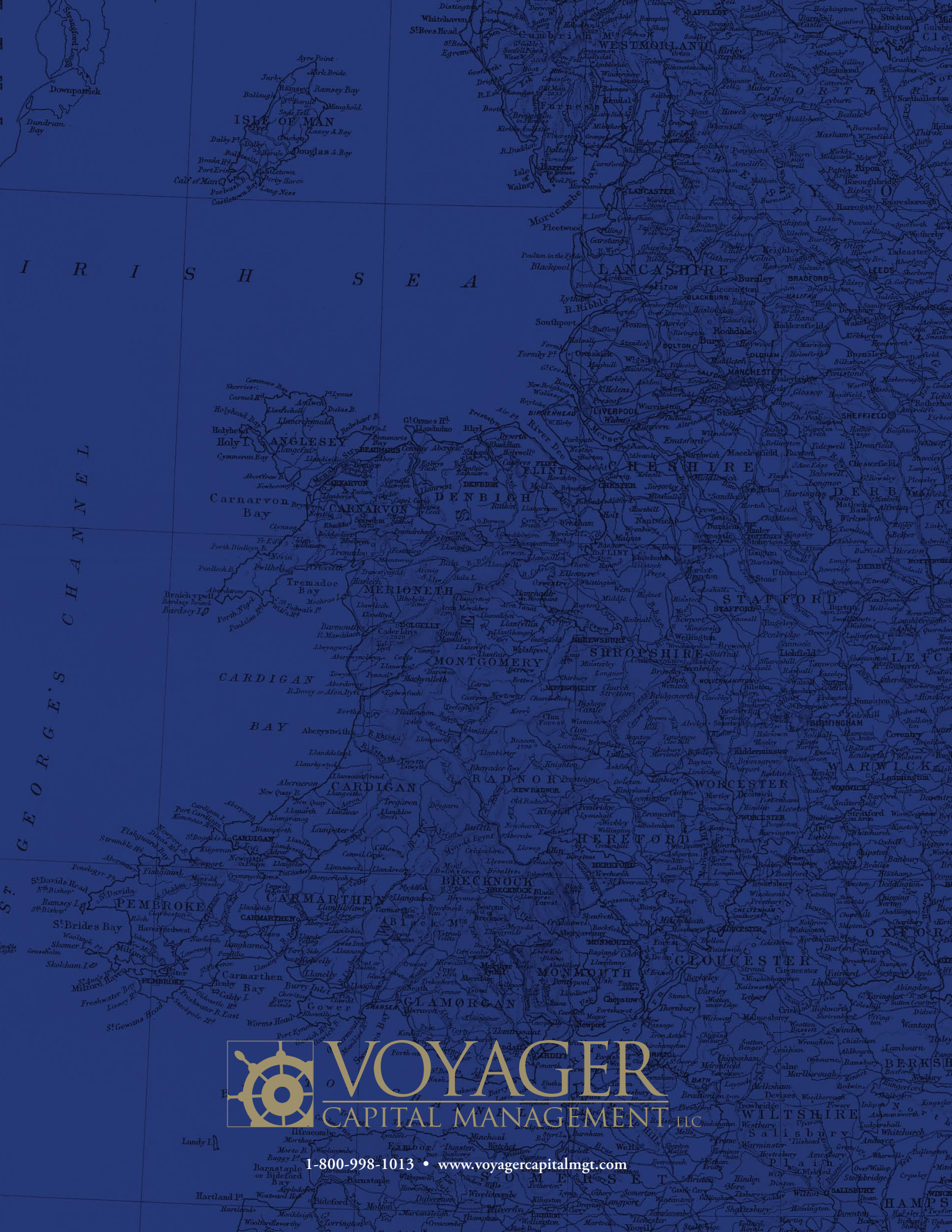
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