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### ***Deal or No Deal***

#### Weighing a sure thing against an unknown payout

The game show Deal or No Deal can be painful to watch. Beyond the squirming contestants and their high-fiving families, one must often endure the melodrama of bad decisions leading to the evaporation of huge payouts.

Still, it is oddly entertaining. And odder still, the show can be an eye-opening object lesson for important investment concepts.

The premise of the show is simple enough: twenty-six sealed briefcases hide monetary values of one cent to one million dollars. The contestant chooses one sealed case to keep, and then opens and eliminates others one by one. The crux of the show is the difficult choice posed to the player periodically – keep the original case and whatever it holds or opt for a lump sum payout offered by the banker.

A sure thing or an unknown payout – this is the pivotal choice of the show...and of modern investment strategy. Amid the sizzling lights, sparkly models, and the shtick of the host, the game show replicates the key decision every investor makes, knowingly or not, when creating a portfolio – accept a known outcome, or chase a speculative one.

#### **The fundamental choice in investing**

Any investor can lock in the market return of an asset class via an index or asset class fund, or choose an actively managed fund that will deliver an unknown return that could be higher or lower than the asset class return. This seemingly simple choice may have more impact on one's long term investment results than any other.

Let's consider how that decision might play out on the investment version of Deal or No Deal. Take for instance large cap domestic stocks. Contestant Annie knows she can buy an asset class fund that will deliver, by definition and design, a very close approximation of the weighted return of large US stocks. She can't know the specific numerical return the market will deliver, of course. In any given year it could be positive or negative, and far above or below the historical return for that asset class. But she can count on it being very close to the return of that asset class going forward.

If the return of large cap stocks is five percent that year, or minus ten, that will be Annie's approximate return. She accepts that return and holds firm, committed to stay the course through whatever ups and downs the market delivers.

Contestant Phillip, on the other hand, is confident that he can do better. Instead of accepting the return of the asset class, he prefers to pick and choose specific large cap stocks himself, or hire a money manager to do it for him, or buy an actively managed mutual fund whose manager will pick securities and decide when to buy or sell them.



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### **Is more information an advantage?**

So who will have a better result? If there was ever a million dollar question, this is it. Human instinct suggests that Phillip has the advantage. Unlike the Deal or No Deal player, he is not making a blind draw among sealed briefcases. He has access to limitless information about companies, the economy, interest rates, past performance, dividend announcements, rankings of funds and managers, and so on. He also has (seemingly) far more control of the outcome. He can buy and sell at any time, overweight specific companies or industries, or get out of the market entirely if he expects a downturn. He can even sell short if he wants to enhance his return in a down market.

With all these resources and options Phillip expects that he will be able to consistently beat the market performance that Annie chose, perhaps by a wide margin. Many casual observers would agree that he has an advantage. Nonetheless, empirical evidence suggests that Annie has a considerable edge. More and more data stacks up each year that shows actively managed funds and money managers underperforming versus the asset class benchmarks they seek to beat.

Part of the disadvantage Phillip faces, of course, is the inherent cost of active management – transaction costs, the salaries of the experts making the decisions, the salaries of analysts and economists making recommendations, plus marketing and other overhead. These costs must be overcome by better investment results just to stay even with passively managed asset class funds.

But costs are only part of the story. Active investors are also prone to, for lack of a better term, mistakes of prediction. Based on rigorous analysis (or hunch, fear, or impatience), active management opens the possibility of selling before a big gain, buying before a big decline, chasing “hot” stocks that quickly cool, or loading up on specific companies or industries at the wrong time.

These miscalculations create the risk of significant underperformance. Over the period 2004 to 2008, for instance, the Standard & Poor's SPIVA scorecard (which compares active versus index fund performance) shows that the S&P 500 outperformed 71.9% of actively managed large cap funds; the S&P MidCap 400 outperformed 75.9% of mid cap funds; and the S&P SmallCap 600 outperformed 85.5% of small cap funds.<sup>1</sup>

The underperformance of active management changes the game for Phillip. It means, essentially, that he is choosing among an uneven field of briefcases, 70-85% of which hold less than the asset class return. If the asset class

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return of large cap stocks turns out to be five percent, Phillip will likely be choosing from a field of considerably more two percents than ten percents. He will need very good fortune or exceptional predictive skills to overcome this steep disadvantage.

### **Sure thing or long shot?**

Without question Phillip could guess right and beat the market average in any given month, year or decade. In the research cited above, 15-30% of the actively managed funds did outperform the comparable index over the five year period. Still, picking the right stocks, funds, or manager must be considered a long shot, relative to the certainty of achieving the approximate asset class return using Annie's passive strategy.

Picking a briefcase on TV in front of millions of viewers must be fun. Contestants on the show, even the losers, appear to have a blast. Of course they are playing with house money. Even when they lose big, they are losing money that was never theirs. Perhaps this explains some of the seemingly irrational choices of contestants – turning down a certain six figure sum for the small chance of collecting more, for instance, while millions of home viewers scream “Don't do it!!!!” at their televisions.

Questionable choices on a chaotic game show should be expected. But some speculative choices made by investors, with their own real money on the line, are more difficult to explain.

<sup>1</sup>"S&P: Majority of Active Fund Managers Underperform Benchmarks Across All Categories Over Past Five Years," Yahoo Finance, yahoo.com, April 20, 2009

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*Deal or No Deal airs on NBC and is produced by Endemol USA, a division of Endemol Holding.*