



a quiet revolution™

### **A Quiet Revolution**

*Fresh approach to wealth management favors planning over prediction*

There is a quiet revolution underway in investing and wealth management.

The revolution is a slow but steady rethinking of the conventional Wall Street wisdom that told us we could systematically beat the market by applying keener insight, stronger research, better rules, or smarter expert advice.

Wall Street has told us for generations that outperformance is the rightful plunder of the smartest and fastest, the spoils earned by the investor who could collect, analyze, and act on the best information. The oracles of traditional investing not only told us that savvy investors could outperform. They also gave us elaborate strategies and tools with which to do so: stock picking, market timing, sector weighting, chart reading, manager shopping, fund rating, and so on.

The revolution is an intentional step away from these predictive approaches that rely on outthinking the market, and toward a model that seeks to deliver capital market level returns by accepting market risks (and avoiding risks not worth taking, such as betting on individual stocks or sectors).

Today's revolutionary investors gauge their success not by their ability to beat the market or own hotter stocks than their neighbors, but by their ability to build financial peace of mind and finance their future plans – from college tuition to retirement. It's about creating a sound plan, a sound portfolio, and getting on with life. Revolutionary investors don't try to outguess the market, they let it work for them.

#### **Rethinking, not outthinking**

The revolution replaces emotional attempts to beat the market with a long-term focus on asset allocation and risk control.

<b>Traditional Investing</b>	<b>Revolutionary Thinking</b>
Speculating	Investing
Prediction	Planning
Breaking news	Efficient markets
Emotion	Science
Individual stocks, sectors, and managers	Asset classes
Market-timing	Buy, hold, rebalance
Commission-based brokers	Fee-only fiduciary advisors

Striving to beat market returns can be exhilarating, but academic research has consistently shown that the pursuit is unsuccessful more often than not. Studies suggest that no value is added through all the effort one might apply to tracking past performance, analyzing industry



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trends, building intricate buy and sell rules, dissecting financial statements, or carefully timing moves into specific stocks or sectors.

The data is most compelling when reviewing the performance of actively managed mutual funds, where skilled and experienced managers – with access to sophisticated predictive investment tools and techniques – seek to deliver market-beating performance to their shareholders. Despite these seeming advantages, studies show that, on average, actively managed mutual funds, fail to match the performance of passively managed benchmarks. Examples include:

- Over the period 2004 to 2008, 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>i</sup>
- These results are similar to that of the previous five year period, 1999 to 2003 (53.2%, 81.7%, and 69.8% outperformance by the three indices, respectively).<sup>ii</sup>
- A study in 2000 by Arnott, Berkin, and Ye showed that 322 of 355 actively managed funds fell short of Vanguard's index that tracks the S&P 500 during the decade of the 1990's. The return shortfall of the 322 underperformers averaged almost 4.8% annually.<sup>iii</sup>
- The 2000 study above reinforced findings by Arnott and Jeffrey in 1993 that revealed that 75% of funds fell short of the Vanguard index over the period 1982-1991, with even worse performance shown on an after-tax basis.<sup>iv</sup>

### **Why so quiet?**

Based on these and similar findings, some investors, both individuals and institutions, are making the shift away from active portfolio management. Often guided by fee-only Registered Investment Advisors, revolution-ready investors are setting aside speculative approaches, focusing instead on disciplined asset allocation to reap market returns while controlling risk.

But many investors still seek to outsmart the market. Why? Given research findings like those discussed above, readily available for many years, why is active management still the standard mode of operation for most mutual funds, money managers, and Wall Street firms? Why is this such a quiet revolution?

There are many reasons that asset class investing has not yet supplanted traditional investing, among them simple overconfidence by investors and inertia. Here are three more. First, we believe, Wall Street firms, built in large part to profit through the traditional predictive model, have little to gain through a careful inspection of the status quo. Most Wall Street business models rely on the idea that there are secrets to investing – specialized



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industry research, proprietary analytical tools, and sophisticated timing triggers – that investors must utilize (and pay for) to outperform the market. Many of these secrets, key Wall Street profit centers, may be rendered obsolete when the quiet revolution reaches full volume.

Second, like most important movements, the revolution has no lead sponsor, no national ad campaign, and no highly paid spokesperson. It doesn't even really have a name. This is largely a grassroots movement, where one investor at a time reaches an epiphany moment that there has to be a better alternative to paying experts to pick stocks and funds that disappoint as often as they outperform. The revolution spreads slowly, friend to friend, advisor to client.

Finally, the revolution is a complete mismatch for the mainstream financial media. CNBC, the iconic financial network, fills every hour with a string of money managers and analysts, each ready to offer bold insights on how to profit from the latest news. CNBC has little appetite for the message of the revolution – buy asset classes, hold for the long term, ignore “hot” stocks, disregard analyst pronouncements, stop guessing, and yes, turn off the TV.

### **A fresh approach**

Bright Sky Group did not invent the quiet revolution. No one did. The revolution is the natural result of speculative thinking and techniques failing to deliver market-beating performance. For many investors, the thrill of picking occasional winners is simply not enough to justify the disappointing overall performance of active management methods. Call it revolutionary thinking or just common sense – many investors are ready to move on.

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i “S&P: Majority of Active Fund Managers Underperform Benchmarks Across All Categories Over Past Five Years,” Yahoo Finance, yahoo.com, April 20, 2009

ii “Standard & Poor's Indices Versus Active Funds Scorecard, Year-End 2003,” [www.spiva.standardandpoors.com](http://www.spiva.standardandpoors.com)

iii Arnott, R.D., A.L. Berkin, and J. Ye. “How Well Have Taxable Investors Been Served in the 1980's and 1990's?” First Quadrant Monograph, 2000.

iv Jeffrey, R.H. and R.D. Arnott. “Is Your Alpha Big Enough to Cover Its Taxes?” *Journal of Portfolio Management*, Spring 1993.

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