The Zero Sum Game & Your Stock Portfolios

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The stock market is a zero sum game. That means that if the market rises by 10 percent over a year, all the investors collectively will earn 10 percent (before costs).

There are essentially two types of players in the market. One type of player takes a passive approach and in effect buys the market in the form of indexes that represent it. This can be done at a very low investment cost. The players that index are guaranteed to get very close to that 10 percent market return. That is simple arithmetic.

The other players as a group are using an active approach and will strive to beat the market by creating a portfolio different from the indexed portfolios. Individually, some of the active managers will beat the market returns, some will get market returns and some will under perform the market. Those beating the market are doing so at the expense of the active managers that do poorly compared to the market. Remember, the market is a zero sum game and the extra return of the winning managers has to come from the lower returns of the managers that do poorly.

Additionally, actively managed funds cost an investor more. Active managers swapping stock certificates back and forth, money spent on research looking for inefficiencies in the market, computer programs and trading strategies repeated over and over again cost a lot of money. Those expenses are passed on to the investors paying for the active managers' services in the form of higher fund expense ratios and trading costs. That is a tough hurdle for all but a small percentage of the active managers to overcome and still get better than market returns over long periods of time. To determine who the small percentage of consistent winning manages are before the fact is an extremely difficult task.

All of the above active manager activity guarantees the enrichment of the brokerage firms and other intermediaries, but not the investors, regardless of the outcome. That is why the intermediaries spend hundreds of millions of dollars each year (an expense also passed on to the investors) promoting the idea that the majority of their money managers and consultants will help achieve above average market returns. They are doing a very good job at this as most investors still believe strongly in active management and keep looking for those active managers that are going to consistently bring them above market returns.

How hard is it to find a consistently successful long term manager? **Peter Lynch** was the first manager of the Fidelity Magellan fund and was one of the few very successful active managers that consistently beat the market averages. When he left Fidelity, he was charged with the responsibility of helping to select his replacement. With all his knowledge and experience, and picking from the very best managers available, Lynch chose a manager that was offered millions in compensation. The results? Soon after Lynch left, Fidelity Magellan became a mediocre fund and then became a poorly performing fund in its asset category in recent years. ■

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