BARBECUE RIBS AND INDEX FUNDS—AH, THERE'S THE RUB

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Boneless barbeque ribs strike us as a culinary atrocity worthy of an investment analogy.

But where does mediocre barbeque fit with investing? Let's start by taking a look at one popular method of investing in equities: low-cost index funds. These passive funds strive to match the performance of a given equity benchmark (most commonly the S&P 500).

As proponents often (and accurately) point out, on average these funds tend to outperform active managers when accounting for fees.[1] The math here is simple- lump together the portfolios of all active managers tracking an index, and you'll more or less have the index. At that point, it's a simple fee game- the fund charging one tenth of a percent (index funds) is likely to outperform a fund charging one percent (actively managed funds). These are the facts, and we do not dispute them.

We do, however, question whether index funds are one of the best ways for a shrewd investor to participate in the stock market. After all, at any given moment, there are likely to be both underpriced and overpriced securities. A high-quality equity manager may routinely buy more of the former than the latter, and charge a commensurate fee. An index fund will, by definition, do the reverse, and charge a commensurately low fee. For instance, an equity manager may purchase a stock he believes to be underpriced and anticipates to outperform in the future. His investors would be paying expenses roughly five times higher for his insight than they would for an index fund's reverse strategy of purchasing of an overpriced stock.[1] While the allure of a lower fee may be tempting, you should weigh the possibility of the manager's hunch being right.

But what about this barbeque business?

A moderately priced chain restaurant may provide a better experience and value than the average restaurant, but it will seldom produce a memorable meal to rival an extraordinary eatery. Top restaurants, money managers, and other service providers may cost a bit more, but customers and clients are unlikely to regret choosing the best product when they receive good value. When choosing an active fund manager, you may be taking on a bit more risk, but isn't that what makes the reward worth it?

When offered the choice between Trout Almondine at a top French Quarter restaurant for $30 or a platter of boneless ribs at a chain restaurant for $15, our response will always be the same: Can the chef throw some jumbo lump crabmeat on our fish?

[1]Rick Ferri, Index Fund Returns Get Better With Age (Forbes, 2013)

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Actively managed mutual funds may have higher portfolio turnover than passively managed funds. Excessive turnover can limit returns and can incur capital gains.

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The S&P 500 is an unmanaged index which is widely regarded as the standard for measuring large-cap U.S. stock market performance. It is not possible to invest directly in an Index.

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