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Facing the Future with Optimism and Courage
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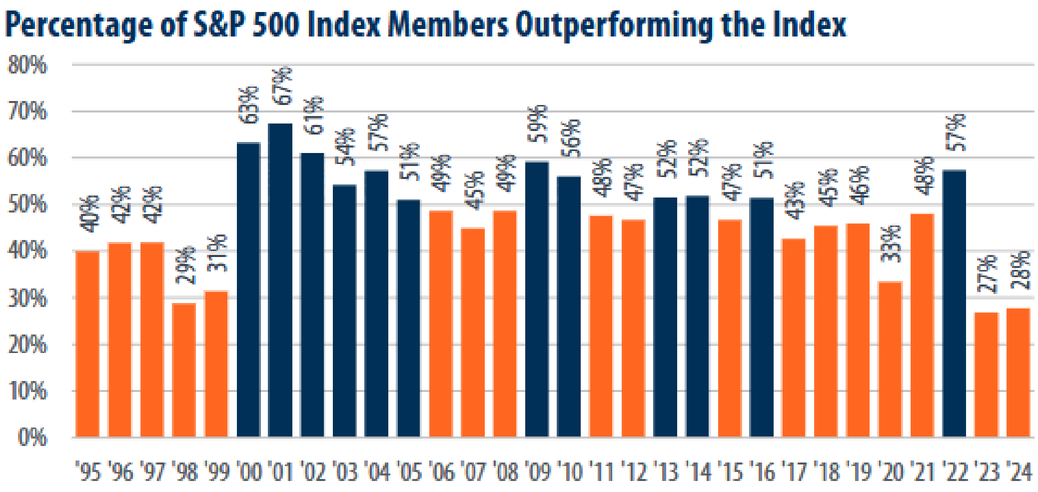
# The Most Difficult Game



Source: Capital IQ, First Trust Advisors. Data from 12/30/94 - 12/31/24.

In 2023, only 27% (135) of the stocks in the S&P 500 Index managed to outperform the index – the smallest number of outperformers in the past 30 years. In 2024, just 28% (140) beat the index - the worst back-to-back years since at least 1995. This trend does not bode well for large-cap fund managers who must identify and own the outperformers and avoid the underperformers in order to beat the index. A fund manager who can identify and overweight his portfolio to the outperformers and shun the underperformers will become a Wall Street superstar. Fame, accolades, and unimagined riches await anyone wise or lucky enough to accomplish this challenging task. This is why active funds will always be with us.

But the historical data does not offer much hope for active fund investors. The relatively small number of outperforming stocks in the index over the past two years must have gone unnoticed by most large cap fund managers. According to S&P, only 35% of large cap domestic stock funds outperformed the S&P 500 last year, even less than the 40% rate observed in 2023. Unfortunately for performance chasers, data from S&P reveals that outperformance tends to be a temporary phenomenon with only a small fraction of actively managed funds able to maintain consistent outperformance.

The S&P Persistence Scorecard is an annual analysis of how many outperforming funds remain outperformers over subsequent time periods. The Year-End 2024 Scorecard notes that among the 162 large-cap active funds that were top quartile (top 25%) performers in 2020, only 11 remained top quartile performers in 2021 and none were top quartile performers in 2022, 2023 or 2024. The results for top half performers are equally disappointing. Of the 330 top half performing large-cap active funds of 2020 only 8 (2.4%) remained top half performers for each of the next four years. We would have expected 21 (6.25%) to do so by random chance alone. Thus, there is no reason to attribute the outperformance to skill rather than luck. The lack of persistence in fund outperformance across meaningful timeframes is common to all equity asset classes tracked in the Persistence Scorecard. The lesson for investors is simple - it is unwise to assume that the 5-star fund that your financial advisor is recommending will continue to outperform.

The average actively managed domestic stock fund holds about 100 stocks, and some well-known funds hold two to three times that number. Diversification can moderate volatility and provide downside protection but there is little chance that a fund that owns 100 or more large company stocks will outperform the S&P 500 Index. The more stocks held by an active fund, the closer its performance will be to that of the index. An active fund that owns a large number of the stocks in an index and nets index-like performance is known as a "closet index fund".

Many managers try to beat their benchmark index by creating what is known as a focused, or concentrated fund. These funds hold a relatively small number of stocks, typically 20 to 30, though some may have even fewer. The goal is to concentrate capital in the manager's highest conviction ideas by taking large positions in companies perceived to be undervalued or poised for growth rather than across hundreds of stocks like a diversified fund or index fund.

Investing in a focused fund is a bet against overwhelming odds. By limiting the stocks in a portfolio to a small fraction of those available, focused funds contain additional risks. One or two losers can lead to dreadful portfolio performance –

especially during market downturns. Concentrated funds, by design, lack broad diversification, which makes them vulnerable to adverse events affecting particular industries or companies. But perhaps the greatest risk is that the fund manager will not be able to identify the best performing stocks. If the manager's analysis is flawed or market conditions shift unexpectedly, the fund is likely to significantly underperform its benchmark index.

One reason that even the most talented fund managers have a tough time outperforming their peers is due to what is known as the "paradox of skill". In activities that combine skill and luck (like investing, sports, or poker), as the skill level of competitors increases, luck plays a more prominent role in differences in outcomes. In other words, when all competitors are highly skilled, the spread between the best and the average gets smaller, and Lady Luck plays a larger part in who comes out on top. All fund managers are skilled, well educated, and have access to the same information. The gap between the "best" and the "average" manager has shrunk. Every year, poor performing funds are closed or merged into more successful funds. If we assume that these funds' managers are less skilled than their more successful competitors, this natural selection raises the average skill level of the surviving managers. If average manager skill level continues to increase in the years ahead, consistent outperformance will become even more difficult, and luck will continue to play a big part in separating top-performing managers from middle-of-the-pack managers.

In theory, it is possible for a focused fund to outperform but results in the real world are likely to disappoint fund investors. In liquid, efficient markets like large cap U.S. stocks, opportunities for consistent outperformance are scarce. Any competitive edge a fund manager may possess is likely to be small and fleeting because there are just too many skilled competitors. Information travels fast and pricing anomalies quickly disappear. Fees, transaction costs, and taxes erode performance, and new investor money coming into successful funds dilutes fund concentration. Repeated outperformance of a fund is so rare that investors are better served accepting market returns through low-cost index funds rather than engaging in a futile search for the next great active manager. Any claim or insinuation by your financial advisor that he or she can identify active funds that will outperform is more delusional hype than prescient insight.

The unspoken assumption in most fund advertisements is that easily attainable, market equaling returns are somehow inferior, insufficient to meet investors' needs. This gives the uninformed investor the idea that outperforming the market should be part of their investment strategy. But once you start trying to beat the market, your focus shifts from your financial goals to the unpredictability, volatility, and daily noise of the stock market. This is one of the biggest mistakes an investor can make. Your biggest edge is not how smart you are, it's behavioral – the ability to ignore the noise and sit still. Attempting to outperform the market is the most difficult game in investing. Fortunately, it's a game that you do not need to play.

## In The News

Edwin Emmett Lickiss Jr., a California financial advisor and owner of Foundation Financial Group faces 20 years in prison after being indicted in a Ponzi scheme that allegedly stole $9.5 million from at least 50 investors over two decades. According to the Justice Department indictment, starting in 1998, Lickiss told investors he had exclusive access to government and other bonds, claiming they would pay interest rates between 9% and 32%. He told investors the bonds were safe, tax-free and could be redeemed anytime. But, surprise, surprise, the bonds did not exist. The DOJ claimed that Lickiss gave clients fake promissory notes, including the terms of the phony bonds, and periodically made "lulling payments," which he told clients were accrued interest but came from funds paid by newer victims. Like all Ponzi schemes, Lickiss would try to convince investors to reinvest the interest they supposedly earned on the bonds. When some investors insisted on accessing their money, he would give various excuses for why he could not pay, including a family illness, banks improperly withholding the money, or that he was under audit. In addition to occasional payments to earlier investors, Lickiss spent the money on home renovations, travel, cars, mortgage and credit card payments, the DOJ stated. Safe, liquid, tax-free double-digit returns! Hey, what could go wrong?

Passive mutual funds and ETFs saw inflows of $899 billion compared to outflows of $230 billion for active funds over the 12-month period ended June 30, 2025. Active stock funds were the biggest losers with outflows of $325 billion compared to inflows of $457 billion for stock index funds. The increasing popularity of index funds has led some proponents of active management to insist that this will help active fund managers in the long run. They claim (hope?) that as the percentage of stock shares that are owned by "dumb" index funds increases, price distortions will increase, and the pricing efficiency of the stock market will decrease – which will enhance the stock picking success of active managers. If this were true, we would have seen improving active management performance as index investing grew in popularity over the past several decades. Instead, the exact opposite occurred. Perhaps promoters of active management should focus less on the stock market's pricing efficiency and more on the paradox of skill.

There are many provisions that pertain to taxes in the One Big Beautiful Bill Act (OBBB) signed by President Trump. The legislation makes permanent many key changes from 2017 that were set to expire at the end of 2025. This is the latest example of why we adjust our tax planning based on what changes in the tax code, not in anticipation of what might change. Here are some highlights of the OBBB -

- Probably the key component of the Act for taxpayers is that the lower federal income tax bracket rates that were enacted in 2017 are permanently extended and will not revert back to higher rates at the end of 2025. Tax brackets will be inflation adjusted starting in 2026.
- The OBBB Makes permanent the increased standard deduction in effect since 2017 and annually adjusts it for inflation. Starting this year, the standard deduction increases to $15,750 for single filers, and $31,500 for married individuals filing jointly.
- The SALT (State and Local Taxes) cap limiting federal deduction for state and local taxes is raised to $40,000 from the current $10,000 and increases 1% annually through 2029. The provision takes effect this year but will revert to $10,000 in 2030. The SALT cap phases down for taxpayers with modified adjusted gross incomes (MAGI) over $500,000. For most taxpayers, MAGI will equal Adjusted Gross Income (AGI) which is the sum of all taxable income for the year.
- There is a $6,000 increase in the standard deduction for taxpayers who are 65 or older. The "senior deduction" begins to phase out when a taxpayer's MAGI exceeds $75,000 or $150,000 in the case of a joint return. This deduction is temporary and will only be in effect from 2025 through 2028. Go figure.
- The bill amends the estate tax exemption and lifetime gift tax exemption to $15 million for single filers and $30 million for joint filers starting in 2026 and it will be inflation adjusted annually.
- The bill makes permanent the $750,000 limit to home mortgage acquisition debt that can be used for the home mortgage interest deduction.
- The bill provides a deduction from AGI of up to $25,000 for qualified tips received by an individual in an occupation that customarily and regularly receives tips. The deduction begins to phase out when the taxpayer's MAGI exceeds $150,000 or $300,000 in the case of a joint return. This temporary deduction will be available for tax years 2025 through 2028.
- Similarly, for tax years 2025 through 2028, the bill provides a deduction from AGI of up to $12,500 or $25,000 in the case of a joint return, for qualified overtime compensation received by an individual during a given year. This deduction begins to phase out when the taxpayer's MAGI exceeds $150,000 or $300,000 for a joint return.
- In the case of tips and overtime, that income is still subject to Social Security and Medicare payroll taxes. Furthermore, the deductions are taken after Adjusted Gross Income (AGI) is calculated, meaning the deductions do not apply for calculating other tax items like the taxability of Social Security income, IRMAA surcharges for Medicare Part B premiums, or income limits for Roth IRA contributions.
- From 2025 through 2028 taxpayers may deduct up to $10,000 per year from AGI in interest paid on an auto loan for a new vehicle purchased for personal (non-commercial) use that has undergone final assembly in the U.S. This deduction is applicable to cars, SUVs, vans, pickup trucks, and motorcycles weighing under 14,000 pounds. The deduction phases out for taxpayers with a MAGI of $100,000 or $200,000 for married taxpayers filing jointly.
- The bill expands tax exempt distributions from 529 plans for education expenses in connection with enrollment at K-12 public, private or religious schools. Currently, families can withdraw up to $10,000 per year for elementary or secondary education. The law expands the maximum limit to $20,000 beginning in 2026. Expenses such as certifications, licenses, and other professional qualifications are now covered.
- Beginning in 2026, for taxpayers who take the standard deduction the bill allows a charitable contribution deduction of up to $1,000 for single filers or $2,000 for married taxpayers filing jointly. For those who itemize, the bill imposes a charitable deduction "floor" equal to 0.5% of AGI. For example, if you itemize deductions on your federal tax return and your AGI is $200,000 your charitable deduction "floor" is $1,000 (0.5% x $200,000). You will receive no deduction for the first $1,000 of charitable contributions for the year. This is to offset the $74 billion in projected lost tax revenue from the new charitable deduction benefit for taxpayers who take the standard deduction.
- The $7,500 tax credit for purchasing a new electric vehicle and the $4,000 tax credit for purchasing a used electric vehicle are repealed after September 30,2025.