ADVISOR PERSPECTIVES

The Best Books on Passive Investing: The Earth Does Revolve Around the Sun

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The evolution through which the literature on passive investing has gone is striking. Early writers started out with a point to prove: that passive investing is the only way to invest that makes sense. Today, the writing in this area has moved beyond "proving a point" to expanding on what is a settled issue.

The issue was settled by William Sharpe's 1991 Financial Analysts' Journal short article, "The Arithmetic of Active Management." Of course, others like John Bogle had been making Sharpe's argument for some time, but he was able to show the logic of why passive investing must work without resorting to data mining to prove his hypothesis. Of course, his Nobel laureate status added heft to his argument.

The books we review below, then, are the ones that essentially take passive investing as a given and expand to consider other aspects of investing over one's lifetime. The passive approach is a long-term approach, and all of the sources we mention below are dedicated to investing for the long term.

Further, several of the books we discuss below in some way respond to the recent conflagration in the stock market. As one would expect, we've lately seen no small outpouring of advice about the inefficacy of passive investment management — many have gone so far as to one more time pronounce the death of the passive approach. The early data on fund flows suggest, however, that passive investors have remained true to their approach, and not fled to the beckoning arms of the active managers. That restraint is to the credit of the authors who have continued to make the case for passive investment, and who are doing a service to the investing public.

Fairness and common sense requires that we start with John Bogle's recent (2010) update of his 1999 classic, Common Sense on Mutual Funds. Bogle uses the very effective technique of inserting highlighted sections labeled "Ten Years Later," in which he updates a specific topic at that point in the book. Similarly, with data tables he highlights the updated data. This is a comprehensive book and essentially covers the waterfront of investing in general and passive investing in particular. Bogle has, of course, written numerous books, blogs, etc., in his tireless quest to make the passive approach the norm.

Charles Ellis was also an early writer in the area, and his classic book Winning the Loser's Game is now in its 5th edition. While less comprehensive than Bogle's "Common Sense," it is well worth a read, and the book, which is a fairly easy read, may be a good place to start if you're new to this area. While mainly directed toward individual investors, it also touches on institutional investing.

Ellis recently teamed with Burton Malkiel (more on him below) to write a very short book (176 pages), The Elements of Investing. While the authors include a chapter on indexing, it is not the central theme of this book, which is more of a personal finance book. It begins with a good discussion on savings and touches on important topics such as asset allocation, diversification, and taxes. This book will whet your appetite for these two authors' larger works, and we suggest it as an excellent gift to young investors in your life.

This brings us to Malkiel's timeless masterpiece, A Random Walk Down Wall Street, first published in 1973 and now in its 9th (2007) edition. Used extensively in university investment courses, this book provides a comprehensive look at the world of investing, covering such topics as technical analysis, fundamental analysis, behavioral finance, and efficient market theory — just to name a few. While passive investing is where this book concludes, every serious investor — active or passive — should read it at some point. It is that good! In 2003 Malkiel, published a follow-up, The Random Walk Guide to Investing, which is a pared-down version of his masterpiece — a very effective cookbook-style manual of Malkiel's passive investment principles.

One of the more interesting reads on passive investment ironically comes from a very active-oriented institutional investment manager — David F. Swensen, the legendary chief investment officer of Yale University. In 2000 (updated in 2009) he wrote Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment, a top seller that gave insights into the very competitive world of highly active institutional investing. When he decided to write a similar book for personal investors, he wrote at the time, "the data clearly pointed to the failure of active management by profit-seeking mutual fund managers to produce satisfactory results for individual investors." He goes on to endorse the passive approach in Unconventional Success: A Fundamental Approach to Personal Investment.

The body of literature underlying the 'efficacy of passive investing' argument is relatively brief. The almost self-evident truths are backed up by fairly irrefutable data. As discussed earlier, William Sharpe did this with passive investing (and did it phenomenally well) in his Financial Analyst Journal article. Active management, however, has served as the norm for decades—if not centuries. The ‘passive’ authors, thus, have been charged with breaking the old investment habits so as to convince their readers to embrace an approach that is more likely to succeed over the long haul.

This task requires a modicum of hyperbole, a succinct recap of financial history and data, and a liberal repetition of the seemingly obvious conclusions to which all that information leads. William Bernstein and Larry Swedroe are, in our opinion, the best at doing this, and they do it for a crucial audience: a typical person-on-the-street for whom portfolio performance matters a great deal in achieving (or not achieving) specific financial goals.

For us, William Bernstein’s first book, The Intelligent Asset Allocator (2000), is his best. A concise book, it lays out the academic case for passive investing, and we’ve used it in our classes. It was not written for the classroom but rather for the popular press, and as such Bernstein does not consider the book a success — it is too “academic,” he says. He followed up with The Four Pillars of Investing, a slightly simplified version of his first book. For those who find “The Intelligent Asset Allocator” to be tough going, “Four Pillars” is a good substitute.

Bernstein’s latest book, The Investor's Manifesto: Preparing for Prosperity, Armageddon, and Everything in Between, is a reaction to the 2008-2009 stock market meltdown. In its pages he not only presents the theoretical framework for passive investing, but he goes on to provide detailed, nuts-and-bolts ETF/Index Fund portfolios for hypothetical investors with very different investment needs and goals.

For Bernstein, a good grasp of investment history goes a long way toward making an intelligent investor, and as such all of his books include a dose of history that puts modern investing in its proper context. In fact, he has written two very good economic history books, too: The Birth of Plenty: How the Prosperity of the Modern World was Created, and A Splendid Exchange: How Trade Shaped the World.   Bernstein is also the editor and founder of the web journal Efficient Frontier, where, among other information, you can find the first chapter of several of his books.

Larry Swedroe is a similarly prolific writer on passive investment. His fourth book, The Only Guide to a Winning Strategy You’ll Ever Need (last updated in 2005), takes a comprehensive approach to passive investing similar to Bernstein’s, but, because he is the director of research at Buckingham Asset Management, Larry’s writings are somewhat more data-driven than Bernstein’s. We have also used this book in our investment classes.

The evolution of passive investing writing that we mentioned at the beginning is best typified by Swedroe's work. Early on, he mainly focused on the index approach, but over the years he has written books about bonds, alternative investments, and financial planning. His latest book-writing venture is using storytelling techniques to illustrate and teach passive investment principles. In 2007 he wrote Wise Investing Made Simple: Larry Swedroe's Tales to Enrich Your Future, and a second volume of these stories will be published this coming summer. His considerable teaching skills are delightfully on display in these two books.

In his continued evolution as an investment writer dedicated to passive investing, Larry has recently started a well-received blog on CBS' MoneyWatch.com called Wise Investing. Each post is a very quick read focused on a narrow topic — again, data driven. If you read Swedroe's many books (he's written nine and co-authored several others) and keep up with his blog, you will be as grounded and up-to-date in passive investing principles as anyone can be.

Finally, we would be remiss if we didn't mention two other writers who, while not specifically focused on the indexing approach to investing, both write about investing using the passive approach as a starting point. Jason Zweig, who writes a regular column in the Wall Street Journal, has written several good books about investing and personal finance. His latest, dealing with the writings of legendary Benjamin Graham, comes out this spring. And Rick Ferri has written several books, but three that we regularly use as a resource are All About Index Funds, All About Asset Allocation, and The ETF Book. Any investment professional, whether they subscribe to the passive approach or not, should have these three Ferri books on his or her shelf — they are authoritative and great sources of information.

There are on-line forums dedicated to the passive investing approach to which anyone (passive investor or not) can post or simply read what others are discussing. There is the Morningstar-based Bogleheads Unite forum (formerly called Vanguard Diehards) and the independent Bogleheads.org forum. There are lots of lively arguments on these discussion boards as active and passive investors mix it up!

The passive vs. active debate has been ongoing for a very long time. The foundation for the theoretical superiority of passive over active approach was laid out very effectively by William Sharpe almost two decades ago in a simple, yet powerful paper. Much of the literature since has focused on getting the investing public to accept that it is, indeed, the Earth that revolves around the Sun and not vice-versa! This is not an easy task. Much of active management can be associated with a first-rate skill set, exceptional training, superior work ethic, and a viciously competitive spirit. It isn't easy for a typical investor to accept that active management (with those characteristics) *isn't* the route to take for statistically superior portfolio performance. Thus, the authors mentioned in this article have to be applauded for doing a remarkable job of using easy-to-relate to data to 'speak' to their readers about why passive investing is the *only* reasonable route to realization of one's financial dreams and goals.