On Course Financial Planning
Facing the Future with Optimism and Courage
June 2017
Vectors
geo@oncoursefp.com
425-861-9997

Is Indexing Mindless?

In 2016, investors pulled $340 billion out of actively managed mutual funds and invested more than $500 billion in index funds – continuing a trend that began in the early 2000s. Since then, almost $1 trillion has flowed into index funds at the expense of active funds. Estimates vary, but it is likely that about one quarter of the money invested in domestic stocks is passively invested in index funds. It's a tough time for mutual fund companies that specialize in active funds. They're laying off employees and closing underperforming funds. Active managers are fighting for survival and some are warning that the exodus of money out of active funds presents a clear and present danger to investors. Their argument goes something like this –

We are in danger of experiencing an "indexing bubble". Indexing is a "mindless" strategy because index investors accept current stock prices as fair and accurate, even when the market is at an all-time high. If the money invested in index funds continues to surge, this will lead to higher prices and create a stock market bubble – inevitably leading to a crash. Only "price sensitive" active managers can keep stock prices in check and keep this from happening.

This assertion sounds reasonable but is nonsensical. Passive index investors are “price takers” – they accept current prices as the best estimate of true value. Active investors are the “price setters” – their ongoing trading creates an efficient stock market in which prices incorporate all available information; including the consensus expectation of what lies ahead. For example, if a company announces disappointing earnings, active investors will sell shares but index funds will still buy the shares – at a lower price. This will continue until the consensus opinion of active investors creates a new, lower, "fair" price. Index funds don't set prices; they accept prices as they are.

Active managers have been creating stock market bubbles and crashes for centuries. There were stock market bubbles and crashes in 1907, 1929 and 1972 – just to name a few – all before the introduction of retail index funds. And it was active managers who inflated the prices of tech stocks before the dot-com bubble burst in 2000 - a time, not so long ago, when almost no one was using index funds.

If indexing investing becomes too popular, will there come a day when there won't be enough active managers to make for an efficient market? I doubt it. If the market becomes inefficient at pricing stocks, numerous active managers will generate market beating returns – bringing more active managers out of the woodwork. Performance chasing investors will reverse the flow of money from index funds to active funds, returning efficiency to the market. The opportunity to earn an almost unimaginable amount of money by outperforming the market, even if just for a short period of time, is enough incentive to ensure that there will always be more than enough active managers to preserve market efficiency.

A perennial problem for those who wish to outperform the market is that for a market timing or stock picking strategy to be successful, it must be kept secret. If it becomes well-known, its performance advantage will disappear. The same problem does not exist for index investors, who just wish to match the market's return. No matter how many investors implement a passive investment strategy, there will not be any "dilution" of the benefits of indexing,

Don't be fooled by claims that active managers can lower stock market risk. Just the opposite is true – active funds add risk. Investors in active funds assume manager risk - the risk that a manager picks the wrong stocks or makes poor market timing decisions. Index funds rise and fall in line with the market but active funds can fall more than the market – something I call "uncertainty risk".

Reversion to the mean is the 800-pound elephant in the room for active managers. S&P's Persistence Scorecard is a semiannual reminder that top-performing funds of the recent past are more likely to be underperformers in subsequent years than to remain top performers. The idea that active managers possess skill that makes them immune to market volatility is more marketing hype than reality.

The arithmetic behind index investing is irrefutable because investing is a zero-sum game. In any market, all securities are held by someone. Thus, if some investors are holding securities that do better than average, it must follow that other investors are holding underperformers and will do worse than average. For every winning dollar, there must be a losing dollar. The costs associated with active investing turn investing from a zero-sum game into a negative-sum game. The index investor can achieve the market's return at almost no cost. For example, the Vanguard Total Stock Market Index Fund ETF (VTI) has an annual expense ratio of 0.04%. Most actively managed domestic stock funds charge annual management fees between 0.5% and 1.0%. So, it should come as no surprise that most active funds underperform a comparable index fund by their difference in costs. Vanguard estimates that in the ten years ending 2015, investors paid $437 billion in active fund management fees. In return, the funds they owned underperformed their benchmark indexes by $545 billion.

Less than 20% of large-cap domestic fund managers outperformed the Russell 1000 large-cap stock index in 2016. A recent research paper, "Why Indexing Works" gives new insight into why so many smart fund managers fail at stock picking. The authors noted that the best-performing stocks in a broad market index perform much better than the average stock in the index. Most years, the performance of a stock index is produced by the large gains in just a handful of stocks that skew the market's average upward, a concept known as "positive skew". For example, in 2016 the 12.2% return of the S&P 500 Index was 1.5% higher than the median (half more, half less) average return of the stocks in the index. In other words, more than half the companies in the S&P 500 Index underperformed the index last year. A fund manager who owns a concentrated portfolio of just a few stocks is not engaging in a risk neutral activity; the strategy of attempting to beat the market's return with a concentrated portfolio is a fool's errand, a loser's game, a sucker's bet.

Historically, the average return of the stock market and the return of the average stock are surprisingly dissimilar. More than half of stocks have yielded a negative return over their lives as public companies. From 1926 through 2015, only 30 stocks (out of the 25,782 companies that were publicly traded during that period) accounted for one third of the cumulative gain of the US stock market. The best performing stock has been ExxonMobil. Less than 4% of all stocks (the top 1,000 performers) account for all the gain over those 90 years. As a group, the other 24,782 stocks underperformed the risk-free, one month US Treasury bill.

J.P. Morgan analyzed the 13,000 stocks that were members of the Russell 3000 total stock market index from 1980 through 2014. During their time in the index, 64% of these companies underperformed the Russell 3000 and 40% of the companies had a negative total return during their years in the index.

In summary, the research paper noted: *"Thus, active management may be even more challenging than previously believed… Missing (or underweighting) the securities that significantly outperform other securities is a strong headwind for an active manager to overcome. This view of the active – passive problem helps us understand the mystery of how so many smart people, with enormous financial and informational resources, systematically do such a poor job investing money… Put another way, passive investing may have a larger head start on active investing than previously believed."*

The rising popularity of index funds is due to the fact that they are easy to understand, transparent, diversified, inexpensive, tax efficient and always provide what's promised – 99.9% of the market's return. But there will always be investment professionals who proclaim the supposed benefits of active management, even as more and more investors come to realize that the promised benefits are more hype than reality. David Kostin, Goldman Sachs' chief U.S. equity strategist, predicted last December that the return of a stockpicker's market is "imminent". I'm not holding my breath. The best strategy to make money in stocks isn't by trading (attempting to anticipate what is going to happen) or selection (attempting to pick stocks that will outperform in the near-term) but by owning a broadly diversified selection of stocks and receiving dividends and their long-term increase in value. Index investing isn't a mindless strategy. It's based on empirical evidence, outperforms most active investors and always provides what it promises. To me, that makes it the most sensible strategy that investors can adopt.

Mia Culpa

In my March newsletter, I mentioned Warren Buffett's now famous bet: "*Over a ten-year period commencing on January 1, 2008 and ending on December 31, 2017, the S&P 500 will outperform a portfolio of funds of hedge funds, when performance is measured on a basis net of fees, costs and expenses."* He challenged any investment professional to select a group of at least five funds that invest in multiple hedge funds (called a fund-of-funds) that would outperform the Vanguard S&P 500 Index Fund over the subsequent decade. Only Ted Seides of Protégé Partners – which manages a fund of funds - took the bet. Through the end of 2016, the Vanguard fund was up 84% and the five funds-of-funds chosen by Seides were up just 22% - leading to Buffett's claim victory in his annual letter to Berkshire Hathaway shareholders in February. Last month, Seides threw in the towel and conceded defeat. However, he couldn't leave the ring without explaining in an article on Bloomberg.com why he lost the bet. He agreed with Buffett that the high fees charged by hedge funds create a performance drag that is hard to overcome but he also blamed unforeseen, extenuating circumstances for his loss –

- When the bet was made, the S&P 500 was near its all-time high. Seides assumed that it would generate lower than normal returns in the future which would have helped him win the bet. But, alas, "*the S&P 500 defied the odds and* *rewarded investors with a historically normal 7.1% nine-year annualized return."* Lesson for investors – predicting the future ten-year performance of any asset class is a fool's errand.

- Seides blames the current bull market (unforeseen by him) for his defeat. *"Hedge funds tend to significantly outperform in bear markets, as demonstrated in 2008 and 2000-2002. These same risk-mitigating properties tempered hedge fund returns in the rally that began in March 2009."* He conveniently fails to mention that when the market crashed in 2008, it gave his horses a huge lead right out of the gate – one that they couldn't maintain. Lesson for investors – investing is a marathon, not a sprint.

- Seides insists that since the S&P 500 Index isn't a total market index (it holds only large-cap domestic stocks), Buffett was really making and "active" bet by avoiding small-cap stocks and foreign stocks. "*During the last nine years, the S&P 500 outperformed most other investment options…Compared to more diversified, low-cost passive investments, the S&P 500 is biased toward U.S. stocks relative to global stocks and large companies relative to small ones. These two bets generated anomalously strong relative performance in this period"*. It's true that international stocks have performed poorly. From the beginning of the bet in January 2008 through the end of last year, the total return of the Vanguard S&P 500 Index Fund was 84% while the Vanguard Total International Stock Index Fund lost 6%. But the Vanguard Small Cap Index Fund was up 117% and the Vanguard Total Stock Market Index Fund was up 88%. Any of the hedge funds could have beaten Buffett by overweighting small-cap stocks or by just owning the Vanguard Total Stock Market Index Fund. To add insult to injury, the five funds chosen by Seides yielded a 22% average total return over the past nine years - 19% less than the return of the Vanguard Total Bond Market Index Fund. Lesson for investors – the future relative performance of various asset classes is unknowable.

- According to Seides, it's unfair to compare hedge fund performance to the S&P 500. "*Hedge funds are not limited to investments in large U.S. stocks, and professional investors in hedge funds don't use the S&P 500 as their benchmark…His excellent choice of the S&P 500 for the bet was the main reason he won."* Hedge fund investors believe that they are investing with the most capable money managers, the sharpest knives in the drawer. They assume that these experts know what assets to own and which to avoid - how else could they justify their usual fee of 2% plus 20% of any gain each year? Lesson for investors – when hedge funds outperform the market they advertise performance. When they underperform the market, they advertise low volatility. I call it retrospect advertising.

- During the financial crisis, the S&P 500 index declined 57%. Sides claims that his five funds had an average decline of only about half that. "*As a result, hedge-fund investors stood a much better chance of staying the course and earning the returns on the rebound, even if those returns were less than those of the index fund."* I don't buy it. Seides conveniently fails to mention that any investor could have limited their portfolio's downside to 25% during the financial crisis by owning a portfolio evenly divided between the Vanguard 500 Index Fund and the Vanguard Total Bond Market Index Fund. Most hedge fund investors are performance chasers. The HFRX Global Hedge Fund Index gained 2.5% last year – matching the return of the boring Vanguard Total Bond Market Index Fund. It should come as no surprise that clients withdrew $112 billion from hedge funds and 1,100 hedge funds ceased operations in 2016. Still, more than 9,700 hedge funds remain. Year-to-date, the HFRX Global Hedge Fund Index is up a mere 2.6% – about one third of that of the S&P 500 Index. Perhaps another 1,100 hedge funds will bite the dust in 2017. One can only hope.

All fund managers believe that they are rational, logical, and disciplined when looking at their past mistakes – their ability to earn a living depends on it. But all investors are subject to "hindsight bias". We tend to think that what is obvious to us today was also obvious in the past; causing us to forget that we had no idea what was going to happen. Hindsight bias is invisible, silent, colorless and odorless – a poison gas to the investor's mind. Buffett didn't bet that the S&P 500 would go up. He bet that over a decade long time horizon, hedge fund managers couldn't outsmart a simple index fund that is available to all investors at almost no cost. He wasn't predicting, he was calculating. Active managers always use 20/20 hindsight to find reasonable sounding excuses for their failures.

Apparently, Seides hasn't learned anything from losing the bet. "*My guess is that doubling down on a bet with Warren Buffett for the next ten years would hold greater than even odds of victory. The S&P 500 looks overpriced and has a reasonable chance of disappointing passive investors... Investing in hedge funds is a bet against continuing bull markets; investing in the S&P 500 is a bet on a continuing bull market."* Note to Seides - this is what you believed when you took the bet in the first place and why you chose the five funds that you did – funds that you believed would outperform the S&P 500. Seides' article comes straight out of Manager Excuses 101 - I was wrong then, but not now. It wasn't my fault; the gods were against me. It's a classic example of manager risk – or should I call it delusional manager risk?