

The Alleged Wisdom of Indexing

Index investing is based on several interlocking assumptions propounded by some academics and widely parroted by financial journalists. These are (1) that prices in security markets move randomly because markets are efficient; (2) that it is therefore impossible for anyone to beat the market except by dumb luck; and (3) therefore since one can do nothing about returns one should focus entirely on expenses and taxes so as to limit their drag on what will otherwise be an uncontrollable experience in terms of returns. Many advocates of indexing also urge that investors buy and hold for the long term, no matter what, because (again since prices allegedly move randomly) they say it is impossible to time the market.

Investors who index their assets have two choices: they must buy into the above assumptions (which come as a complete and inseparable package) and hope for the best -- or they can educate themselves about the economy and investing and attempt to do better by application of some common sense.

The nature of any broad index (e.g. the S&P 500, which follows large-capitalization U.S.-listed stocks) is that it attempts to represent the nature of the universe it covers. Investors buying an index-based product (mutual fund, ETF, or annuity using indexes) have no choices or power: they must take the whole index or leave it. Common sense tells us that at various times the whole market is overbought or oversold, and in particular that some types of stocks are risky holdings. It is of course impossible to sell stocks at their exact highs, but some obvious risks can be seen and indexed investing forces the investor to ignore them.

Risks to investments come from four major sources. One is the macro environment: if a severe recession or depression is beginning, stock prices will fall across the board. Another type of risk is industry or sector risk. Some parts of the economy have worse prospects than others (for example consumers will continue to buy groceries but may cut back sharply on buying new cars). A third type of fundamental risk is that specific companies are more vulnerable to setbacks or mortality – perhaps because of bad management, products or services made obsolete by competitors, or because they have too much financial leverage in their balance sheets. A final type of risk is simply stock-price risk: sometimes individual stocks or whole industry groups get ridiculously overpriced. That is fun while it is happening but is unsustainable. A recent example was the internet/technology bubble of 1999-2000.

The effect of owning an index fund is that an investor is forced to remain exposed to the losses involved in owning every component of the package. The index provider does not make judgments about the outlook for component companies; stocks are generally removed only if they become acquired by other companies (a happy event) or if they decline so sharply as to no longer fit the definition of an admissible component (an unhappy event recognized only very late).

In the past few years, for example, owning a large-stock index like the S&P 500 via a mutual fund or ETF has kept investors exposed to some companies and industries they would not rationally have chosen to buy or hold. In the post-911 world, airline stocks were removed from the major indices only when they went into bankruptcy or when their market capitalizations fell to such tiny sizes that they were no longer large enough to qualify. Rational, observant investors would long ago have wanted not to be invested in that industry. Similarly, the housing decline started in the autumn of 2005; reasonably smart investors would have wanted “out” long ago, but homebuilder stocks remain in the indexes. Most recently and painfully, banking and brokerage stocks have been terrible performers as the forced unwinding of financial over-leveraging has caused failures and takeovers at distress prices. Yet these remained in the indices, forcing passive index investors to ride them all the way down. Presently, if one believes that a worldwide recession will cause a drop in demand for energy (an arguable issue), by owning an index fund one remains fully exposed to oil stocks, like them or not.

To make matters worse, when a component of an index is deleted for some reason (typically, only because of bankruptcy or dire price decline), it is replaced by another company whose stock is up rather than down. For example, the sponsors of a large-capitalization index choose among the largest non-included stocks when selecting a replacement component. This means that the index becomes more heavily represented in industry groups that have already performed better than average. The phrase ‘buy high and sell low’ correctly describes this pattern.

Expenses and taxes driven by portfolio turnover, which are predictably low in index funds, are the only attributes that academics and media writers can calculate. So they focus on those issues, which by definition are immensely smaller than variance in performance. So the focus of many investors who buy index funds and index ETFs is on the wrong (smallest) issue.

Individuals need to learn to become intelligent investors. This is a necessary life skill. Turning it over (‘outsourcing’) leaves one at the mercy of those given power over your assets and therefore over your financial future. Some parties in the investment industry may not be especially talented, and of course we have all heard of those who are dishonest. And still others may be too aggressive or too cautious for your personal needs. Learning to be an investor is not like rocket science. Much as we wish otherwise, there is never a perfect answer or a risk-free solution. The world is constantly changing, so we must develop some skill at analyzing things and must become able to make changes in our holdings rather than blindly hold in hope that things will get better. As recent events have stunningly demonstrated, companies with famous names cannot be blindly assumed to remain always strong forever.

Indexing makes one a passive investor in a full basket, and some of the apples in that basket predictably go bad. That’s what happens in a dynamic world.