Is Popularity Ruining Indexing?
February 28, 2012

William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

We have been traveling around the world delivering a talk to CFA Societies on why passive indexes beat most active equity funds. We start the talk with the following William Sharpe quote from 2002:

"Should everyone index everything? The answer is resoundingly no. In fact, if everyone indexed, capital markets would cease to provide the relatively efficient security prices that make indexing an attractive strategy for some investors. All the research undertaken by active managers keeps prices closer to values, enabling indexed investors to catch a free ride without paying the costs. Thus there is a fragile equilibrium in which some investors choose to index some or all of their money, while the rest continue to search for mispriced securities.

Should you index at least some of your portfolio? This is up to you. I only suggest that you consider the option. In the long run this boring approach can give you more time for more interesting activities such as music, art, literature, sports, and so on."

Jason Zweig of the Wall Street Journal wrote a blog last week titled, "Simple Index Funds May Be Complicating the Stock Market". In it he explained how passive investments have risen to 33% of the money in equity mutual funds. He theorizes that all these agnostic investments might be adding to the volatility and the high correlations in the marketplace:

"Recently, leading investing experts—including Rodney Sullivan, editor of the Financial Analysts Journal, consultant James Xiong of Morningstar Investment Management and Jeffrey Wurgler, a finance professor at New York University—have been warning that index funds could destabilize the financial markets.

The rise of trading in index funds, these researchers say, is causing stocks to move more tightly together than ever before—as if they "have joined a new school of fish," as Prof. Wurgler puts it. That is reducing the power of diversification and could make booms and busts more likely and more extreme.

Unlike conventional funds run by highly paid stock-pickers who seek to buy the best securities and avoid the worst, index funds—including most exchange-traded funds, or ETFs—effectively buy and hold all the securities in a market benchmark such as the Standard & Poor's 500-stock index."

Let us unpack Sharpe's theory, Zweig's hypothesis and our manifesto on "Long Duration Common Stock Investing", to see if we can make sense out of today's stock market environment.

William Sharpe was an efficient market believer in 2002. His beliefs are predicated on two ideas. First, "All the research undertaken by active managers keeps prices closer to values, enabling indexed investors to catch a free ride without paying the costs." In his research on intrinsic values in February of 2009, Ben Inker at Grantham, Mayo and Van OtterLoo (GMO) concluded that 75% of the intrinsic value of a company comes from cash flows starting 11 years from now and that 50% of the intrinsic value is from cash flows that come more than 25 years from today. Since there is almost no long duration equity research analysis done on Wall Street, the market can't possibly be efficient. The stock market and its participants have been compacting the duration of their equity investments constantly since the stock market topped in early 2000. Holding periods are down to historically low levels on the NYSE, institutions are heavily committed to hedge funds with very high turnover and active equity fund managers have average turnover around 100%. A manager with 50% turnover is considered a low turnover manager!

Second, Sharpe was expecting that those who get paid to asset allocate would never get so heavily involved in indexing as to ruin the goose that laid the inexpensive and consistent "golden eggs". Indexing success is predicated on being a small minority of the marketplace. In effect, its popularity is dooming the strategy and making the market even more inefficient than it was before! Between short-sighted active investors and agnostic indexers dominating the market, Zweig explains that you get very high correlations and extreme volatility. The volatility drives potential long duration investors away from the marketplace.

"Considering that index funds charge annual fees about one-10th of those levied by actively managed funds, it isn't any wonder indexing has become a money magnet. A decade ago, 278 index mutual funds and 119 exchange-traded funds held $347 billion, or about 16% of all assets in U.S. stock funds. Today, according to Morningstar, 336 index funds and 1,148 ETFs hold $1.24 trillion, or fully one-third of all the money in U.S. stock funds.

That worries some analysts. "Markets work best when people think and act independently, not all together," Mr. Sullivan says. When investors add money to an index fund, it generally will buy every security in the market that it tracks—hundreds, sometimes thousands at a time, regardless of price. When investors pull money out, the index fund has to sell across the board."

We believe the solution to these times is at the heart of our manifesto. You need to analyze companies with a special focus on characteristics which contribute to long duration. We like wide moats, sustainable high profitability, high free cash flow and strong balance sheets. GMO likes low beta, low leverage, high sustainable profitability and low earnings volatility. These are all factors which contribute alpha over long stretches of time.

In our opinion, you either need to be a low turnover stock selector or hire one to be your equity representative. Warren Buffett is quoted as saying, "The stock market serves as a relocation center at which money is moved from the active to the patient." The main attraction to the S&P 500 Index is it has low management fees in a mutual fund or ETF form and very low trading costs due to turnover that averages below 5% per year. Boston College's Center for Retirement Research found that the average US equity fund spent 1.44% per year on trading costs. Add this to management fees and operating expenses in the mutual fund world and you need the equity manager to beat the S&P 500 Index by at least 2.5% per year just to keep up. We strive for turnover in the 15-25% range and seek miniscule trading costs.

Scarcity creates value in economics. In our view, what is scarce today is an equity manager doing long-term/long duration equity analysis and institutions/individual investors willing to employ them. Since 33% of the stock market is indexed and most of the other 67% works in very short analytic time frames, we believe the market must be as inefficient as it has ever been. Time is the ally of the long-duration common stock investor and we believe more so now, because indexing is getting too popular and investing in short durations is at epidemic levels. We wonder what William Sharpe would say today.

Best Wishes,

William Smead

This Missive and others are available at www.smeadblog.com.