Indexing: The Key to Sensible Investing

In the age robo-advisory, wirehouses are progressively relying on enhanced machine-learning and indexing methods to achieve diversified investments with attractive returns for passive investors. Mutual funds and other open-end vehicles are constructing funds to mimic the returns of the broader S&P 500. And for good reason! We are currently in the tenth year of economic recovery since the financial crisis. Since 2007 to 2017, the S&P has averaged a compounded return of 13.3%. and currently performing 93.14% up 10 years from today. Hedge funds only averaged a 0.12% compounded return over the same period. Moreover, sector and industry performances have yielded significant double-digit returns, namely in Consumer Discretionary, IT and Healthcare, whereas sectors such as Telecom and Energy have produced weaker returns of 3.30% and -13.78%, respectively.

If you are not a market analyst spending hours a day reading on the new developments of every single sector, creating complex quantitative models to assess future performance and undertaking endless sensitivity analysis, then this is for you.

First, let’s define what exactly is indexing? What are the benefits of passive investing over more active strategies, the risks, and why should you advocate for the former? Lastly, what is the significance of indexing today as opposed to before?

Broadly speaking, a financial index is a market-capitalization weighted static basket of securities used to assess a market’s financial activity. In the 19th century, Charles H. Dow created the first market index as an average of stock prices to communicate the financial health of a market. The first index, colloquially known as the Dow Jones Transportation Average, was an indicator to the transportation sector. This ultimately led to the developed of the Dow Jones Industrial Average (DJIA) in 1896. These indicators were essential for assessing the health of an economy, and usually, the DJIA could explain the performance of the DJTA. For example, if the DJTA was performing poorly, it could be because industrials were down, so the two move in tandem.

Therefore, an index fund constructed of a diversified set of companies across industries could serve as a proxy for the market portfolio. This has many distinctive benefits. Firstly, it is a clear and transparent strategy able to be understood by most simple investors. The intuition is simple: by not putting all your eggs in one basket, you are spreading your risk across different sectors with the attitude that the overall market will appreciate in value. The evidence previously mentioned by the S&P returns for 10 years since year-end 2017 accentuate just that. More broadly, if you assess how financial institutions are evolving, the growth of technology, and the rise of innovative healthcare solutions are all indicative of growth to come.

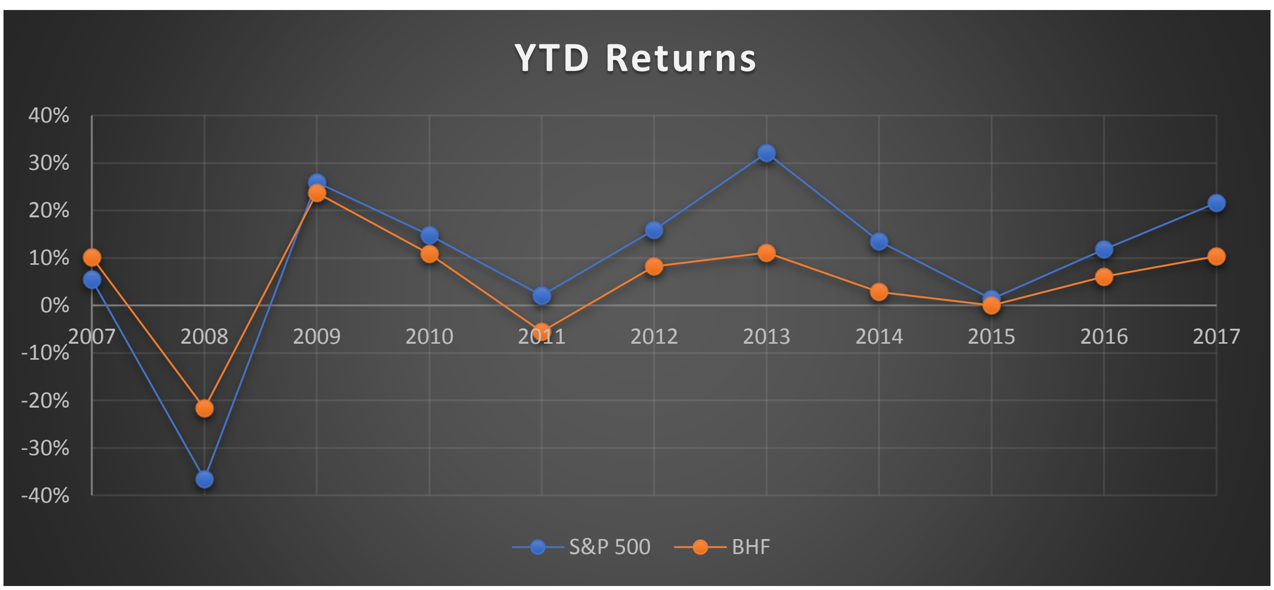
This allows investors in such funds to take the back-seat while the market yields all returns for them. It is also consistent with Eugene Fama’s Strong-Form Efficient Market Hypothesis, which states that since all inside and public information is already discounted into a stock’s price, it is impossible to earn excess or abnormal returns. This does not mean you cannot have positive gains, but rather, you will be rewarded for the amount of risk you are exposed to.

The simple investor can also appreciate index funds for the benefits of diversification in achieving long-term, sustainable returns. If you invest all your money in a single stock or sector believing it will appreciate over time, and does not reach your expectations, you will be disappointed and lose wealth. However, if you look across industries and companies and allocate your investment accordingly, you may receive positive and negative gains, as opposed to being exposed to only one direction. This is sublime for the risk-averse investor who does not understand the intricacies of the market and is highly sensitive to capital losses.

However, every strategy comes with risks. An index fund may diversify the idiosyncratic, i.e. the stock-specific, risk in a portfolio but still face systematic, or market risk. From history, we can see that the market does not always yield positive results. Take the dot-com bust years of 2000-2002 or the financial crisis of 2008. By investing in an index fund, you are essentially long the market and forfeit the opportunity for short-term capital appreciation by taking an alternative stance in bear market years. You must have the sentiment and discipline to ride out the harder years and stick to your belief that the market will continue to rise.

The other disadvantage of most funds is that you cannot compose the basket of securities; they are already predetermined by the fund manager. Though you may not concern yourself with which companies are in because you are only interested in seeing results, there may be certain things you know about different industries that the fund manager doesn't. As a result, you may want to allocate more of your money to a healthcare sector rather than sticking it in an general market-cap index to reap the benefits of capital appreciation you believe exist.

If you are reading this and you are new to the world of finance and investing, this is my advice for you; don't believe you can beat the market. Here's why:



As you can see, Hedge Funds (as measured by the Barclay Hedge Fund Index) only outperformed the market in years of financial distress, probably as a consequence of implementing hedging strategies to minimize capital losses. Every other year, the market has outperformed active managers on a nominal basis, and it is worth considering the effects of management and performance fees these funds charge.

An index like the SPX (the proxy for the S&P 500) usually stands as a benchmark for active managers to beat. It's implication is as simple as saying, "This is how you performed relative to placing your money in a market-cap fund and did nothing". If a seasoned investor has had issues beating the market most years, it may be worth considering before you attempt your own active strategy.

Indexing is one of several great methods of investing for retirement in a conservative, sensible manner. The stable returns, the diversification of capital, and the low fees all contribute to positive appreciation with a long-term focus for the predominantly risk-averse investor.

Why does indexing matter more today than it has in the past? There are a couple of reasons. A study conducted by the National Institute of Retirement Savings found that millennials, who are the largest, best educated and most diverse generating in U.S history are not financially savvy. Nearly 66.2% of working Millennials have nothing saved for retirement, and only 5% have saved adequately for retirement. Moreover, 66% of Millennials work for an employer that offers a retirement plan but only 34.3% participate in their employer's plan.

What does this mean? Well, it could indicate a few things. First being that this generation lacks a strong understanding of money management and the magic of compounding. It can also be evidenced with the rising costs of living and higher consumption patterns. Nevertheless, it overall suggests a large portion of capital received by labor is not in the hands of the financial markets. Prospective investors are sitting on a pile of cash that could be growing if it were invested in companies that could apply that capital for profitable projects. This would result in a long-term stock price appreciation, thereby benefitting both the firm seeking money and the investor providing that money.

Secondly, look where we are in terms of technological advancements as opposed to five or even ten years ago. The uncertainty of the future, the rising fears of an upcoming recession are driving cash into investor's pockets. But, where is the future headed? Driverless cars, robotic surgery, groundbreaking developments in medicine all point to a brighter future. But to get there, companies need capital to invest in such projects. If you don't want a company to go bust by levering up their balance sheet over 4x earnings, you may be the key to getting them there.

I have a long-term investment horizon, and I strongly believe in the potential for the market to grow. My core investment beliefs are centered around companies with strong fundamentals and ample prospects for growth with a strong focus on ESG. As a fervent advocate of the EMH, I ascertain this is how I will achieve long-term capital appreciation.

In sum, there are benefits are risks to passive strategies. Ultimately, as an individual investor, you should assess your risk tolerance, your long-term beliefs for the market, and your retirement goals.

To your success,

Bryan Baratian

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