April 14, 2017

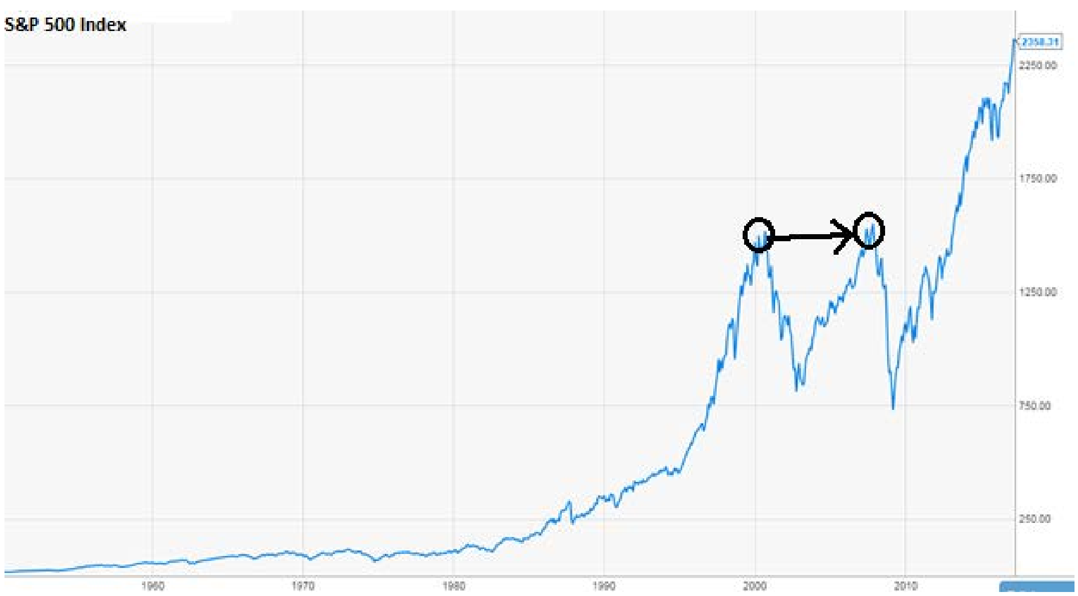
Re: Index Funds

Dear client,

Since our April conference call last week, some of our clients have asked me to explain why I think index funds could be bad for retirees. I have been thinking about this very subject since the ‘dot-com’ bubble in 2000 and subsequent market crash. I would like to share with you my thoughts on this subject.

As we discussed in our April conference call, the biggest problem with index funds occurs at market peaks. In year 2000, many people inside and outside of technology stocks got terribly hurt in that downturn. In fact, after the 2000 bust, index funds remained flat for long period of time with little or no return. We can see from Chart 1 that the S&P 500 was flat for over 10 years. Obviously, an S&P 500 index fund would have performed the same as the underlying index. In contrast, good money managers can produce positive returns when index funds don’t, if those managers can carefully select stocks that are not overvalued and balance the portfolio with bonds and other asset classes. This is especially true in declining markets and corrections. Another major problem with index funds is that they may not offer shelter from a bubble. Again, the 1999 peak in the S&P 500, in Chart 1, proves my point.

Chart 1



Because of the way traditional indexes are structured, the bigger the company, the bigger its weight in the benchmark relative to other stocks. This can leave you more vulnerable to bubbles. For example, technology stocks made up nearly 30% of the S&P 500 in 1999. By 2002, technology stocks made up just 14% of the index. However, today, the allocation of tech is back up to 20%.

In periods of high market volatility, getting out of index funds may prove to be problematic because many investors in those funds may be heading for the exits.

What is really worrisome to me are the distorted levels of valuation within index funds. The combination of a long market rise (2009-present) and a significant shift to passive investing has indiscriminately overvalued the majority of the stocks in the S&P 500, Russell 2000 and Dow Jones Industrial Averages. Stocks that might not be bought singly on their own merits have been lifted by the wholesale buying which has led to outlandish valuations. If the market is overvalued, indexes are overvalued even more. This creates and environment not unlike the "dot-com" era.

The stock market has proved to be a great investment in the long run, but it hasn't gone up in a straight line. There are years when the market does fine, but in other years, the market can significantly decline No doubt, investing in an index fund like the S&P 500, will give you the upside when the market is doing well, but also leaves you completely vulnerable to the downside.

However, active management can take advantage of the misguided behavior in the market, something an index fund can't do because an index is set and can't be changed. A smart investor can watch out for good companies that become undervalued and sell companies that become overvalued for the same reason. For example, Elbit Systems in Chart 2 was an undervalued (in my opinion) cybersecurity stock when we purchased it. We wanted to focus on the cybersecurity sector and other profitable sectors of the market and not blindly invest in an index that contains stocks we don't want. Benjamin Graham, the father of value investing, believed that purchasing undervalued stocks when they are cheap and selling them when they are dear is most likely to prove to be profitable and be of lower risk than purchasing overvalued stocks.

Chart 2

Index investing does not allow an astute investor to purchase undervalued stocks and sell them when they are overvalued. In an index, an overvalued stock carries more weight in that index because most indexes are weighted towards the highest capitalization of the stocks in the portfolio. This is opposite of what should happen. If a stock is overvalued, exposure to that stock should be lowered or it should be sold.

There have been studies both in favor and against index investing. It is true that many managers perform worse than their comparative benchmarks, but that does not change the fact that there are exceptional managers who regularly outperform the market. Index investing has merit, but there are many reasons why it's not always the best route to achieving your personal investing goals.

Best regards,

Steven Yamshon
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