The Emperor's New Index Fund

The popularity of indexing, and of new financial products built around the idea of buying everything in a category rather than imposing traditional criteria on stock or bond investments, continues to grow unabated. Aided by marketing from those whose business is built around selling such investments, as well as financial writers who position such investment as a sort of Robin Hood to rescue the people from the villains of Wall Street, the reputation of indexing and ETFs have reached a point where few voices are raised questioning whether they are actually the best way to invest. Formerly termed "passive" investing, because such vehicles did not "actively" evaluate companies for the deployment of capital, this term (with its negative connotations of inactivity and weakness) has been replaced recently by a new adjective with better marketing promise: "insensitive" investing, in which the vehicle you buy is "insensitive" to the business prospects of the underlying companies. As in the story of the emperor who had no clothes, the adoration of the crowds for these new media darlings bears closer examination.

At Taylor Frigon Capital Management we do not use insensitive investments for our own capital nor do we advise others to do so, for several reasons. Most fundamentally, we seek long-term investment success through ownership in businesses, while indexes and ETFs, by definition, are tools for *participation* in markets or sections of markets – a critical distinction. In spite of the usual benefits cited as the unassailable arguments for passive investing – lower cost, and performance records that beat the performance records of many active managers – rejecting fundamental criteria for evaluating companies into which you deploy your capital is not the wisest process for achieving goals over the course of many years or even decades. Can you imagine a venture capitalist firm that simply gave capital to every single entrepreneur that approached them, without scrutinizing the business plans of those hopeful entrepreneurs? The past hundred and fifty years testify that the vast majority of wealthy people gained their wealth through ownership of good companies. Yet suddenly much of the world is ready to abandon the well-developed criteria for evaluating companies and replace them with a mindset of participation in one section of the market or another, although the criteria for analyzing a market sector are imprecise and largely unproven. Whether the growth of larger and larger piles of capital that blanket entire sectors or markets without regard for the individual business prospects of various companies proves unhealthy on a large scale is still open for debate; however, it is equally true that at the level of the individual, the foundation, or the institution, the proposition that indexes and ETFs are the best basis for long-term success should certainly be open for debate as well. The current climate is such that anyone arguing against indexes and ETFs can face the knee-jerk reaction accusing him of having only his own "big Wall Street" profits as a motive – although the motives of the accusers, who may well have a profit motive in the growth of the insensitive investing trend, are rarely considered. At Taylor Frigon Capital Management, we are not afraid to stand up for the ownership of individual companies based on their business prospects, and to point out some of the questionable aspects of the emperor's new clothes.

The entire concept of insensitive investing attempts to eliminate the importance of the business prospects of the companies investors own. The simple fact is that just because a company has gone through the regulatory hurdles and offered its stock to the public does not make it a good investment. Bad companies exist. Insensitive instruments force you to fund those companies with your money. Giving money to every company that approaches you would be like betting on every hand you are dealt in a poker game, regardless of whether you have a royal flush or a complete bust (and betting the same amount on each hand to boot). On the other side of the coin, exceptional companies exist also, but insensitive investing downplays the importance of trying to seek them out. And even wealthy people can be talked into indexing, even though most wealthy people achieved their wealth in the first place through association with, and ownership of, exceptional companies. Refusing to look at the quality of the companies into which you deploy your capital is analogous to refusing to care about the quality of the companies that you work for over the course of your life. Maybe the financial media should be counseling people to just accept every job offer they get, regardless of the prospects, because that is the most reliable way to achieve your goals! Such advice would be ridiculous, and yet that is what they are advising that you do with your money, without fear of criticism.

The natural result of abandoning a process based on ownership of businesses is a focus on markets. There is a key distinction between the market price of a stock and the business underneath the market price for that business – they are two different things, as Ben Graham labored to explain by way of an illustration “in the nature of a parable” in the 1949 edition of *The Intelligent Investor*. Graham posited a small private business in which you own a share, and your irrational business partner, Mr. Market, who often “lets his enthusiasm or his fears run away with him” and who daily proposes to tell you what your business is worth and either buy your share of it or sell you more of the same, at a value that often “seems to you a little short of silly” (42). Graham was distinguishing between the business itself and the often very divergent market price for that business. It is clear that, once you abandon the principle of analyzing the business itself, you are thrown upon the alternative strategy of playing Mr. Market instead. You may have a plan for giving more to one Mr. Market when his fears are running away with him, and taking back from other Mr. Markets when their enthusiasm has been running for a while, but you are now focusing on Mr. Market instead of the underlying business. Strategies based upon index funds and ETFs, by their own admission, eschew the idea of looking at the underlying business, and replace it with a process based on participating in this sector or that sector, this geographic region or that one, this band of market capitalization one year and that band of market cap the next. But that is the inevitable consequence of “insensitive” investing’s rejection of the analysis of business fundamentals.

Although proponents of indexes and ETFs loudly assert the “inevitable failure of individual investment managers to outpace the market” (in the words of John Bogle), many of the processes that employ those vehicles are based on trying to “outpace the market” by other schemes. Typical is to overweight one sector or set of sectors at one time, and then making a call as to the best moment to shift to a different set of sectors to overweight (or geographic regions, or industries, or currencies, or market capitalizations). A variation on this theme is the popular “core-satellite” approach developed by those whose process entails buying every single company in a broad market index with the bulk of one’s capital (the “core”) and then relying on an ability to pick a few “hot” sectors or themes at any given time (like biotech, or energy, or some other timely story) which are purchased as “satellites” to juice returns over and above the core index. It is amazing that the same people who are vehement that nobody has the acumen to beat the market by selecting individual companies can convince the world that they can beat the market by cunningly selecting gigantic baskets of stocks in a sector. The fact is that portfolio management requires a disciplined and consistent process, with well-developed criteria for evaluating what to buy and sell and when to buy and sell it. Some adopters of these new ideas may have a process, although many appear to be doing it based on gut feelings. It is certain, however, that the criteria for evaluating the business aspects of a company are far more numerous and well-developed than the criteria for evaluating a sector. Shifting in and out of sectors or other "satellite" selections without a valid, consistent process is a recipe for underperformance that is as inevitable as anything that indexers can say about active managers. Furthermore, many records exist of active managers who have decidedly beaten the averages over a period of many years. And, investors with significant wealth to invest do not have to look to the historical records of others: chances are, their own history of obtaining that wealth involved a successful business that they themselves either started, owned, worked for, or all of the above. This personal history at the disposal of nearly every investor argues for a process based upon business ownership, and against a process based upon timing the moody swings of Mr. Market.

Finally, it is certain that most of the processes of investing in insensitive investment vehicles like indexes and ETFs are recent and have no significant track record. Investing based upon the analysis of individual companies, and the stocks and bonds that those companies issue, has almost a hundred years of history that contributed to the tools available today for the analysis of a business and its potential as an investment. It is a field of study which has been shaped by the candid written contributions from geniuses such as Thomas Rowe Price, Benjamin Graham, David Dodd, and countless others, many of whom backed up their intellectual assessment with decades of actual practical experience investing real money into real businesses. By contrast, indexing and ETF investing and all the core-satellite methods currently being sold to investors are a very recent phenomenon. Sales literature for strategies based on these vehicles may show historical charts going back years or even decades, but examination of the fine print often reveals that these are "theoretical returns" of what someone "would have" achieved if they used some method developed with the benefit of hindsight. Before jumping onto the current investment idea that everyone has decided is beyond reproach, investors should ask themselves what new method the investment community will be pushing in five, ten, or twenty years, complete with new hypothetical returns based upon what "would have" worked very well.

Insensitive investing, in which investors are told to ignore the business prospects of a company, has achieved a kind of conventional-wisdom nirvana, in which the media, the world of academia, and most of the people you meet can declare confidently that "just indexing" is the wisest path for investment success. Few dare to attack this groupthink. But, abandoning the ownership of individual companies for their business prospects should not be done lightly. Building a process around insensitive investments is not as easy as it might appear, because the criteria for evaluating a sector of companies are much less rigorous than the criteria that have been developed over many decades for evaluating those companies themselves. Methods recommended for insensitive investment processes often involve shifting to overweight one sector and underweight another, and then back again, or some variation of the core-satellite idea, but these methods have a dubious history. Hypothetical track records, which are sometimes used to show what could have been achieved by some novel method, should cause those who are thinking about indexing to ask another question: "If I could pick individual stocks over the past twenty years, with the benefit of hindsight, could I have beaten an index?" If the answer is yes, it stands to reason that some companies are better than others, and undermines the premise of being insensitive to business prospects, no matter how many people have currently convinced themselves otherwise.

Works Cited

Graham, Benjamin. *The Intelligent Investor*. New York: Harper, 1949. Reprint 2005.
Bogle, John C. "Forward to *The Intelligent Investor*." New York: Harper, 2005.