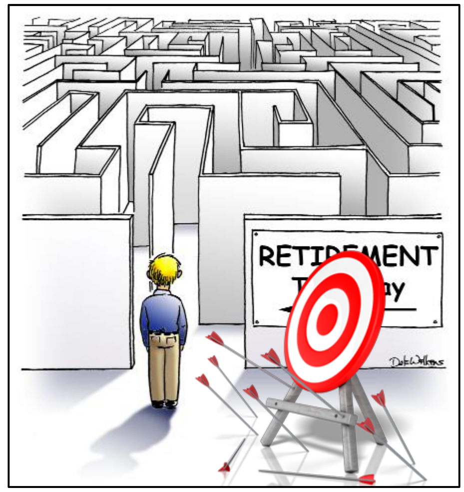
Reprinted from the
Lexington Minuteman

COROMANDEL WEALTH MANAGEMENT

March 2017

Why Indexing Doesn't Always Work

Navigating the Retirement Maze



"Everything popular is wrong."

– Oscar Wilde, author, poet, playwright (1854 – 1900)

These days, most investors have become members of the "Church of Low-fee Index Funds." The fact that Vanguard, the creator of the first index fund and regarded as the reigning index fund champion, pulled in more new money last year than all its competitors combined, attests to the current popularity of low-cost passive investing. It has proven to be a good strategy for the past eight years, as the US markets have risen considerably from their 2009 lows, and only a small percentage of actively managed large-cap funds have been able to best the S&P 500 over that time.

However, no strategy works all the time. What goes up eventually comes down, and it can be quite a shock after eight years of gains. As more investors move greater percentages of their assets into US index funds, we're starting to see some evidence of a "crowd mentality." And what crowds tend to do best is panic when they shouldn't. I have no doubt that many investors will feel compelled to bail on stocks at the next significant market correction, once their losses exceed their personal pain threshold, and sell at the worst possible time. The popularity of indexing has ironically set the stage for amplified losses during a correction – when an index fund is sold, the fund must sell a proportion of all of the stocks in that index – and when that happen, many investors may start to question their choice of religion.

It makes sense to take a closer look at indexing in order to understand its underlying principles, as well as how it can affect investments both positively and negatively. That way, you may avoid being part of "The Panic of 201?".

Indexing 101

You can't buy an index. It is a number created by a third-party company – Standard & Poor's, Barclays, Morgan Stanley – to indicate the current pricing of a collection of stocks, bonds, or other financial instruments. What you can buy is a fund that attempts to replicate a specific index, the most popular of which is the S&P 500. There are hundreds of financial indices, many of which are used by index funds and exchange traded funds (ETFs). An important distinction is that each index uses its own selection criteria and weighting methodology. For example, the S&P 500 is an index of the 500 largest US stocks by market capitalization, where the percentage of a stock's position in that index is proportional to its market cap. Thus, Apple currently represents 3.66 percent of the total S&P 500 weighting, and the ten largest stocks by market cap, or 2 percent of the stocks in the index, account for 18.5 percent of the weighting. By comparison, an equal-weighted S&P 500 stock index gives the same weighting to the smallest stock in it as it does to Apple.

What most investors fail to understand about indexing is that its advantage over actively managed funds is due primarily to two things: low cost and a "buy and hold" strategy. Absent the management fees, many actively managed funds have been shown to exceed the performance of index funds. It is the lower fees that tip the balance in favor of index funds. It is also a function of not trying to time the market, as many investors tend to sell at the worst possible time.

Large crowd, small exit door

An important aspect of index funds is that as more investors purchase funds based on a particular index, those funds must purchase more of the underlying holdings in the index, thus pushing up the price of those securities. As an index fund holder, you may view this as a good thing. Well, at least while index fund assets are growing. In the event of a market correction, when investors started selling off their index fund holdings, the opposite occurs. Decreasing index fund assets means lower demand for the underlying securities in the index, and those shares will fall. The greater the total assets invested in these funds, the more pronounced the effect on price loss. Google the phrase "positive feedback" to better understand this phenomenon.

Two things that you can do to mute this effect are to diversify your holdings outside of just one or two index funds, and to resist the urge to sell when the rest of the world is doing this.

Bond index funds: Caveat investor

I have come to believe that bond index funds are not worth the lower fees, and come with inherent risks that most investors don't understand. Like their equity counterparts, many bond index funds are cap weighted, which means that the largest holdings in the funds are those companies with the largest amounts of debt outstanding. For example, the two largest "junk bond" ETFs have over $28 billion in assets. In the event of an economic downturn, the first casualties are often those companies with the largest debt burdens.

As simple as the concept of a bond is – you loan a company money, and they pay you interest – the reality of bond selection is much more complex. Many factors go into the valuation of a bond, and I want my clients to be holding bond funds that are actively managed, with managers who are highly trained bond specialists. Bonds also tend to be less liquid than stocks, and massive sell-offs can result in disproportionate losses to fund holders. I'm willing to pay a few tenths of a percent more in management fees for that level of expertise, or for an actively managed closed end fund that is selling at a 10 percent discount to its underlying assets.

When active management wins

The effect by popular index funds on the prices of securities as described above can have another consequence: those securities not included in the indices tend to see lower demand, and thus may be underpriced relative to their value. Enter the actively managed fund. Unlike index funds, they are not constrained to purchase specific stocks, only those within the prospectus guidelines for the fund, and so they can search for bargains ignored by the indices. The greater the popularity of index funds, the more bargains available for the actively managed funds. So ironically, the immense popularity of indexing could actually be a boon to them.

Solution: Mix and match

Index funds have proven to be a good addition to investment portfolios, but don't become overly reliant on their ability to always outperform managed funds. Diversify your holdings among different index funds and asset classes, and consider some of the better actively managed funds, and you are less likely to be a victim of "crowd mentality" when the markets eventually correct.

George Gagliardi is a financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor. *This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.*

Coromandel Wealth Management
15 Muzzey Street
Lexington, MA 02421

Phone: 781.728.9001
info@CoromandelWM.com
www.CoromandelWM.com