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Is Indexing Getting Too Popular?

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Market watchers have noted the stunning growth of indexed vehicles over the last few years. Coupled with the ease of trading and transparency of exchange-traded funds (ETFs), the low cost and tax efficiency of indexing have led to a boom in the growth of these vehicles to the detriment of actively-managed mutual funds. With indexing beating the majority of active managers in most asset classes, indexing has been an easy concept for investors to buy into.

Domestic equity index funds (including ETFs) have seen growth in assets every single year since 1993, with net new flows exceeding $250 billion in 2016, according to Ned Davis Research. In contrast, domestic equity active mutual funds have seen net outflows for 11 straight years beginning in 2006. Last year, net outflows topped $320 billion, the highest on record.

The popularity of indexing has been driven by a convincing performance advantage. According to the Wall Street Journal, the last time more than half of actively-managed U.S. stock funds consistently beat the S&P 500 on a rolling 12-month basis was in the middle of the last decade. Even then, the percentage of outperforming funds never reached 60 percent. Notably, these comparisons exclude the impact of taxes, which would skew the results even more in favor of indexing.

Some active managers argue that they can protect investor capital better than an index during market declines. The evidence would say otherwise. The WSJ cited a study that looked at the market crash of 1973-74, when the S&P 500 lost 37.3%. Stock funds lost 38.9% on average, even though they had almost 10% of their assets in cash at a time when interest rates exceeded 7%!

Indexers have a legitimate concern if we reach the point where indexing becomes a dominant force in equity markets. Since traditional indexing allocates money on the basis of market capitalization (i.e. company size), it is conceivable that valuations could become disconnected from company fundamentals, and that the largest companies would attain extremely high valuations based upon attracting the lion's share of new fund flows. So far, no evidence exists to support this claim. Apple, as the largest company in the S&P 500, represents about 3.7% of the market cap of the index. It trades at a price/earnings ratio in line with the market as a whole, about 18 times earnings.

Estimates of indexed assets range from approximately 28% to 35% of total fund assets, but when including individual securities held in retail brokerage accounts, the percentage of indexed assets drops to below 15%. In other words, indexing has a long way to go before it can move prices in a material way. In the meantime, active managers will be doing their best to correct any obvious mispricings caused by indexed fund flows by shorting overvalued stocks and buying undervalued ones.

Indexing has had a long run of superior performance, and nothing lasts forever in financial markets. Indeed, 63% of active managers beat their benchmarks in April, their best month since February 2015. But one month does not a trend make. If active management in US stocks is to stage a recovery, managers will need to find a way to overcome the inherent drag of higher costs and less tax efficiency compared to their indexed brethren. It is a tall order.

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Bruce is a Managing Director and Director of Portfolio Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. n addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.