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FANG, Indexing and Mystery Meat

Our spirited political environment now may include debate over the definition of what constitutes "news," but this is not new. In Hollywood, public relations hype precedes every new supposed blockbuster. In sports, endless analysis precedes each week's Game of the Century. In the investment world, repeated stories assess whether active investment managers as a group beat their index benchmarks.

This is nonsense. Of course indexing beats active managers as a group, as a matter of math. Consider an investment universe consisting of stocks of companies in the S&P 500 index and those investing in those companies.

Once you take index investors out of the total market capitalization, what is left, the aggregate holdings of active managers, will look exactly like the whole.

If you have a gallon of 15 percent salt solution and take out a quart, the remaining three quarts will still be a 15 percent salt solution.

Active managers have real world costs, so as a group they underperform the index by the exact amount of those real world costs, just as indexers underperform by the exact amount of their lower costs. Indexers *uniformly* underperform by their relatively low costs.

Active managers also underperform by their relatively higher costs, *but not necessarily in a uniform way* because they are doing different things. Some could do very well while some could do horribly.

While the "news" breathlessly reports the low percentage of active managers beating the index, invariably it fails to point out that the comparable percentage for index funds is *zero*.

Recent years have seen a surge in the popularity of indexing.

While indexing is a valuable tool, we are alarmed at some of its unthinking, unblinking acceptance.

Extending a thought experiment introduced in our 2014 newsletter "Cars" (available on our website), imagine an investment universe consisting of a Honda Civic, priced at $120,000, and a Toyota Corolla, priced at $20,000.

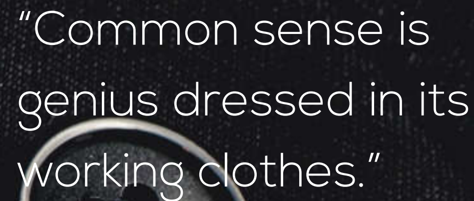
If the Japanese Compact Car Index were capitalization-weighted like the S&P 500, purchasers of the index are putting six times as much money in the ridiculously priced Civic as the fairly priced Corolla.

We are not suggesting the markets regularly produce such valuation gaps, and many in academia dismiss *any* difference between price and value. Consider, though, the stocks of Facebook, Amazon, Netflix and Google (FANG). From the end of 2014 through August 2017, the S&P 500 index gained 7.09 percent annualized.

Take out the four FANG stocks, and the other 496 stocks in the index gained only 5.66 percent. An active manager, avoiding *only those four stocks,* underperformed the index by 1.4 percent annually.

FANG stocks sell at almost 45 times earnings and well over five times sales. Any sentient, value-oriented investor is likely to avoid those stocks, but many investors buy them automatically, packaged in index funds.

The market did not reward a sentient value-orientation in the past two and three-quarter years, just as it did not in the technology bubble two decades ago or the real estate bubble a little more than a decade ago. Lack of sentience may work well for a while, but not ultimately.



We are ardent customers of the products and services of the FANG companies.

Cisco Systems, the backbone of the internet, is also a great company, but its stock declined 90 percent early this century. Valuation matters.

At Sigma, we are also enthusiastic users of index funds in client portfolios, but it is important to work to know what lies beneath a fund name.

If there was mystery meat served at the neighborhood potluck, wouldn't you investigate it before blindly gobbling it up?

Why risk the equivalent in the investment world? We believe, in a world of performance chasing and short attention spans, that sentience is a virtue, not a vice.