SIGMA
INVESTMENT MANAGEMENT COMPANY

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Investing is a Social Science, Not a Natural Science

Investor behavior changes market outcomes, many times in erratic and volatile fashion. Human psychology can be capricious, impacted by new technology, new philosophies of investing and the recent performance of different types of assets, among many other factors. Because of fickle behavior, taking even good ideas to extremes warps the reality of the markets in risky and unpredictable ways. Over the course of this month we will consider the science of investing. This is the first of four discussions of the social science aspects of the indexing trend.

One good idea, index investing (tracking a stock index rather than attempting to "beat" the market) has grown so substantially in influence in the past few years that it is changing the structure of the financial markets.

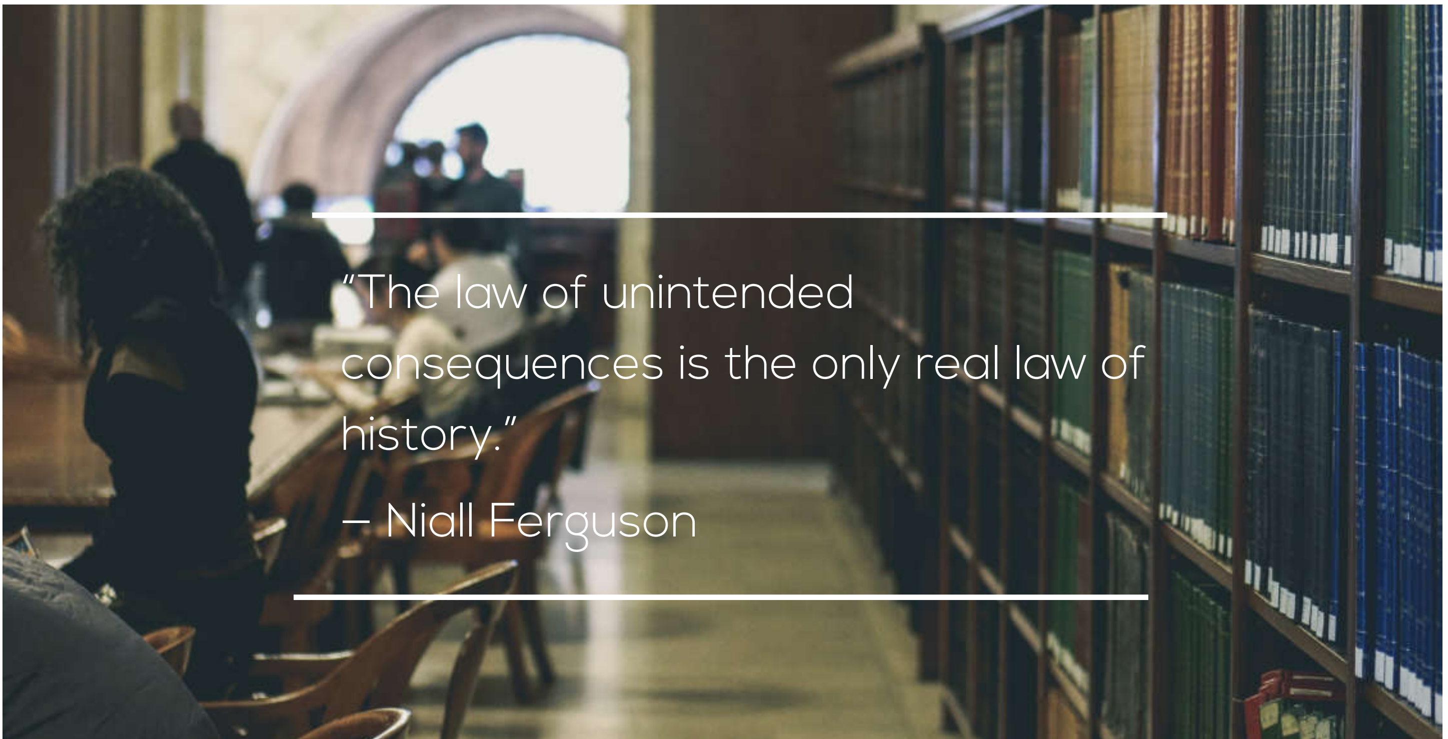
Nobody knows whether current index investment levels represent an extreme, but the concept is a relatively recent phenomenon.

There were no index funds before the 1970s, and their popularity is of even more recent vintage. J.P. Morgan recently estimated that index investors and quantitative investors (cousins of indexers, investing based on numerical factors rather than human analysis or opinion) now account for about 60 percent of equity assets, double that of only a decade ago.

Only an estimated 10 percent of trading volume stems from those following a traditional, fundamental, active investment approach.

Sigma has a positive view of indexing. We are substantial users of index and quantitative funds in our client portfolios, although often to manifest an active investing idea.

The move towards indexing has been a tremendous, salutary factor in decreasing



overall investor costs. The ultimate consequences of this huge change in investment thinking and behavior, though, remains unknown.

If history is any guide, there may be significant, unexpected effects on the financial markets.

Certain questions trouble us when we observe this rapid, considerable shift in how investors approach the markets.

We do not have the answers, but we believe it important to ponder the potential issues.

Is it wisdom, or just the same old bad behavior?

The idea of indexing investments started in academia in the development of investment and portfolio theory, a relatively recent branch of economics and finance.

Social scientists suffer from physics envy, tending to develop elaborate quantitative theories that ignore human psychology and behavior.

Index investing proponents interpret the recent popularity of index funds as evidence that people have "grown," overcoming their past unfortunate investing conduct.

Most indexed money, though, is in U.S. stocks, one of the best performing assets since the bottom of the global financial crisis.

Why should we be so quick to assume this is the result of the utopia of enlightened education and human advancement rather than the traditional pre-enlightenment investor flaw of performance chasing? Unfortunately, we will not know for sure until the next severe bear market.

If steely-nerved, newly educated investors stay the course, the academics were correct. If investors panic as they always have in the past, not so much.