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Who is Minding the Store?

As indexing popularity has increased, active managers argue that index investors are free riders on their research and activities that make the prices of stocks commensurate with underlying corporate values.

Index investors then pay those "correct" prices, packaged into an index, without having to spend any money or time on research.

Index proponents argue that it only takes a tiny minority of the market players assessing relative values for the financial markets to function adequately.

We do not know what the right number of active managers is, but it is interesting to imagine an extreme, all-index-investor world.

The price of one company would never change relative to any other.

We still would be paying the same relative prices for Eastman Kodak, Bethlehem Steel and Xerox relative to Apple, Microsoft and Cisco as we were two decades ago.

We explored a similar relative pricing issue in a previous blog entry *Fang, Indexing and Mystery Meat*, available on our website at www.sigmainvestment.com.

The index fund sizes its investment in a company solely based on market capitalization, with no notion of value other than the stock price.

The more money that flows from active management into index funds, the smaller the overall industry budget available for research analysts to investigate underlying value.

This also produces a bonanza for stocks included in the index. As investors switch to indexing, they sell securities not in the index in favor of stocks included in the index.

If you are the CEO of a public company, it may be more important to have your company stock in an index than to have your recent product introduction go well.

What is the right measure of success?

What are you trying to achieve through your investments?

Your focus should be your individual goals and risk tolerance rather than an obsession with some abstract benchmark.

If you are saving and investing for retirement and are unable to meet your desired lifestyle, it will matter little whether your performance correctly tracked the S&P 500 index.

If you meet your desired lifestyle or legacy goal, what does it matter if you trailed MSCI ACWI index over some random period?

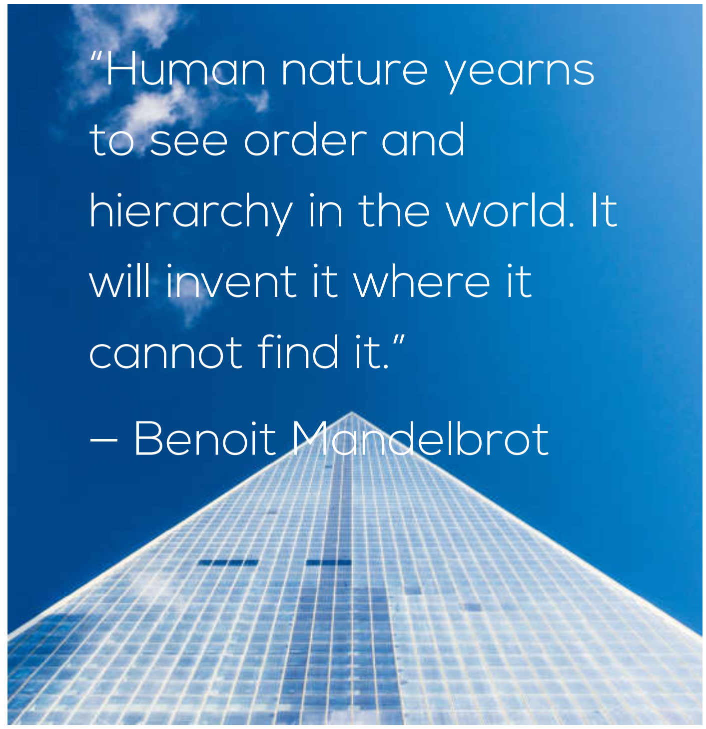
Just because something is available and easy to measure does not make it the right metric for success or failure.

An index comparison can be a useful tool to track progress, but it should not be an end in itself.

What should the evaluation period be? Any comparison over less than a complete market cycle is fraught with difficulty, and the periodicity of market cycles varies.

A comparison period only including a rising market will penalize unfairly any approach considering risk, making aggressive, risky investments seem superior.

A performance evaluation that only encompasses a down market will encourage excessive conservatism. We have been in a



bull market since the 2009 market bottom, a period in which the U.S. stock market has tripled.

Since this upswing is far longer than usual, any three, five or even ten year comparison (periods commonly used by institutional investors for index comparisons) will be dominated by a market where any consideration of risk was punished.

If we were in early 2009, any similar-period evaluation would be the exact opposite because we were at the end of a decade with negative equity returns with the bursting of the technology bubble and the global financial crisis.

Managers or investment approaches that seem tinged with genius in one period will seem marked by stupidity in the next, even though no underlying fundamental has changed.