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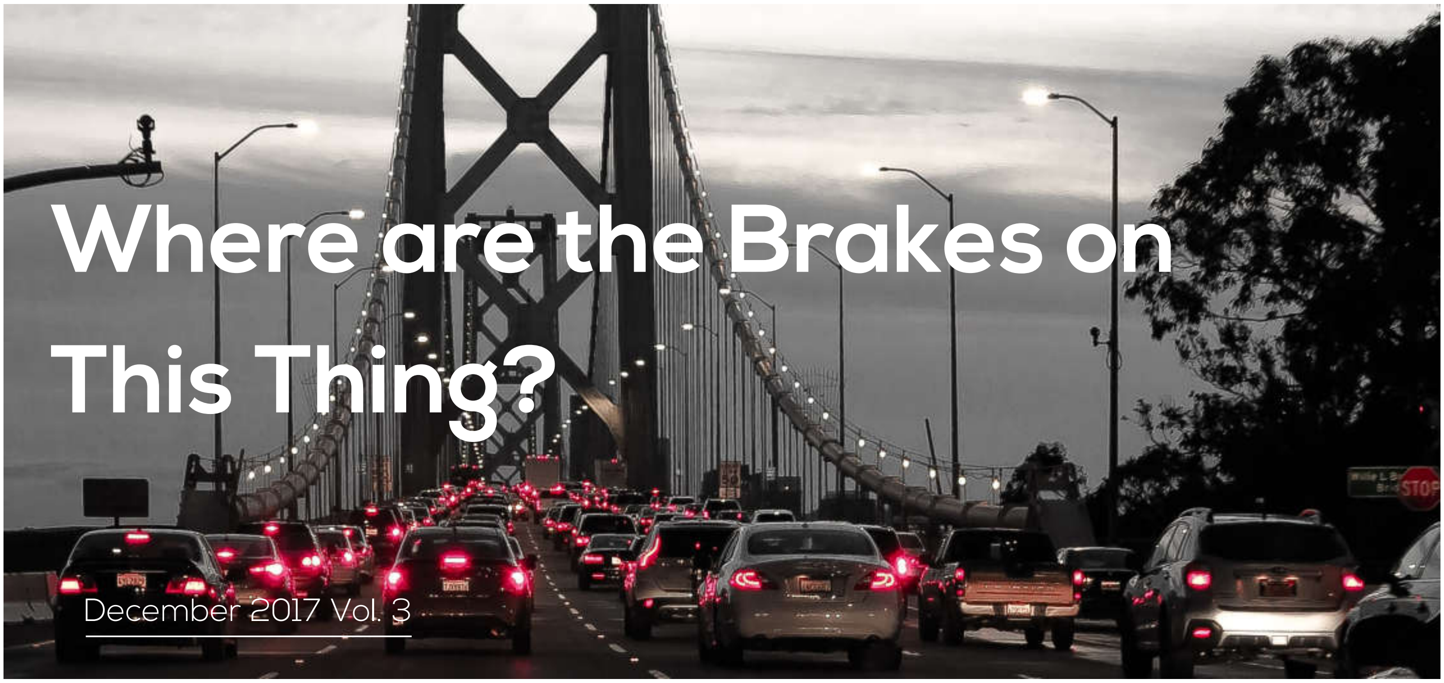

Where are the Brakes on This Thing?

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Active, value-oriented managers typically keep a cash reserve to take advantage of market opportunities. In a severe market decline, they put this cash stash to work buying perceived bargains. Their behavior acts as a natural brake on what otherwise could turn into a more sudden and severe decline. Investors evaluate index funds solely on "tracking" error – how closely they follow their benchmark index.

In an indexed world, any selling by investors transmits more quickly into falling prices than past market cycles.

Corporate governance – Who Will Represent Shareholders?

In an ideal world, the financial markets are a democracy of educated shareholders, voting in the most qualified directors and selecting the best governance approaches for each company.

If index funds own a huge percentage of listed shares, however, we may be moving away from this hypothetical utopia. How much effort will index funds expend on understanding and voting the proxies of the stocks they own?

Index funds seem to compete mainly based upon price. Imagine you sponsor an index exchange-traded fund (ETF).

The operating expense ratio to shareholders can be 0.15 percent if you hire an extensive corporate governance staff sifting through and voting proxies on every stock owned.

It can be 0.05 percent if you ignore the proxies. Which fund will attract the most money from investors? If money flows to the cheaper, light-governance option, what does that do to the power of managers versus shareholders in corporate America?

Corporate Buyouts – Good or Bad?

Corporations buying back their own stock has been a huge tailwind in this bull market. Despite the media lauding buy-backs, corporations have exhibited poor timing, buying the most stock at high valuations but cutting back when their stocks are at bargain prices.

Buybacks often approximate the size of option issuances to management, obscuring the dilution caused by that form of manager compensation and raising further questions about whether buy-back timing helps or hurts shareholders.

Any stock buy-back also is an admission of the lack of attractive investment opportunities in the corporation's business.

If buy-backs really are a good thing, though, the increased importance of indexing by investors may create a disincentive for buy-backs in the future.

Most index funds weight their holdings by the relative capitalization of the companies in the index – the greater the market capitalization of a stock relative to others in the index, the more any new money will flow to that stock.

Buy-backs can help a stock's price in the short run by increasing demand.

The effect of retiring shares, though, shrinks the company's market capitalization and therefore may lead to forced selling by index funds who now must adjust downward that holding as a result.

"In finance, I believe the conventional models and their more recent 'fixes' violate the Hippocratic Oath to 'do no harm.' They are not merely wrong; they are dangerously wrong."

– Benoit Mandelbrot