Indexing: A Love Story

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Readers of a certain age may remember *Love Story,* the best-selling and top grossing film of 1970, written by Ivy League classics professor Erich Segal. The last, most famous line from the pop culture melodrama is "love means never having to say you're sorry."

Another love story evident in the financial markets recently is between investors and index funds.

As discussed in our past several newsletters, Sigma is an avid user of index funds, but we are concerned that the virtues of index funds (low costs, specificity of underlying securities) appear to be blinding investors to the valuation of the U.S. market.

Indexing love appears to mean never having to analyze anything or think about what you are doing.

The attention to index funds and inattention to other investing factors results from an extension of something logical into something illogical.

The logical step is recognizing the common mistake of hubris in picking stocks. Investors often vastly overestimate how much they know about a particular company.

They fail to take full account of the near-certainty that other investors, many professional, against whom they compete, will know the same information.

This overconfidence is one reason why so few active stock pickers beat their index benchmarks over time.

The illogical extension is to assume that because picking superior stocks or investments is very difficult, we can know *nothing* of any use in making tactical decisions in investing.

In our messy, complex world, everyone should be humble about their ability to judge the relative merits of Exxon and Chevron in a way that will yield superior returns.

On the other hand, would it not be useful to know if oil stocks, relative to the market and relative to their own history, are cheap or expensive?

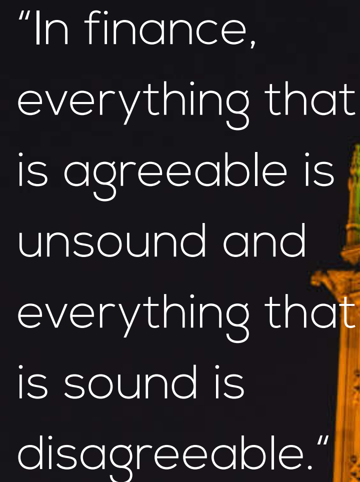
Investment research is hard, and always frustratingly probabilistic. You may never know with certainty what will happen in the future, but isn't it useful to know the odds?

You should want to know if, historically, buying expensive stocks will yield disappointing results, say, less than half the overall annualized buy-and-hold return, even if it is not a certainty. In rising markets, though, investors seem prone to assuming that no knowledge is worth having, so it is easier just to buy index funds.

Peaks in net investments into index funds seems to coincide with the market tops in 1999-2000 (the technology bubble) and 2007-2008 (leading to the global financial crisis). Now we see a new peak in inflows almost double the 2008 peak.

There appears to be a secular shift towards indexing, and there generally is more money sloshing around in the markets.

The pattern of accelerating money flows into index funds before previous market peaks, though, should serve as a caution now.



A blast furnace bull market makes stock pickers and market timers look particularly bad while rewarding those who just buy the overall market and serenely go with the (cash) flow. Going with the flow is considerably less pleasurable in a bear market.

Nobody knows for sure, but it seems likely that investors in a down market will respond as they always have and flee stocks generally, even index funds.

The "love story" investors have with indexing may be a bull market phenomenon, with psychology changing substantially when there is a sharp market break. As the market continues to march upward, investors seem to be embracing the message of another pop culture phenomenon, Bobby McFerrin's 1988 hit song *Don't Worry, Be Happy*.