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Debunking The Indexers' Myths

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When it comes to the great debate in the investment community on the merits of passive investing versus active investing, the indexer typically throws up a number of myths to support the merits of their cause. Gerry Rocchi's article *'The Arithmetic of Active Management'* in the August issue of *Benefits and Pensions Monitor* makes a number of these same claims.

However, every one of them is based on faulty reasoning.

That's strong language to be sure, but it is time for active managers to tell it like it is, to challenge the indexers, and, along the way, to reveal the truth.

The real myths in the investing world are those promulgated by indexers:

- ***Myth #1***: Active managers can't beat indices after fees.
- ***Myth #2***: It's not possible to identify managers who can reliably beat indices.
- ***Myth #3***: Statements that are true on average remain true when directed at specific situations.
- ***Myth #4***: All active managers are equal.
- ***Myth #5***: Index investors know what they are getting.

Let's see where these myths break down.

Myth #1: Active managers can't beat indices after fees

Indexers base this claim on the statistics, repeated in the Rocchi article, that the median return on managed funds trails the return of the corresponding index. It's important to note that this proves nothing about specific managers. An analogy will make this clear:

The *median* man is under 6' (indeed, about 5'10"). However, we can all name specific men who are over 6' tall… and the National Basketball Association is an entire industry based on the ability to reliably identify these men.

In the same way, it may be valid to say the index (as the sum of all investors) may at times outperform the median manager. But this does **not** mean that specific managers can't beat the index. Which leads to ….

Myth #2: It's not possible to identify managers who can reliably beat indices

Try this experiment at home.

Think about active managers who you consider to be good, and then see how they have performed on rolling four-year or five-year basis. The authors tried this experiment, and found that five of the seven managers they came up with in the first 30 seconds all consistently beat their equity indices, after fees, on a rolling basis. We have resisted the temptation to open a manager search firm and instead simply point out that this myth – widely repeated though it may be – is just that: a myth!

It's true that if you look at short periods, which the indexers generally do, it's hard to predict outperformance. It's also true that if you include a bunch of 'closet indexers' in your sample, you will have far worse results. But if you stick to genuinely active managers with a sound discipline, you can easily identify managers who have and will consistently beat the index over reasonable rolling time periods.

But, the indexers splutter, this is not possible. After all, the average manager can't beat the index. The fact is that this is plain incorrect reasoning …

Myth #3: Statements that are true on average remain true when directed at specific situations

We already saw in considering Myth #1 that statements about averages don't contain information about specific instances. Canadians – even Canadians who manage index portfolios – should know this. After all, the average temperature in Saskatoon may be 2.5°C, but on any given day the people of that fine city can be enjoying a summer heat wave or suffering a mid-winter deep freeze.

Arguments from averages to specific instances are well-known in the world of logic as an example of 'category errors.'

Myth #4: All active managers are equal

Indexers also make another logical error to support their argument when they treat all active managers as if they are the same. All indexers may be the same, but there are wide variations among how active managers go about their work.

We're not just talking about style differences here. There are significant differences from one value manager to the next as well. For example, some rely on P/E ratios and screening, while others look first for sound businesses and then examine cash flow, not earnings. Both can be value managers and both would be active, but you cannot say much about both of them beyond that and still make sense.

And remember that in the universe of 'active' managers the indexers like to look at, there are lots of managers who are by no means stock-pickers. For example, there are lots of closet indexers messing up the statistics to help the indexers draw their erroneous conclusions.

Myth #5: Index investors know what they are getting.

This is an argument that indexers make it all the time. Typically they claim that with an index portfolio, a client knows exactly what to expect in the way of risk and return.

That this is nonsense is demonstrated by the dropped jaws of the clients who indexed their portfolios before the tech wreck.

The fact is that the market indices are constructed specifically to contain large, liquid companies, and to do this in a way that gives larger weight to the larger companies. This has little to do with creating specified levels of risk, and even less to do with any notions of what constitutes a suitable company to invest in. Due to the way indices are constructed, index investors inherently buy high and sell low, making them the ultimate momentum players.

Furthermore, when a company is added to an index, indexers (and closet indexers) will be forced to buy it, regardless of its actual merits or valuation. The classic example is

Yahoo! Inc., which was added to the S&P 500 Index in December 1999. The majority of institutional investors had previously not owned shares of Yahoo!, perhaps waiting for more 'steak' and less 'sizzle.' But with the announcement that Yahoo! was being added to the S&P 500, the index players and the closet indexers had to get on board, there was no choice, or manager discretion, or merit involved. The result: In one trading day, Yahoo! shares jumped 89 per cent from $213 to $402, despite the fact that there was certainly no change in Yahoo! as a company.

In one sense, investors *do* know what they're getting when they index: They are getting a market weight of fraud (remember Bre-X?), bad management, and overvaluation. This knowledge should steer investors *away* from indexing, not towards it.

By contrast, the prudent and intelligently constructed portfolios of experienced money managers can offer better diversification than "lumpy" indices, and an opportunity for more conservative management than the indices.

If you *really* want to know what you're getting, you have to go with active managers with well-defined approaches to selecting stocks and building portfolios that meet your needs and objective.

While famed mountain climber George Leigh Mallory may have answered "because it is there" as his reason for climbing Mount Everest, investors ought to have a more compelling reason than just "being there" as a reason for buying securities.

The Real Myth

It seems clear enough that the value of indexing is mythical – from an investment point of view. Of course, many careers were temporarily saved by choosing index managers in 1999, so indexing may have some non-investment uses.

But is this how pension funds should be run? We think not.

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