Will Indexing Kill the Market?

BY MARSHALL JAFFE FROM THE MAY 2013 ISSUE OF RESEARCH MAGAZINE
April 29, 2013

One of the fundamental laws of investing is that when everyone agrees on something there is something important they are not seeing. There are few if any observers today who don't hold that indexing is as perfect an investment strategy as has ever existed: simple, cheap, effective, and with little to no downside (other than the market itself). Try Googling "risks of indexing" or any other permutation of the phrase. The results (or lack of them) are a powerful testimonial of how one-sided is our perception of indexing.

There is a robust intellectual, experiential and statistical foundation for this belief. Indexing just might be the most brilliant investment insight of the last 50 years. Yet hidden in the shadows of indexing's monumental success is a growing body of evidence that this truly elegant idea not only has the potential to threaten the stability of the market, but has already changed market behavior in ways few if any investors understand.

Historic Rise

For most of its life, indexing was a peripheral strategy with a market share rarely rising above the low teens. But over the last decade the popularity of ETFs has pushed that share to more than a third. The*Financial Times* reported last year that institutional indexing of U.S. equities could increase its market share to 50% as early as the end of 2014. *Pensions and Investments* recently reported that CalPERS, the largest pension fund in the U.S., had begun a five-month review of all of its investments to see if it is worth continuing with *any* active managers. And if CalPERS is considering it, you can be sure that they are not alone.

Up until now potential negatives from indexing were mostly academic observations. NYU professor Jeffrey Wurgler's 2010 paper "On the Economic Consequences of Index-Linked Investing" summarizes nearly 40 studies about indexing that go back as far as 1986. He shows us quite convincingly how and why indexing has been affecting the market and its components for decades.

When a stock becomes part of an index its behavior changes instantly. "It is as if it has joined a new school of fish," Wurgler writes. In summarizing the implication of all of these studies he turns the conventional wisdom about indexing on its head: "The popularity of indexing may not be simply a reflection of the fact that active managers are unable, on average to beat the index; it may actually be

contributing to their underperformance." If Wurgler is even close to being right, our perception of indexing may be due for a major adjustment.

Some observers have suggested that indexing will never become large enough to pose a systemic threat to the market because there will always be enough investors to offset the mispricing that excessive indexing might produce. However, in the real world extreme behavior in markets is driven by powerful forces and rarely has a benign end. I'm reminded of the quote, often attributed to Lord Keynes, that "Markets can remain irrational longer than you can remain solvent."

Wurgler notes that the more popular indexing becomes, the harder it will become for active managers to beat it. If that scenario plays out, and indexing continues to trounce active management, it would reinforce the growing conclusion among large institutional investors that their only sensible choice is to increase their exposure to passive strategies, setting the stage for an index-driven investment bubble (or if Wurgler's hypothesis is correct, exacerbating the one that has been in existence perhaps for years).

But there's more: When investors like CalPERS consider eliminating all active strategies, what is the real message of that choice? By choosing to index, they are, in effect, saying that attributes like intelligence, experience, expertise, wisdom, intuition, patience and discernment—which we all prize as guides for every other aspect of our lives—don't apply to investing.

They are saying that there is no good reason to understand the difference between a good business and a bad one, between a good CEO and a thief, between a healthy balance sheet and a dangerous one, between a temporary problem and one that can lead to devastation. There is no reason to understand what a business does, who works there, what they make, whether it's a good product or a bad product. They say it doesn't matter, because if you just own the whole market you'll make more money.

Logical Extremes

One way to evaluate the legitimacy of any idea is to take it to its logical conclusion—an intellectual stress-test. If it maintains its rational and intellectual integrity at the extreme, that is one way of evaluating and eliminating possible risk. If CalPERS is considering the active versus passive choice, so should we; and by taking both to their logical extremes we might be able to see them more clearly.

What would the investment world be like if it was all active, if everyone was trying their hardest to make good choices? It probably wouldn't look much different than it has looked since modern stock markets emerged less than a hundred years ago. Some investors would do very well, some would do horribly, and most investors would probably be somewhere close to above or below average. More importantly, the market mechanism would reflect that diversity and the elements for an efficient market would be in place.

And what would the investment world be like if it was all passive—if everyone was indexed? No one knows because the idea is absurd. Without active investors—without optimists or pessimists, without long-term investors and short-term traders, without people actually making value judgments about the businesses whose stocks are publically listed—there would be no supply or demand, there would be no efficient market, and more importantly, there would be no *average* to index.

As long as indexing appears to be the perfect solution, to have no particular risk (other than the market itself), the choice to index is close to self-evident. But if indexing is really not such a perfect solution, and its increasing success is actually perverting the supply and demand of the market itself, perhaps dangerously, then underperforming that market may no longer be the badge of shame it appears to be. In fact, underperforming the market could turn out to be a low-risk way to avoid

climbing on a mechanical strategy whose endgame is chasing an abstraction that it is in the very process of destroying.

Investors who are attracted to indexing because it avoids the risks of human judgment should reflect for a moment that it also avoids the benefits.