Has indexing gotten too big?

Lauren Virostek: Hello, and welcome to Vanguard’s Investment Commentary podcast series. I’m Lauren Virostek. In this month’s episode, which we’re taping on August 19, 2014, we’re going to discuss indexing’s rise in popularity and why it’s raising some concerns in the investment community.

I’m here with Chris Philips, a senior investment analyst in Vanguard’s Investment Strategy Group. Welcome, Chris.

Chris Philips: Thanks for having me.

Lauren Virostek: Chris, the concept of buying the market has grown in recent years to the point where some believe that indexing is getting too big. But before we get to that, can you share your opinion on why indexing has grown so popular with investors?

Chris Philips: Sure. Indexing itself is getting a lot of publicity in the media. There’s been some well-documented challenges of active management, and the beneficiary of that has been indexing. The other wing of that has been the acceptance of indexing from financial advisors in terms of building out their clients’ portfolios.

So whether they’re actually looking for a core investment for their clients or looking to have more tactical satellites, if you will, indexing can play both those roles. I think the combination of strong performance or relative underperformance of active plus the acceptance as part of the core portfolio has really driven that interest in indexing.

Lauren Virostek: And how have ETFs contributed to the growth of indexing?

Chris Philips: ETFs themselves have really exploded in terms of the number and variety of ETFs out there. So think back 15 years ago: You couldn’t get a reasonable exposure to, say, global real estate or commodities. And now with ETFs, you have that access. You have easy penetration into a wide variety of markets and wide variety of strategies.

The growth of ETFs has really spurred this, and the ability of ETFs to deliver a particular benchmark at, hopefully, very low cost is really that other leg to this trajectory. And it is that new markets or traditional markets at very low cost, as well as the ease of use, which has really driven the rise of ETFs, as well as indexing.

Lauren Virostek: So if investors like the idea of indexing and it’s pushing the cost of investing lower, why do some believe that the concept is getting too big?

Chris Philips: Well, I think there’s always going to be questions out there whenever you see popularity of anything rising, because we know that nothing can grow forever. So we always hear that one company, whether it’s Apple or Microsoft or Exxon, can’t grow to become the economy, or one country can’t grow to become the world.

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Same thing: We get these similar questions about indexing. So it’s very easy to ask, “Well, what is the tipping point? Is there a tipping point for indexing, and should we be concerned by that? Are investors at some point going to be worse off with indexing relative to some other form of management?” But I think that really the genesis of some of these questions is, there’s been rapid growth, rapid acceptance, and it’s just natural for us to question these things.

Lauren Virostek: You’ve referred to investing as a zero-sum game in the past. Can you explain what you mean by this?

Chris Philips: Sure. The idea of a zero-sum game is actually pretty simple. It’s for every buyer, there’s a seller; for every winner, there’s a loser; and before costs, every investor’s invested dollar has to aggregate up to form a particular market. That in and of itself means that all the winning assets have to exactly equal or offset the losing assets.

Well, the idea of indexing is that you’re trying to get the average of all those assets at the lowest cost possible. So after costs, we know with bid-ask spreads, with frictions, with market impact, the taxes with management fees, that the process of active management, of picking stocks, picking bonds, managing those portfolios, is actually pretty expensive. After costs, the majority of dollars actually has to underperform the market. The beauty of indexing is that you can, therefore, outperform a majority of the higher-cost, actively managed dollars that are out there.

It doesn’t mean that it’s always going to be that this manager underperforms and that manager outperforms. It can be very dynamic over time. But the zero-sum game is one of those mathematical certainties in the marketplace that always has to take place.

Lauren Virostek: You mentioned that a major concern with the growth of indexing is that it will create market inefficiencies. What threats do these potential inefficiencies pose?

Chris Philips: One of the thoughts out there is that the more indexing grows and becomes more popular, that it’ll lead investors to have portfolios that are more inefficiently managed. And the thinking behind that is that index funds, ETFs, they generally are priced at the day’s close. So they’re building up their portfolios. And if a majority of monies are actually passively managed, then the price-discovery process of active managers is marginalized. If that takes place, then, the theory goes, you could actually end up with more inefficiencies in the marketplace, more arbitrage opportunities, poorly priced equities or fixed income investments. That’s really the theory that’s out there.

At the end of the day, I’m not sure if that really holds a lot of water. It’s nice to think about these things, but there are very, very strong profit motives throughout the world. And we always have to take a step back and remember that the vast majority of dollars out there are actively managed in some aspect, and the desire for excess returns, the desire for alpha, the desire for profit, is a hugely motivating factor in investment management. You’re always going to have this force at play.

So the idea that indexing can get too big and create these inefficiencies—if there is an inefficiency, it’s going to be arbitraged away very quickly because of that profit motive. That’s always going to exist.

Lauren Virostek: Chris, let’s dig a little deeper on that. How are market inefficiencies measured? And do current data show signs of inefficiencies?
Chris Philips: Well, I think there’s really two ways that you can measure an inefficiency. You can measure transactional inefficiencies: Is it harder or easier to negotiate the markets? And one of the ways we look at that is overall costs of doing business.

For trading, you can look at bid-ask spreads. We actually ran some numbers and we show that even within the S&P, which is one of the lowest-cost and least friction-potential indices out there, the bid-ask spreads have come down tremendously. You can attribute that to things such as the rise of high-frequency trading, the rise of sophisticated investors applying technical portfolio techniques with their analysis. And that tells us that the markets are becoming more transactionally efficient over time. So it’s a lot easier and more cost-effective to actually apply a given strategy.

The other way is really kind of, you know it if you see it. If we take a step back and think in terms of are markets becoming less efficient, then it should be easier for a manager who has stock-picking ability to actually outperform. And so you’d like to see some relationship between the rise of indexing and an increasing proclivity of active managers to actually add value over time.

We just don’t see that. We looked at some data and we see that active management and the general outperformance tend to cycle back and forth. There’s really no persistence in the marketplace in terms of outperformance. But what we do see is that, as indexing has risen in its popularity, the performance of active management has not followed suit. It’s actually gone the other way. So it’s becoming more difficult for active managers to outperform, which would tell us that they’re not doing a good job of picking these inefficiencies if they exist, or they don’t exist and it’s just becoming more difficult for active managers to do what they do.

Lauren Virostek: Chris, I want to get your thoughts on the flip side of that argument, too. Some suggest that the rise of indexing is actually hurting active managers rather than helping them. Can you share your thoughts on that?

Chris Philips: This is kind of the other side of the story. I kind of view this as, well, you can’t have it both ways, right? It’s either indexing is increasing efficiencies and making it harder or it’s decreasing efficiencies and making it harder, but you can’t have both. But there’s still this cohort of individuals or investors out there who can also point to the fact that stock correlations have been rising over time. So are the actual securities in the marketplace becoming more correlated because of indexing or program trading or all these other types of vehicles and portfolio techniques that are out there?

I think, generally, you can see periods of time where correlations have risen. But, again, there’s really no consistency out there in the data.

We’ve also looked at whether correlations or dispersion of returns matter more. One of my colleagues, Jim Rowley, actually did a very nice piece on the dispersion of stock returns. His analysis actually showed that in any given year there’s a significant number of stocks that significantly outperform or significantly underperform the index itself. So correlation is one measure, but the actual magnitude of returns is another measure. And I would argue that an active manager can either underweight the underperformers or overweight the outperformers. If you have this dispersion, there’s plenty of opportunity to outperform. They’re just not doing it.

Lauren Virostek: Chris, do you expect indexing growth will slow down in the near future?

Chris Philips: It’s always difficult to maintain a significant growth year-over-year. So odds are they’ll probably slow down at some point. But I think when you look at it in terms of the rise
of target-date funds as the default option for institutional 401(k) plans, when you look at the acceptance of core ETFs as a core building block for advisors as they move to a fee-based model—when you look at these things, these are huge growth areas for the marketplace. And those are areas that are not slowing down, at least that we can see.

I think where you might see some slowdown would be in areas such as the really targeted or segmented or specific ETFs or index funds. Do investors really see a ton of value in having something that is measuring, say, European small-cap biotech stocks? I don’t know. Maybe there’s some opportunity out there. That might be some area where we see some slowdown; but I think in terms of the broad building blocks, that seems to be in early stages of the game and just poised to continue to increase over time.

Lauren Virostek: Thanks so much for joining us today, Chris.

Chris Philips: It was my pleasure.

Lauren Virostek: And thank you for joining us for this Vanguard Investment Commentary podcast.

Be sure to check back with us each month for more insights into the markets and investing. Thanks for listening.