FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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The Problem With Index Funds

One of the most common recommendations that the popular financial media and conventional financial advisors provide to individual investors is to invest in stock index funds because they have low expenses and "you can't beat the market." An index fund is a fund (either a traditional mutual fund or an exchange-traded fund) whose holdings are virtually identical to those of a specified index. Most index funds try to replicate the S&P 500, which includes 500 of the largest publicly traded corporations in the U.S.

Index funds were invented in the early 1970s by adherents of the Efficient Market Hypothesis (or EMH; note that it's a hypothesis and not a law), which claims that financial markets are efficient—meaning that there are no abnormal profits to be had—so you should just own all of the stocks in the market and try to minimize your expenses. The EMH provides a convenient excuse for investors who are overwhelmed and/or lack sufficient knowledge/time/energy. And its assumptions are way too broad and obviously false. They include:

- all new information is immediately disseminated to everyone, who act on it immediately, so securities are always fairly priced
- all investors always behave in completely rational ways

Here are the problems that I've identified with index funds:

1. It has been proven that you *can* beat the market (and often with lower risk) in several different ways, such as investing in small cap and value stocks, stocks that have a long history of increasing their dividends each year, stocks that have a high degree of insider ownership, etc.

2. The vast majority of index funds are weighted by market capitalization (i.e., the value of its stock). So the more richly valued a stock is (i.e., the lower its expected return), the greater its weighting in an index fund. This is an insane strategy that results in high risk and low returns.

3. Index funds work best when everyone else is doing the fundamental analysis that is required to have properly priced securities (e.g., in the early 1970s). The more that investors use index funds (i.e., the fewer the number of investors who are actually trying to figure out if prices are fair), the less they work. Sure, when they first came out, an index fund was an attractive alternative to getting cold calls from a Merrill Lynch broker who received an exorbitant commission for selling you shares that Merrill was receiving exorbitant fees for underwriting, but there are now even more attractive options.

4. Index funds provide cover for corporate managers to get away with bad behavior (such as cooking the books or other fraud; squandering the shareholders' money on excess compensation and perks, stock buybacks [to goose the price of the stock just before the executives exercise their stock options] or expensive acquisitions/empire building; not paying [or reducing] a dividend; not owning much company stock; implementing poison pill measures to prevent a hostile takeover; turning the company into a de facto social justice nonprofit, etc.). For example, let's say you're a typical employee with $50K in a 401(k) that's invested in an S&P 500 index fund. If the management of one of those 500 companies engaged in any of the bad behavior above, would you know about it, care about it, or be able to do anything about it? No. The management of companies that are in the S&P 500 index know that they are like a college professor that has been granted tenure, and therefore have much less incentive to perform well and avoid bad behavior. This huge unintended consequence of the creation of index funds may well end up being one of the primary causes of the collapse of capitalism.

5. Index funds take power from shareholders and transfer it to the top executives at woke companies such as Vanguard, Blackrock and State Street that manage index funds. These companies harm their customers and violate the fiduciary duty they owe to them by pressuring (via proxy votes) companies in the index to spend money, time and energy on irrelevant and profit-destroying social justice issues. It's like having capitalism without shareholders. Who needs the workers of the world to throw off their chains when you have Larry Fink? Who needs a dictatorship of the proletariat when you can have a dictatorship of Davos Man?

6. As Doug Casey says, when it comes to investing, you're either a contrarian or you're

roadkill. It's pretty much impossible to be a contrarian and invest in index funds, unless you do so at a time when stocks are universally loathed (e.g., early March 2009).

7. During a financial crisis, the correlation coefficient of financial assets tends to increase towards +1.0 (i.e., perfectly positively correlated); read the book The Fearful Rise of Markets. The correlation coefficient of an S&P 500 index fund with the total stock market would be very close to +1.0, giving you nowhere to hide. If you own an index fund, you probably don't own much else, so your options are limited—you can either hold or sell the fund (or maybe buy more, but you probably won't be interested in catching a falling knife). You would have far more options if you owned, say, 50 or 100 individual stocks (which have an expense ratio of zero, BTW).

8. An index fund is a *collective* investment that is highly affected by the decisions of Dumb Money investors. For example, if you own shares in an S&P 500 index fund and the stock market crashes, a large percentage (perhaps most) of investors who own that fund will sell it (at a low price), thus further reducing the value of your shares. If the people in your lifeboat panic and all try to get out of it at the same time by going over the same side, you will probably end up in the icy water with them even though you did not panic.

9. If you own (in a taxable account) shares in a traditional mutual fund that invests in a stock index, it's very possible that you could receive taxable capital gains distributions even though you had an unrealized capital loss. For example, the fund had a lot of unrealized capital gains for years, then you bought shares, then the market crashed, then a lot of your fellow fund shareholders sold their shares. Since index funds are always fully invested, the fund would have to sell shares (and thus perhaps realize some capital gains) in order to meet redemptions, which would then get passed on to you, even though you did not enjoy the benefit of those capital gains. This is less of a problem in an ETF due to its greater accounting flexibility, but it can still happen.

10. Since index funds are always fully invested, they provide Dumb Money investors with maximum exposure not only to stocks, but (assuming they are weighted by market cap) to the most richly valued stocks when they want it most, which is almost certainly at exactly the wrong time. So even if an index fund provides a long-term average annual return of say 11% per year, most of the fund's shareholders will actually earn far less, because not only are they eager to buy stocks when they are richly valued, but because the fund is weighted by market cap, most of their money is invested in the most richly valued stocks. Remember, currently the U.S. stock market is the second most richly valued in the world, and close to 1929 levels.

11. Most index funds do have low expenses—sometimes incredibly low—but a number of fund families sell a commodity product for a price that is many times higher than it should be. They take advantage of investors who have heard that index funds are

cheap and just assume that all of them are cheap.

12. The S&P 500 is not simply the 500 companies with the largest market capitalization, so there is some human discretion, politics, survivor bias and potential for corruption and insider trading involved. Some professional investors specialize in trying to predict which stocks will be added to or removed from the index.

Never before have so many investors been doing the same thing at the same time. What could go wrong?

What You Should Be Doing Now

1. The yield on the 5-year U.S. Treasury note is very close to the highest since 2008! We are heading into a currency/sovereign debt/banking/financial/economic crisis. I have long said that it will not only be the worst of our lifetime but the worst in human history.

2. Platinum hit a 1-year low this week. Its optimism index is low (29 out of 100) and the hedgers position is favorable. Now is a good time to accumulate some physical bars if your weighting is low.

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Generally, I don't have time to answer questions about your specific situation, but if you have a general question that I think other readers also have, let me know and I will provide an answer in a future issue.

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Before starting a new diet or exercise regimen, you should consult with a doctor, nutritionist, dietician, or personal trainer.