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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Index Funds

These days, the most common equity investment is the stock index fund. (If you're a novice investor, an index fund is a passively managed fund—either a mutual fund or an exchange-traded fund—that replicates a certain index, such as the S&P 500). There are several reasons for this.

First, index funds can greatly reduce unsystematic risk, which is risk that is unique to a company, industry, or country. The market doesn't pay you to accept unsystematic risk since it can be eliminated through diversification, leaving only systematic (or market) risk. One index fund by itself, however, probably provides less diversification than you think. For example, an S&P 500 index fund provides exposure to large cap U.S. stocks. It provides no exposure to U.S. small cap stocks, international stocks, bonds, real estate, precious metals or cash.

Second, generally, index funds have a low expense ratio (sometimes incredibly low), which increases your returns after expenses, *ceteris paribus*. However, the expense ratio of some index funds is surprisingly (or even egregiously) high for a passively managed investment.

Third, index funds and passive investing are commonly recommended to retail investors by academics (thanks to the Efficient Market Hypothesis, which I'll write about in a future issue), journalists, pundits, and even Warren Buffett.

Up until recent years, I think index funds generally served retail investors fairly well, at least compared to the alternatives. If you had a small portfolio, little knowledge about investing, and no time, money or energy to manage your own portfolio, index funds would have provided quick and easy access to broad asset classes at a low price. Awesome, right? Just send your money to Vanguard and let 'er rip. No thought or due diligence required.

Well, not so fast. Let's take a closer look. What does a stock index fund actually own?

Does it own companies where management and the board of directors own little or none of the shares (i.e., their interests are not aligned with those of the shareholders)? Check.

Does it own companies with a historically low rate of return on invested capital? Check.

Does it own companies that don't pay a dividend (so all of the potential return must come from capital gains)? Check.

Does it own companies that weren't around during the last recession or financial crisis (i.e., they haven't stood the test of time)? Check.

Does it own companies with poor corporate governance? Check.

Does it own companies that short sellers (Smart Money) have sold short a large percentage of the shares because they think the stock will tank? Check.

Does it own companies that are in financial distress (or soon will be) because they borrowed too much, spent too much on stock buybacks, overpaid for an acquisition, made poor strategic decisions, failed to please their customers, employees and shareholders, became uncompetitive, hired or fired the wrong people, failed to innovate, turned its inventory over to shoplifters, etc.? Check.

Does it own companies that have excessive or egregious executive compensation and perks? Check.

Does it own companies where the CEO is engaged in "empire building" (so he can get a larger pay package)? Check.

Does it own companies that are probably engaging in accounting fraud? Check.

Does it own highly regulated companies (e.g., utilities) and companies that have high moral hazard (e.g., banks due to the bailouts after the Great Financial Crisis)? Check.

Does it own companies whose assets primarily consist of bonds (which may eventually become worthless due to either default or hyperinflation), such as insurance companies? Check.

Does it own companies that are very richly valued (i.e., they have a low expected return)? Check.

Does it own companies that have high investor sentiment (i.e, which have a low expected return)? Check.

And lastly and perhaps most importantly, does it own companies that have signed on to "stakeholder capitalism" and have turned into de facto social justice nonprofits? Check. In fact, *the very investment companies that operate these index funds* (especially Blackrock, Vanguard and State Street) have been using their proxy voting power to coerce corporate executives to adopt the woke agenda (if they weren't on board with it already), at the expense of shareholders. So if a company does something with shareholders' money that's completely bat-sh*t crazy (like give billions of dollars to the Marxist group Black Lives Matter) *and* you also own shares of a stock index fund, you almost certainly own that company. But doesn't BLM deserve a dividend more than you? That's *equity*.

You know, Vladimir Lenin was wrong. He said, "The Capitalists will sell us the rope with which we will hang them." It turns out that capitalists will *give them* the rope. But don't worry, because in five or ten years from now, your stock index fund will have earned that 11% average annual return that you were expecting, and you'll be able to enjoy your retirement and live happily ever after, and in a free country no less!

OK, well at least an index fund is diversified, because it owns hundreds or even thousands of companies, right? Let's talk about weightings. Nearly all stock index funds are weighted by market capitalization (the number of shares times the market price). So in the S&P 500 index (the most popular stock index in the world), Apple currently has a weight of 7.15%. Should you have over 7% of your portfolio in one stock? Maybe Apple will grow even bigger. In a finite world that imposes limits on size, it's not bloody likely. The top five companies in the S&P 500 comprise over 24% of the index. But at least you're diversified, right?

As an aside, it's fascinating to look at the top components of the S&P 500. Those companies provide the products and services that Americans are most addicted to (and that will also be their downfall): technology, pharmaceutical products, banking (credit), credit cards, online shopping and oil. Those companies also have the most political power, and virtually all of them are woke.

There are two reasons why a company can have a large market cap. First, it's a large company (i.e., lots of assets, revenue, free cash flow). Second, it's richly valued given its economic fundamentals. Index funds that are weighted by market cap overweight large cap stocks (many if not most of which are richly valued) and underweight small cap stocks (which tend to be value stocks). The former have the lowest expected return while the latter have the highest. So index funds tend to buy high and sell low.

During a financial mania when valuations and investor sentiment are off the charts and risk is extremely high (such as the Dot Com bubble), stock index funds are fully invested, with the largest weightings in the most richly valued stocks. It's a business strategy called

Give The People What They Want. The masses are never wrong, right?

Conversely, during a financial crisis, correlation coefficients between stocks and between asset classes move towards +1.0 (i.e., perfectly positively correlated) as everyone wants their money back at the same time (read The Fearful Rise of Markets). In other words, there's no place to hide. Since most investors are invested in index funds today, which don't have a cash reserve, during the next financial crisis (which may well have already started), index funds will need to sell stocks to raise cash to meet redemptions. The selling will be indiscriminate and impatient. Everything will be sold at the same time, at whatever the market price might be at that time, because that's how index funds work. The baby will be thrown out with the bathwater. This will create a huge opportunity for contrarian value investors who have a lot of cash on hand and a list of individual stocks they would like to buy at a great price.

Index funds have become the victim of their own success. They provided the most utility when they first appeared in the 1970s, especially since brokerage commissions were unconscionably high at the time. But ironically, the more that investors use index funds, the more abnormal profit opportunities exist for active investors such as myself.

Index funds have also corrupted corporations by providing a hiding place for bad actors to get away with bad behavior. If you own hundreds or thousands of stocks via an index fund, you don't know (or care) about the sketchy things that management is doing at a company that comprises less than 1% of your fund, and even if you did, you wouldn't be able to do anything about it, especially since the investment company that manages the fund is now forcing companies to do things that also destroy your wealth.

In closing, why does someone like Warren Buffett recommend index funds to retail investors? Is he just a benevolent, grandfatherly guy who wants to help people by giving them free investment advice? Well, if he cares about his own pile more than he does about yours (which I think is likely), then if he wants to maximize his investment returns, he needs a lot of Dumb Money to trade against. He needs a mark—investors who will buy anything and everything at whatever the current market price is without even thinking about it, much less doing any research. Passive investors who use index funds help him get what he wants.

But at least index funds (usually) have a low expense ratio, right? Sometimes something is cheap for a reason.

Recommended

Citizenfour and/or the related book No Place to Hide: Edward Snowden, the NSA, and the U.S. Surveillance State by Glenn Greenwald.

I would love to hear from you! If you have any comments, suggestions, insight/wisdom, or you'd like to share a great article, please leave a comment.

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