

EUREKA *report*



Should you follow the index?

By Scott Francis
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PORTFOLIO POINT: Setting up your portfolio to track the market index means you won't get ahead of the pack, but ensures you won't trail it, either.

Does the strategy of indexing – buying a low-cost portfolio of all the assets in a market – still make sense?

About nine out of 10 investors don't think so. They choose a more active approach: looking to pick and choose stocks that will provide above-average market returns or to employ someone to do this for them. In doing so, they shun index-style investments.

But a new consensus appears to be forming. As Alan Kohler suggested on **Saturday** with small-caps expected to outperform blue-chips in the months ahead we are entering a "stock-picker's market". If that's true, it only follows that index funds, as Alan suggested, are passe ... after all why buy the index when you know it is likely to be flat or meek in the near future.

I have no problem with buying small-cap stocks. This calendar year the ASX Small Ordinaries Index Total Returns index, which measures the performance of small companies, is up a "portfolio assisting" 20%-plus, against the roughly 10% return from the ASX 200 Total Returns index).

But which small-caps will I buy? I simply cannot get sufficient data on this "undercovered" area of the market. I don't have sufficient information to make investment decisions. But I do know that whatever stage in the cycle we are at, the majority of people suggesting they will "beat the market average" will not do so. On this basis I see there is still a lot in favour of using index funds in a portfolio.

In May this year Investment Trends released a survey that was conducted in November last year (after much of the market downturn) on the use of index equity (share) funds. A number of the findings were interesting:

- Their modelling showed that use of index funds had increased by 18% a year over the previous two years.
- Index fund investors had a median age of 45, which is low compared with other investment options. (This is probably not surprising, as index funds are a relatively new addition to the Australian landscape, only being available for about 12 years.)
- Index fund investors cited low fees, their investment strategy and long run returns as the key reasons for using an index fund.

For the sake of balance, I want to start by outlining some of the negatives of index funds:

- There is a small level of "forced trading" for the funds each quarter, when the smaller companies in an index might change (some might fall out of the index while others are included – a process sometimes known as "reconstitution").
- When you buy into an index fund (as with any managed investment) there is likely to be a level of "unsold" or "unrealised" capital gains in the portfolio. This is not great as when shares with a capital gain are sold; this gain is passed on to investors even if the gain existed before they bought in.
- There is no ethical screen (again, like many investments). However, this is an issue for some investors. Some would say there are no "really bad" companies (eg, tobacco, ammunition manufacturers) in the biggest 200 companies in Australia.

And although these failings are not in themselves arguments for index funds, the good news is that index funds have consistently become more sophisticated and diverse: there are many players in the market now, offering a huge range of indexing choices. So, for example, if you really believe blue-chips are for losers in the year ahead and small-caps will win, then you can concentrate on specialised index funds that focus on small caps.

Stock picking rarely works

But first I want to tell you the truth about stock picking. The greatest-ever was probably not Warren Buffett but his mentor, Ben Graham, who is often cited in these pages (see ***Back to basics, a Graham and Dodd primer***).

Many investors have heard of Graham, but not many know that at a seminar just prior to his death, he made the following statement: "I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when [the bible of fundamental stock analysis, Graham and Dodd's] *Security Analysis* was first published; but the situation has changed.

"In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now carried on, I doubt whether in most cases such extensive efforts will generate sufficient superior selections to justify their cost. To that very limited extent I'm on the side of the "efficient market" school of thought.

I find this a fascinating and quite profound piece of analysis by Ben Graham, an admission that the basis of his life's work with security analysis was somewhat superseded by the increasingly competitive research environment. What he said 33 years ago reflects the significant amount of research done since – the benefits of research don't appear to outweigh the costs for precisely the reason he stated – because there is so much research into each individual share on the market that it is hard to get an advantage over everyone else.

The performance evidence from 'skilful' investing

I want to use a number of academic studies to look at the performance from investors trying to "beat the market". I know that people are often cynical about the practicality of academic research. In this case, however, academics are focused on the most practical outcome of investing: the amount of money that ends up in your pocket from the investment.

Managed Funds, an article by Ross Miller published in the *Journal of Investment Management* in 2007, looked at the performance of more than 4700 funds between 2002 and 2004 inclusive. These were all active funds, with managers who harnessed their resources, training and experience to beat the average market return. The result was that large company funds underperformed the average market return by 1.5% a year.

Sharemarket Analysts by Sarah Azzi and Ron Bird looked at the profitability of analysts' recommendations in the Australian marketplace. They studied recommendations made between 1994 and 2003 and found that analysts' recommendations "if anything, have negative value". Even given the resources, training and access to companies analysts have, their efforts do not appear to generate profitable recommendations.

Media. I often collect magazine and newspaper articles that contain stock-picking and forecasting ideas to see how they fare in the future. In June 2007 a well known Australian investment publication carried an article entitled *VIP Stocks – Very Impressive Performers*. The article nominated 25 stocks that were chosen on the basis of historical earnings growth, their earnings outlook for 2007-08, return on equity and price/earnings multiple. The result? During 2008 the average market return for this group of stocks was –55%, much worse than the average market return of –39%. Two of the stocks (Babcock & Brown and Allco) disappeared completely and nearly half (12 of the 25) lost 60% of their value or more.

Everyone wants to be above-average

Nobel Prize winner Bill Sharpe wrote a paper entitled ***The Arithmetic of Active Management*** in which he makes a simple point: the average market return, or the index return, is the average experience of the investor in the market, less that investor's costs.

When I take seminars I often ask people to fill out a short survey, which includes providing a ranking of their own driving ability. Every time I have done this more than 80% of the people rate themselves as above-average in driving skill. Generally people get a chuckle out of this, they recognise that really 50% of people will be above-average, 50% below. It is a sign of overconfidence that more than 80% of people consider themselves above-average.

It is the same in investment markets: 90% of us assume that we will have above-average investment returns but the reality is that this won't happen. After fees, less than half of the investors will have returns above the market average.

David Murray, the former chief executive of the Commonwealth Bank and now in charge of the Future Fund, provided a practical example of this when he was quoting as saying "alpha [the excess returns from active management] is a zero sum game, but a negative sum game after you subtract fees".

Conclusion

Index funds are not perfect. Any discussion of investment approaches that considers the pros and cons of using index funds is really looking at whether a market participant has the skill to beat the market or should settle for the average market return.

My opinion is that there are strategies well worth considering beyond simple index funds (including exposure to small companies, value companies, a careful asset allocation including bonds and cash). Index funds do, however, remain a reasonable way to exposure investment capital to markets.

Indeed, if I was told that my investment future was restricted to only being able to use a good quality cash account and a low-cost Australian share index fund in my portfolio I could comfortably cope with that.



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