To Index or Not To Index? That Is Not the Question.

April 25, 2002
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Indexing, or passive investment management, seems to have re-emerged as fashionable recently, and it is not difficult to understand why. Most active money management strategies have trailed the major indexes over the last several years, lagging even more after fees and taxes. In addition, investors seem to have forgotten that, not that long ago, active money management provided alpha.

In fact, both investment strategies are cyclical, yet most investors continue to react to recent past performance when considering where to place their money. The true long-term investor, however, knows that neither strategy is always better than the other, and there may be room for both in certain circumstances.

Let's look first at the active side of portfolio management. The recent track record is not promising. From 1994 to 2000, not more than 25% of all actively managed portfolios beat the S&P 500 index fund in any given year. However, prior to the momentum-driven market of the late 1990s, the long-term record of active management is much better. Like outperformance among value and growth stocks, large-cap and small stocks, alpha from active management occurs in cycles.

In the late 1990s, it was difficult for active managers to beat the upward-spiraling market. But what prudent money manager, acting as fiduciary to clients, would take the risk of placing 40% of client assets in Technology stocks when most were trading at 120 to 200 times estimated earnings? Their fiduciary responsibilities virtually handcuffed active managers, making it impossible to outperform the ballooning market.

Active management has tended to perform well when the stock market is not dominated by any one sector or by a handful of companies, and when aggregate fundamentals such as earnings and valuations are at extremes (this is the scenario today).

Arguments in favor of active management are strong. For the long-term investor, investing should not be about beating a market index. It should be about how the aggregate investment portfolio (multiple managers/multiple assets) grows, relative to future financial objectives. Controlling risk and managing for net returns (after fees and taxes) are the most important objectives under this criterion, and active management has a history of providing both. In an actively managed environment, managers check for redundancies of holdings between accounts and take preventive measures against wash sales (one manager buying and another selling the same security). These, and other functions that require active judgment and oversight, are often lacking in a passive, or index, approach.

On the other side of the ledger, investing in index funds is not as easy as it sounds. First, investors must select the appropriate index, among the hundreds available. Index investors must decide what areas of the market can be replicated without incurring unnecessary transaction costs and liquidity risk. These are decisions that can be costly, if wrong.

Also, investors should realize that the most popular stock market index, the S&P 500 index, is not 100% passive. A committee of investment professionals at Standard and Poor's essentially determines what stocks move in and out of the index (this seems like an active decision to me). This index is capitalization-weighted, consisting of the 500 largest and most representative list of stocks traded in the US. As mentioned earlier, there are times (like the late 1990s) when this index is less than diversified.

There are other considerations, too, when trying to implement some indexing decisions. Outside of the US large-cap core equity universe of stocks, indexing has a less-than-perfect track record. Style purity, or tracking to the index, has been an ongoing challenge in the small/mid-cap area as well as the international area, because of liquidity constraints and transaction costs. Other indexes, such as the Russell stock market indexes, turn over a large portion of their constituent stocks each summer. This creates both a challenge and a moving target for the index fund manager.

Given that there are advantages and disadvantages to both investment strategies, how should investors consider constructing their long-term investment portfolios? For some investors, the best solution may be a hybrid approach, using both active and passive strategies. For taxable individual portfolios, I would strongly suggest that a predominantly active, separate-account approach be considered. In this case, taxes are a critical consideration, and controlling them requires active decisions at both the manager and the total portfolio levels. For institutional tax-exempt situations, a combination of active and passive strategies may be warranted. Under this scenario, hiring too many active managers (or too few) may be redundant, expensive and risky.

Those investors who now move their assets to a passive-only strategy are continuing to act on their belief that what happened in the recent past is likely to happen again in the near future. We all know that this approach is dangerous and, in most cases, likely to prove wrong. Given that most market watchers are projecting returns over the next few years to be significantly lower than we saw during the past two decades, and that the current stock market is not dominated by any sector or group of stocks, we believe that the argument tilts in favor of active management.