Fiduciary Focus: Active vs. Passive Investing (Part 6)

W. Scott Simon | 7-29-05 |

This month's column, which continues to dispel some widely accepted myths of passive investing, will be the last in my seven-part series on active investing and passive investing in the context of modern prudent fiduciary investing.

Myth: *S&P 500 Index Funds create a self-fulfilling prophecy that drives up the value of the S&P 500.*

The inflow of money to S&P 500 index funds in the 1990s drove up the prices of S&P 500 stocks, which, in a "self-fulfilling prophecy" of success, generated even more investment in S&P 500 index funds. This is what caused S&P 500 index funds to outperform most active mutual funds.

Reality: There are at least five reasons why S&P 500 index funds were not the cause of the tremendous advance of the S&P 500 over the period of 1995-99.

1. There was a net outflow of all money indexed to the S&P 500.

Institutional investors such as pension funds and separate accounts of individual stocks invest about 80% of all money indexed to the S&P 500. Non-institutional investors in S&P 500 index mutual funds that are sold directly to the public (i.e., "retail" funds) account for the rest. As institutional investors moved money into broader indexes such as the Wilshire 5000, they withdrew more money (over $100 billion) from funds indexed to the S&P 500 than had been invested by investors in retail S&P 500 index funds. There was a net outflow, then, of all money indexed to the S&P 500 for each of the five years during 1995-99.

This fact is little known because the financial media report cash flows for only retail S&P 500 index funds open to non-institutional investors--which did show a net inflow of money. The media thus presented only part of the picture, while representing it as the whole picture. Since there was a net outflow of money from all funds indexed to the S&P 500 for each of the five years during 1995-99, money indexed to the S&P 500 didn't cause the run-up in value of that index.

2. Money invested in passive stock funds comprises about 8% of money invested in all stock mutual funds.

Despite the increased popularity of passive investing, the percentage of money invested in passive funds is still small relative to the total amount of money invested in all stock mutual funds. Money invested in passive stock funds comprises only about 8% of money invested in all stock mutual funds. The percentage is even smaller relative to the amount invested in all bond mutual funds. Even in 1998, when passive investing received particularly heavy media attention, just over 20% of net inflows went to passive funds and only 16% went to S&P 500 index funds. This means that nearly 80% of net inflows still went to active funds--much of which was invested in the stocks of the S&P 500.

3. Actively managed money has a tremendous impact on the performance of U.S. large-company stocks.

Because the S&P 500 performed so well in 1995-99, many active money managers shifted their holdings from medium-size and small-company stocks to S&P 500 stocks--even when the S&P 500 stocks didn't conform to the stated investment objective of their funds. Many active managers may have engaged in such "closet indexing" so that they wouldn't underperform the S&P 500 and thus lose business. In making this shift to the stocks of the S&P 500 index, active managers had a tremendous impact on the performance of the S&P 500. Since actively managed money comprises the vast bulk of money invested in the stocks of the S&P 500, this money has had a far greater impact on the performance of the S&P 500 than passively managed money.

4. All S&P 500 stocks didn't rise in value by the same amount.

If it's assumed that indexing drives up the value of the S&P 500 index, each stock represented in the index should increase in value by the same percentage. But this didn't happen to S&P 500 stocks in 1995-99. For example, in 1998 the 50 largest stocks in the S&P 500 by market capitalization returned 39.1%, while the next 150 largest stocks gained 26%. The 201st through the 500th stocks gained 14.2%. Since S&P 500 stocks varied widely in their performances, it's difficult to see how indexing drove up the value of the S&P 500.

There's another way to confirm the point. If it's assumed that indexing drives up the value of the S&P 500, the largest stocks in the Wilshire 4500 index--those just outside the S&P 500--shouldn't have performed as well as those represented in the S&P 500 because they didn't benefit from the money invested in S&P 500 index funds. Again, this didn't happen. In fact, the largest stocks just outside the S&P 500 performed about the same as similarly sized stocks just inside the S&P 500.

Myth: *When the overpriced stocks driving up the value of the S&P 500 crash, passive investing fails.*

During 1995-99, S&P 500 index funds were overweighted dangerously in a relatively few "overpriced" U.S. large-company blue chip stocks that were largely responsible for driving up the value of the S&P 500. When the values of those stocks collapsed, the advantages of S&P 500 indexing vanished.

Reality: There are a number of reasons why this myth isn't true.

First, it's always possible that there are better bargains to be found in U.S. small-company stocks, bonds, or even emerging-markets stocks than the relatively few U.S. large-company stocks that drove up the value of the S&P 500. But this isn't an argument against passive investing. Rather, it's an argument (suggested by modern prudent fiduciary investing) for greater diversification--not only diversification of a portfolio across a greater number of different asset classes, but also enhanced diversification within each asset class.

Second, in making the "overweighting" argument, proponents of active management make a claim against passive funds that isn't true, but is generally true of active funds and separate accounts: underdiversification within a given financial market. Portfolio managers at such firms as Goldman, Sachs & Co., for example, typically invest in only 20 to 30 stocks for their high-net-worth clients. According to a key tenet of Modern Portfolio Theory, such portfolios (indeed, all active portfolios) are always underdiversified (and thus always riskier) relative to comparable passive portfolios. The Act and the Restatement ordinarily require diversification of portfolios--preferably broad diversification.

Third, any claim that a stock is overpriced (or underpriced) is really an assertion that the market is "wrong." The personal judgment of the claimant is substituted for the "verdict" already rendered by the collective opinion of millions of investors that compose the market. The verdict is that the current market price of any given stock is the best estimate, however good or bad, of its "true" investment value.

Fourth, active money managers can outperform the market only if they have successfully overweighted (i.e., underdiversified) their portfolios relative to the market portfolio.

Fifth, it may be that the most vocal of those claiming many of the stocks in the S&P 500 are vastly overpriced failed to invest in them before they increased in value. If they had, it's possible that they wouldn't have been concerned about such overpricing, but instead would be offering detailed narratives about their prescient stock picking abilities.

Myth: *Passive funds generate more capital gains taxes than active funds during market downturns.*

Many advocates of active investing assert that passive funds (especially older ones) carry large amounts of unrealized capital gains. During market downturns, passive funds pay off departing shareholders by selling assets containing these embedded gains. This, maintain advocates of active investing, generates excessive capital gains distributions and forces even non-departing shareholders to pay capital gains taxes.

Reality: In fact, passive funds appear to generate fewer capital gains distributions in market downturns than active funds since a) managers of passive funds are more likely to employ "tax-sensitive" trading strategies and b) many active fund managers seem to manage money as if taxes don't matter.

What happens when passive fund shareholders want to sell out in a market downturn? One way that managers of passive funds pay departing shareholders is to sell those assets (purchased before the market downturn) with the highest cost bases. This strategy, which generates losses, not only minimizes the amount of pretax return lost to taxes, but also largely avoids taxing the fund's remaining shareholders.

Another tax-sensitive strategy used by passive fund managers is to "harvest losses." This involves selling assets at a loss to offset realized capital gains. The manager of a passive fund also seeks to discourage short-term trading (which could generate taxes) among its shareholders by sometimes assessing redemption fees.

Finally, whenever possible, passive fund managers typically defer realization of short-term capital gains until they become long term. Forgotten in the discussion concerning embedded gains in passive funds is the fact that active funds also have embedded gains. For example, at the end of 2000, the potential capital gains exposure of the Vanguard 500 Index was 39%; that of Fidelity Magellan was 37%.

The assertion that the unrealized capital gains in passive funds are "ticking time bombs" that will explode eventually in the form of large taxable distributions, therefore, seems to have little validity. In 1995, for example, Vanguard began to use a "Highest In, First Out" trading strategy that sells the stocks in the fund with the highest cost bases first to defer capital gains. Using this strategy and others, Vanguard's S&P 500 index fund could have declined 20% and withstood a 69% redemption rate without realizing any capital gains.

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Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA™ qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

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