Pathways
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STEPPING STONES
Exploring Financial Pathways

Client Adventure: Roger & Suzie's Road Trip - The Good Ole U.S.A.
Roger Stach

Suzie and I, who have traveled to many places around the world, decided that we needed to see more of what our country had to offer. So, last September, we set out on a 20-day road trip through the western states.

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Planner Article: Is Too Much Indexing a Problem?
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Over the last several years, index funds have received increased attention from investors and the financial media. This is a victory for the investment public and testament to the evidence shared by all proponents of low-cost index funds over the years. In particular, it's a timely tribute to the most prominent advocate of low-cost indexing John Bogle, the late founder of The Vanguard Group who passed away on January 16th. However, some have used the increased usage of index funds to argue against price efficiency, one of the core beliefs of index-fund investing. This argument, that a rise in indexing distorts market prices by "blindly" buying the underlying holdings, carries some theoretical weight. The devil, of course, is in the data.

HOW BIG IS INDEXING, RELATIVE TO OTHER BUYERS AND SELLERS?

First, while the popularity of indexing has increased, it's still a relatively small percentage of overall investors. For example, per data from the Investment Company Institute, despite index-fund growth from 15% of net U.S. mutual fund and ETF assets December of 2007 to 35% by December of 2017, the majority (65%) of U.S. mutual fund and ETF assets were still managed by active mutual funds in 2017. As shown in **Exhibit 1** below, domestic index mutual funds and ETFs as a group comprised only 13% of total U.S. stock market capitalization in 2017.

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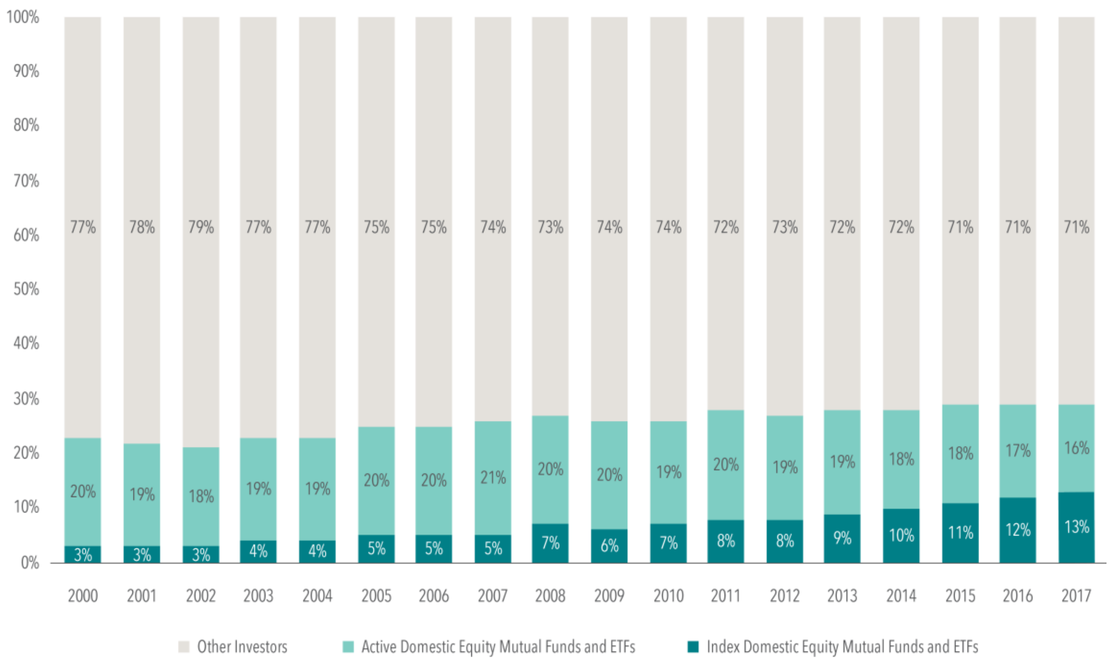
Exhibit 1. Investor Breakdown in the U.S. Stock Market as a Percentage of Total U.S. Stock Market Capitalization



All totals may not equal 100% due to rounding. Sourced from the 2018 ICI Fact Book: ici.org/pdf/2018_factbook.pdf

With this context, it should also be noted that some investors use passive vehicles, such as ETFs, to engage in active trading. For example, while both a value index ETF and growth index ETF are classified as index investments, investors may actively trade between these funds based on short-term expectations. In fact, several index ETFs regularly rank among the most actively traded securities in the market.

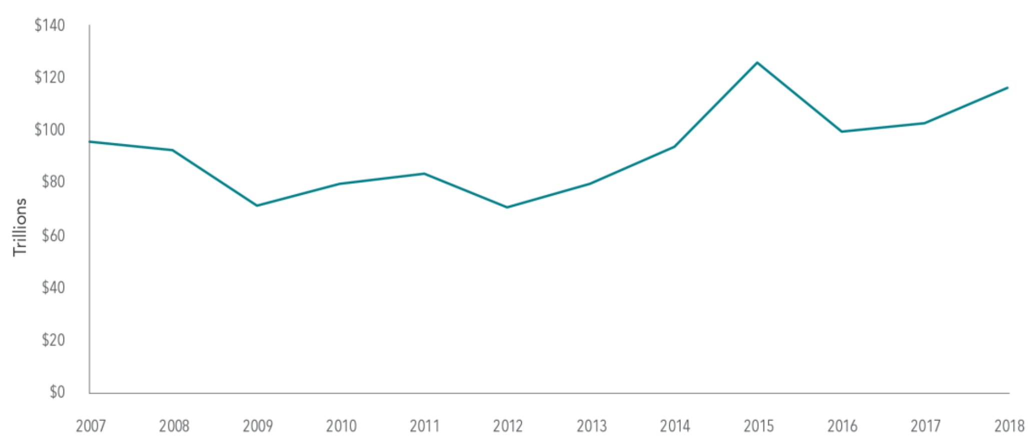
Further, there are many other participants in financial markets, including individual security buyers and sellers from actively managed pension funds, hedge funds, and insurance companies, to name a few. As you can see from **Exhibit 1** above, security prices reflect the viewpoints of all investors, not just the population of mutual funds.

WHAT ABOUT TRADE VOULME?

Trade volume data is another place to look for evidence of well-functioning markets. **Exhibit 2** shows that despite the increased prevalence of index funds, annual equity market trading volume hasn't changed much in the past 10 years. Markets continue to facilitate price discovery at a large scale.

Exhibit 2. Annual Global Equity Market Trading Volume, 2007–2018

In U.S. dollars. Source: Dimensional, using data from Bloomberg LP. Includes primary and secondary exchange trading volume globally for equities. ETFs and funds are excluded.



WOULDN'T ACTIVE MANAGERS CAPITALIZE?

If one accepts the argument that indexing distorts markets and in turn causes prices to become less reliable, despite the evidence above, wouldn't stock-picking managers capitalize on this mispricing with an increased rate of success over time?

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Exhibit 3 shows little evidence of this. The chart indicates the percentage of active managers that survive and beat their benchmarks over rolling three-year periods. As you can see, there is no tangible evidence of a link between the rise in index fund usage and the percentage of active funds outperforming benchmark indices.

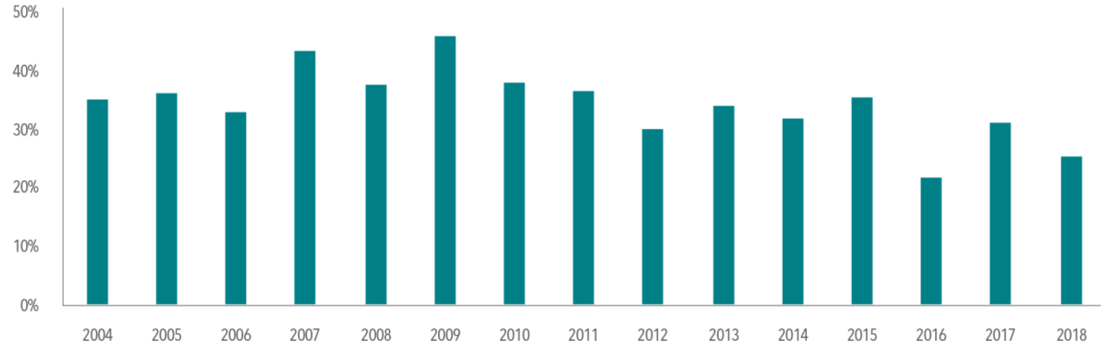

Exhibit 3. Active Manager Performance Has Not Improved Percentage of Non-Index Equity Funds Outperforming for Three-Year Rolling Period, 2004–2018

Equity mutual fund outperformance percentages are shown for the three-year periods ending December 31 of each year, 2004–2018. Each sample includes equity funds available at the beginning of the three-year period. Outperformers are funds with return observations for every month of the three-year period whose cumulative net return over the period exceeded that of their respective Morningstar category index as of the start of the period. U.S.-domiciled non-Dimensional mutual fund data is from Morningstar. Dimensional fund data provided by the fund accountant. Past performance is no guarantee of future results. For more methodology details, see the latest [Mutual Fund Landscape] brochure.

Lastly, in a world where index funds bias prices, we should expect to see evidence of such an impact across an index fund's holdings. In other words, there should be more uniformity in the returns for securities within the same index as inflows drive prices up uniformly (and outflows drive prices down). The S&P 500 Index returns from 2008 and 2017 in **Exhibit 4**, however, show little evidence of this. In 2008, for example, despite large net outflows and an S&P 500 index return of –37.0%, constituent returns still ranged from 39% to –97%. In 2017, a year of large net inflows and a positive index return of 21.8%, constituent returns ranged from 133.7% to –50.3%.

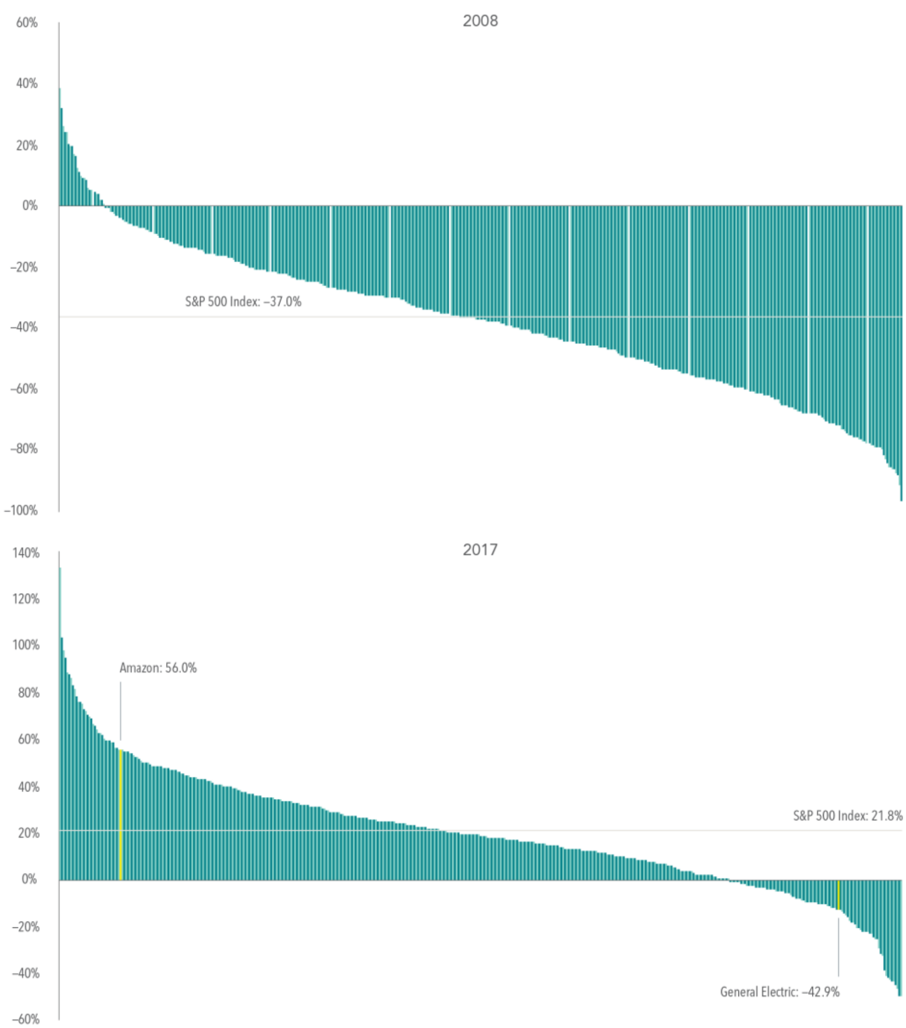

Exhibit 4. Range of S&P 500 Index Constituent Returns

Upper chart includes 2008 total returns for constituent securities in the S&P 500 Index as of December 31, 2007. Lower chart includes 2017 total returns for constituent securities in the S&P 500 Index as of December 31, 2016. Excludes securities that delisted or were acquired during the year. Source: S&P data ©2019 S&P Dow Jones Indices LLC, a division of S&P Global. For illustrative purposes only. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

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IS TOO MUCH INDEXING A PROBLEM?

In the end, despite the increased popularity of index-based approaches, the data still reveals a highly functional auction market that sets prices. Indexing is a modest percentage of overall market capitalization. Annual trade volume remains massive and active management underperformance continues. At this point, the argument that too much indexing is a problem, appears more theoretical than anything else. There's just too much price discovery at work!

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We saw many remarkable places, making it nearly impossible to pick our favorite, but some of the highlights were: the majestic mountains adorned with bright yellow Aspens in Colorado; the beautiful and unusual formations caused by wind and erosion in Monument Valley, Arches, Badlands, and Zion National parks; our patriotic feelings gazing up at Mt. Rushmore; the blue skies and vast landscapes of Wyoming and Montana; the herds of grazing bison in South Dakota; the beautiful red rock canyons of St. George. One of the most memorable places was the Grand Tetons –our blistered index fingers are nearly healed from all the snapshots we took.

In addition to all the memories and picturesque views, Suzie and I had plenty of laughs along the way. While patiently waiting for Old Faithful to erupt in Yellowstone, we watched a group of Japanese tourists excitedly whoop and holler every time the geyser spurted a little steam. (You had to be there.) Another funny thing happened when we pulled over to take a selfie with a "Welcome to Wyoming" sign. I am not sure how, but in the photo, I ended up with two heads.

We considered an RV for this trip. Looking back, our minivan worked out great. It got good gas mileage, was easy to park, and handled some backroads too difficult for an RV.

Lessons learned:

September: kids are back at school but retirees and foreign tourists clog the motels and hotels – Reserve Ahead!
Popular Destinations: Reserve Ahead!
Roads Less Traveled: Shun the freeways, Explore the backroads.

It's a great, big, beautiful country. Don't miss it. See the U.S.A. in your Chevrolet (or Toyota minivan!)