



## **Dumb Beta: Why index funds cost much more than you think and how they can jeopardize your life savings.**

A Long-Term Solutions white paper

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Every once in a while a friend will tell me “I don’t need an investment advisor, I’ve got my IRA/401K/life savings in index funds. The fees are low, I get market performance and I don’t have to do anything; I love it.” Worse, some people think that investing 60% in an equity index fund and 40% in a bond index fund (or in a 60/40 “balanced” index fund), gives them a balanced portfolio. I wince and fight the urge to embark on an hour-long dissertation on why entrusting their life savings to index funds is a horribly risky, penny wise/pound foolish strategy. So I have decided to condense my thoughts into a short paper that I can hand to every friend who utters that terrible mantra.

I can’t really say I blame non-professional investors for believing the hype about index funds, whether they use index mutual funds or exchange-traded index funds (ETFs). You usually get market performance, (less fees, however small), with no decisions or hassles, at a very low management cost. John Bogle of Vanguard Funds took an idea originally expounded by Burton Malkiel in his book, *A Random Walk Down Wall Street*, and in 1975 created the first retail mutual fund to passively hold a fixed basket of stocks that mirrors the components of a widely quoted index like the S&P 500. Index funds adopt as their reason for being the efficient market theory, which states that securities prices always reflect all available information about a given security, and that therefore an active manager cannot possibly achieve better results than the market as a whole. With no active management required, payrolls and costs can be kept to a minimum, and fees to investors can be kept low. If the efficient market theory is correct, an active manager’s results are not going to be any better than the market as a whole, so why pay any more for an actively managed fund? In addition to simplicity and low cost, index funds also have low turnover, and thus low trading costs and low tax impacts for taxable investors. An attractive proposition, but with many drawbacks and hidden risks.

Don’t get me wrong, there is a place in most portfolios for passive index stock funds. They work best for getting broad and inexpensive exposure to stocks, especially large cap stocks. In a rising market, allocating a small portion of your core portfolio to a passive large-cap index stock fund helps capture the upside in the market in a cost-effective manner and supplements the active managers and alternative asset allocations of a well diversified portfolio. Bonds index funds are a different story, though. Broad-based bond indexes are heavy on U.S. Treasury bonds and carry a great deal of interest rate risk. Even

John Bogle himself has admitted that buying a passive bond ETF based on the Barclays US. Aggregate index is not a good idea. But a passive index fund cannot compete with a talented active manager who has the flexibility to take advantage of market anomalies and gyrations rather than being locked into a set allocation. Although index fund proponents will tell you that no active manager beats the index all the time (which is certainly true), the fact is that 38% of active small cap managers outperformed their respective index ETFs over the five year period ended December, 2010. (1)

But index funds have inherent drawbacks that often aren't appreciated by retail investors. One is that when a company is added to an index, all the funds tracking the index have to buy that stock to keep the fund accurately tracking the index. That creates sudden demand for the shares, which in turn runs up the price. So investors in index funds wind up buying high, not low. As indexes are usually market cap weighted, meaning a company with a large market capitalization (the value of all its traded shares at the current market price), like Apple, will occupy a disproportionately large percentage of the fund's holdings. Since large market capitalizations are primarily a product of high share prices, market cap weighted index funds tend to hold a disproportionate number of relatively expensive stocks that are susceptible to decline, and a smaller proportion of lower priced stocks that are potentially undervalued and ready for a run up in value. The solution here in non-market cap weighted funds.....And then there's the real performance gap, but we'll get to that.

Nevertheless, index funds continue to gain in popularity, fed by their low cost, low tax impact and the myth of the efficient market. After Google went public, the company brought in advisors for their newly-wealthy employees who touted the virtues of index funds. And a lot of them bought it. Even Warren Buffett recently advised a friend sitting on a pension plan board to eschew hedge funds in favor of index funds. Warren should know better, and he does; he either has a weird sense of humor or thinks that no one else can be as good an active manager as he is. More on that later.

So what's wrong with capturing 99+% of the performance of the broad market at very low cost? Well, to start with, it means you not only capture 100% of the upside in a bull market, but also 100% of the downside in a bear market (don't even try to tell me you're going to take your gains at the end of the bull market and sit out the bear market; no one, not even Buffett, has figured out how to pull off perfect market timing). So in a year like 2013 your S&P 500 index fund is going to be up 32%. Trouble is, in a year like 2008 your index fund is going to be down 37% (including dividends). You'll never do better than the market, up or down.

Adding a bond component to stock holdings, often in the ratio of 60% equities to 40% bonds, is the traditional "balanced portfolio" approach to diversification. The idea is that equities and bonds are non-correlated; that is, when stocks are down, bonds will be up, and vice versa. Trouble is, the correlation between bonds and equities has been increasing, especially during bear markets when you need that protection the most. During the November 2004 to September 2007 bull market, a balanced portfolio would have returned almost 70% over less than three years, an average of about 23% per year. But in the next year, from October 2007 to October 2008, the same portfolio would have returned *minus* 31.6%. (2) So the traditional balanced portfolio approach no longer offers a "sleep well" solution to portfolio construction. Add to increasing correlation between equities and bonds the fact that unlike

equity ETFs, bond ETFs have liquidity issues that make their prices very volatile, especially during downturns like 2008, and you have an accident waiting to happen. During that bear market, the popular iShares High Yield Corporate Bond ETF saw its price swing from a premium of 12.7% (that is, the ETF was trading at 12.7% more than its underlying asset value), to discounts of as much as 7.9%, a swing of more than 20% in a matter of months. And this from the component of the balanced portfolio that is supposed to protect against volatility. (3)

So what, you may say, it all averages out, doesn't it? Not really. The way the math works, if you had an exceptionally bad year and your portfolio declined in value by 50%, you would need a 100% gain just to get back to even. There aren't many 100% years for the S&P 500 index; in fact there aren't any. The record increase in the index was 37.2%, including dividends, in 1975. So big losses have a much more profound impact, and are a much bigger risk to your financial health, than big gains. Avoiding \$1 of loss can be worth \$2 of gain, and that doesn't take into account taxes and trading costs. So shouldn't our investment goal be to first avoid losses, and then to capture as much of the gains as we safely can without exposing ourselves to too much volatility? That way our portfolio will sidestep big losses, and lock in moderate gains to grow at a nice, steady pace. An index fund is meant to track the market, so it does just the opposite, whether "balanced" or not..

That's where active portfolio management and alternative asset classes come in, and why their use makes more sense than passive index funds. Active management costs more, as the index fund advocates will gladly tell you. And in most cases you'll want or need an investment advisor to help you select, monitor and manage a portfolio of active managers, so add that cost also. But so what? If I pay 1% or 2% per year more in management fees, but average 2% or 3% more per year in performance, you're still ahead, net after fees. And that excess return compounds every year. As we'll see, the best active managers are capable of much larger relative performance differentials, at relatively little cost. The only performance that counts is net performance, after fees.

To illustrate, let me return to Mr. Buffett. (Full disclosure: Warren has been my investment guru since I bought my first share of Berkshire Hathaway in 1980. Thank you, Warren.) He didn't become the world's fourth richest man by investing in index funds. He made his fortune through active management using smart leverage. During the period 1965—2013, Berkshire Hathaway has increased in book value by an average of 19.7% per year, while the S&P 500 index has increased an average of 9.8%. That's more than DOUBLE the long-term S&P performance, compounded over 48 years. Lucky streaks don't last that long, but a disciplined approach to active management does.

"Buffett's returns appear to be neither luck nor magic, but, rather, reward for the use of leverage combined with a focus on cheap, safe, quality stocks. Decomposing Berkshire's portfolio into ownership in publicly traded stocks versus wholly-owned private companies, we find that the former performs the best, suggesting that Buffett's returns are more due to stock selection than to his effect on management. These results have broad implications for market efficiency...", according to a 2013 National Bureau of Economic Research analysis. (4) In other words, the argument for index fund investing, namely that the market is efficient so why bother to try to beat it, and that active

management doesn't add enough extra return to justify its extra cost, is pure baloney. And with it goes the rationale for index funds.

What does this tell us about how mere mortals should structure their investment portfolios? First, there are many active managers who do achieve consistently higher net after-fees performance than passive index funds; and second, we can increase returns and reduce volatility to actively limit losses in down markets by diversifying our portfolio beyond traditional stocks and bonds.

To implement this approach, we first have to seek out the best-in-class active manager for each category to which you wish to allocate funds. The statistics needed to research and select these star managers are readily available, but the universe of fund managers numbers more than 29,000, so it is difficult and time-consuming to evaluate good managers effectively, let alone to monitor and continually adjust based on performance and economic conditions. That is where the financial advisor comes in: He earns his fee many times over by ferreting out those investment managers whose returns consistently capture more of the upside in bull markets and less of the downside in bear markets. Allocating your core portfolio among these best-in-class managers over a mix of asset classes positioned to benefit from current macroeconomic conditions is another way a financial advisor increases net after-fees performance. And of course, Warren Buffett being one of the best active managers himself and his firm being publicly traded, one approach is to simply use Berkshire Hathaway shares as one of your active manager allocations. Used that way, this active manager is even more cost effective than index funds, since the management fee is zero.

Second, strategically incorporate the use of "alternative" investments in your portfolio to go beyond the volatility of traditional stock and bond portfolios. Think of stocks and bonds as two legs of a three-legged stool; they are necessary components of your portfolio but it is not complete, nor stable, without the third leg. By alternative investments I mean those assets that (1) allow diversification away from stocks and bonds, (2) provide higher yields, faster growth, or both; and (3) have a positive correlation with inflation to protect the value of your assets. These alternative investments include assets such as floating rate bank loans, high yield bonds, commodities, real estate and real estate investment trusts (REITs), emerging market debt and currencies, infrastructure investments such as gas and oil pipelines (so-called Master Limited Partnerships), and carefully selected private equity, debt and hedge fund investments. (Not all of these assets are appropriate for all investors or at all stages of an economic cycle; they must be carefully selected to compliment the actively managed core stock and bond holdings.)

Private equity investments in particular, have been shown to provide cash flow or growth that can be almost totally uncorrelated with broader markets. Private equity refers to managed pools of long-term capital used to acquire stakes in non-publicly traded companies. The stakes can be early stage investments (venture capital), expansion capital for growing pre-IPO companies, buyouts of mature companies, or hybrid investments such as mezzanine debt which combines aspects of equity and senior debt. Private equity managers often seek to add value by becoming active in strategic decisions or on the companies' board. Private equity investments are an excellent portfolio diversifier that can add incremental performance, especially at time when publicly traded equities and debt are fully priced. By

definition less liquid and longer term than publicly traded securities, their contribution to portfolio growth and income can be significant. Yale University's \$20 billion endowment has scored the highest returns of all university endowments in eight of the last ten years (20.2% in the year ended June, 2014) and allocates 32% of its portfolio to private equity investments. (5) Of course, private equity investments are long term—the typical private equity fund has a lifetime of 4 to 7 years—and more or less illiquid during the life of the fund, as well as difficult to source and evaluate, but the long time horizon suits endowments well and your financial advisors are the key to finding suitable private equity managers.

Taken together, this three-legged stool approach of incorporating best-of-class active managers and alternative investments can yield consistent returns with minimal volatility, and much better performance compared to a balanced portfolio using passive index funds. An intelligent allocation to a globally diversified core portfolio of active managers in multiple asset classes and a satellite portfolio of alternative investments results in an all-weather, conservative portfolio that will protect your assets against inflation, generate growth and provide reliable retirement income.

Notes:

- (1) Blackrock, Morningstar data as quoted in "The Fundamentals of iShares ETFs", undated Blackrock publication
- (2) "A Study of Traditional Asset Correlation in the New Millennium," Kirk Chisholm & Joseph W. Chase, Seeking Alpha September 13, 2010.
- (3) "Rethinking Bond ETFs" Michelle Knight, Financial Advisor Magazine, June 25, 2011.
- (4) "Buffett's Alpha," Anrea Frazzini David Kabiller Lasse H. Pedersen Working Paper 19681 <http://www.nber.org/papers/w19681> NATIONAL BUREAU OF ECONOMIC RESEARCH 1050 Massachusetts Avenue Cambridge, MA 02138 November 2013
- (5) The Wall Street Journal, November 4, 2014 and Report of the Yale Endowment, 2013

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**Long-Term Solutions, LLC** is a San Francisco-based boutique wealth advisory firm that researches, designs and manages core portfolios of active and passive managers, and originates and sources alternative investments including private equity pooled investments.

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