NORTHSTAR
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FINANCIAL PLANNING NOTES
CLIENT NEWSLETTER

"I am tomorrow … what I establish today. I am today what I established yesterday."

—James Joyce

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INDEXING'S BIGGEST MYTHS

Talk to an active stock trader for a while, and they'll tell you—well, I'm not positive what they'll tell you. I avoid talking to active stock traders for a while, or any other length of time.

But if I did find myself in such unfortunate circumstances, and if I couldn't resist the urge to proclaim my belief in efficient markets (and the fundamental principle that active trading is a losing endeavor), I am sure I'd be treated to a litany of evidence and theories (and perhaps an outright lie or two) in support of active trading.

And in building up their bona fides, these traders would attack the passive approach known as indexing, or buying funds that hold all of the stocks found in an underlying index (like the S&P 500) without making any judgment of which stocks are better than others.

While our investment approach at Northstar is a little more nuanced than a straight indexing approach, it is way closer to a passive strategy than an active one, and I would rather see any investor in a well-diversified, low-cost index fund than your typical high-cost active fund.

We've covered many of the hollow claims of the active managers in articles past, but here's a recap, and a fun new one I don't think we've discussed before:

1. **"You can't beat the market with indexing."** While the claim that the purpose of indexing is to get, not beat, the market return is basically true, the conclusion that active investing is better is specious. Just because you can beat the market with active investing doesn't mean you will. In fact, there is a much stronger possibility you will do worse than with a passive, index-based portfolio. And that's mainly because of the falseness of Claim #2:

2. **"Good money managers beat the market."** It is also true that every year some fund managers beat the market. But we don't know which ones until after they've done it, which in the absence of a Wayback Machine won't help you. Active-management arguments to the contrary, we have no proven method of determining which managers will do well going forward. So the claim that some managers will beat the market is an empty one. It's like claiming the million-dollar scratch-off is a good investment strategy because "some" of the cards are winners.

3. **"Active management can help you avoid losses in bear markets. Indexing can't."** Another true but worthless claim. A big part of active management is market timing, getting in when markets are good and exiting when they turn bad.

But there is no evidence that active managers are any good at this. Their attempts to time both their exit and reentry result in overall returns no better than, and often worse than, just riding the market ups and downs with a passive strategy.

4. **"If everyone indexes, markets will become inefficient."** This one is my new favorite. A brief history lesson is needed to understand where it comes from.

A Brief History Lesson

Despite their dominant control of the market and massive sales efforts, active managers have watched their market share slip over the past couple of decades. According to recent data from the Investment Company Institute, index funds grew from 15% of the mutual fund and ETF market in 2007 to 35% in 2017.

So now, with passive strategies on the rise, the active management misinformation machine has offered a new argument against indexing: It distorts market prices. Once again, they form the argument in a sound bite that seems logical: Active management sets proper market prices (equilibrium) as buyers and sellers come together to buy and sell their shares of stock. As more active market participants leave, the less efficient the markets will be at maintaining equilibrium pricing.

Like other arguments against indexing, it looks good on paper, but it isn't supported by real-world evidence.

Longtime research partners Kenneth French and Nobel Prize Economist Eugene Fama recently pointed out that the large outflow from active investing might easily be a good thing for establishing proper pricing in stocks: "If misinformed and uninformed active investors (who make prices less efficient) turn passive, the efficiency of pricing improves."

Of course! And who is more likely to be exiting the active marketplace? Well-informed investors who are successful at the task or poorly informed actors who exit out of frustration of their dismal performance? The less efficient traders are, the less efficiency they are adding to the market, and the less they will be missed if they leave it.

But how many participants can leave the market? Don't we need a lot of trading activity to set prices to their proper equilibrium level? French and Fama continue:

"The answer also depends on the costs of uncovering and evaluating relevant knowable information. If the costs are low, then not much active investing is needed to get efficient prices."

Clearly, Fama and French believe markets can maintain efficiency even if a substantial percentage of active trading stops. And we'll look at some evidence of that in a minute.

Another problem with the anti-indexing argument is that it ignores other market activity through which prices are set and reset as new information becomes available. Companies issue stock shares (such as IPOs) and repurchase shares (buybacks). Buyers of newly issued shares and sellers of buyback shares can be both active and passive investors. Derivatives markets also see trading of hundreds of millions of dollars of stock options and futures. Again, not all of those traders are active investors. Some investors buy futures as hedges or to cover another position. All of that activity helps set proper stock prices.

My favorite counterargument against the claim of inefficient markets is so obvious it's a wonder the active world ever dared to suggest the claim in the first place. If markets are becoming more inefficient, then *why aren't active managers doing a better job of beating the market?* Really, isn't that exactly what they are supposed to do? Find market inefficiencies and exploit them? Find improperly priced securities, buy the undervalued ones, and sell the overvalued ones?

As passive market share has skyrocketed over the last decade, we've seen the same trend from active managers: Very few of them beat the market return after costs.

In the end, that makes any other claim they offer meaningless. What if we reach a point when indexing does impact price equilibrium? Active managers still have to prove they can take advantage of it and deliver better returns. Until then, I'm not changing my strategy, and I don't see myself recommending that any of my clients change theirs either.

—Steve Tepper

Sources:

The Index Bogeyman from Dimensional Fund Advisors, April 2019

Ici.org/pdf/2018_factbook.pdf

Famafrench.dimensional.com/questions-answers/qa-what-if-everybody-indexed.aspx.

FUN MONEY FACTS THAT I HOPE ARE ALL TRUE

Yes, I found these on the internet, so probably about 40% of them are true. If you have any corrections, let me know:

- Ever have coins in your pocket setting off the airport security alarm? You aren't alone. In 2015, the TSA collected $765,759.15 in loose change at security checkpoints. (They just finished putting it all in those little coin rolls last Tuesday.)
- Worn-out bills are turned into compost at a rate of about 4 tons a day at a farm in Delaware.
- Need to take your worn, wrinkly bills to a vending machine? Microwave them for 20 seconds. That flattens them out (and makes the world's least tasty soup).
- It really is all about the Benjamins: $10 bills have the shortest life span, retired after an average of 4.5 years, while Franklins ($100) last 15 years.
- Holding on to that $2 bill because it's so rare and might increase in value? Think again. There are over a billion in circulation (about the same as $50 bills, and I don't see you hoarding them!).
- Speaking of the deuce, the main reason they never caught on is because cash registers and teller drawers had no slot for them, as none of the other denominations was retired.
- And one more fun $2 bill fact: The government has a bunker in Virginia where they have a large stash of cash, presumably to restart the economy after nuclear Armageddon or the zombie apocalypse. Because they had so many surplus $2 bills on hand, about a billion Jeffersons are stored there.
- You might think the mint uses a lot of ink printing bills, and you'd be right. Nine tons of ink is used to print 26 million notes each day! And you thought your Office Depot bill was high.
- Why was the Secret Service created? It doesn't help to know when it happened: two months after Lincoln's assassination. The Secret Service guards the President, so obviously they were created to: stop counterfeiting! True story.
- The best way to make money in a Gold Rush? Sell pickaxes! The 1850s California Gold Rush brought so many fortune seekers to San Francisco that prices skyrocketed there. In today's dollars, a dozen eggs went for $90, a hotel room for $300,000 a month, and a pickaxe for the reasonable price of $1,500. So don't wait for the next rush to begin—get a pickaxe at Walmart today for $14.97. In fact, get a couple hundred.

—Steve Tepper

Sources:

16 Mind-Blowing Facts About Money That Will Make Your Jaw Drop by Brandon Specktor. Readers Digest.com

Why Are Two Dollar Bills So Uncommon? Quora Forum, John Bennardo (September 25, 2017) and Paul Burchstead (March 18, 2019).

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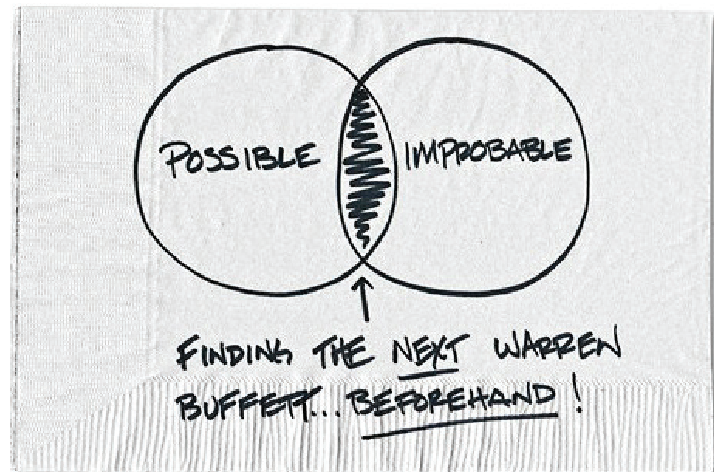
FROM CARL RICHARDS' NAPKIN BLOG



FINAL THOUGHT

"You should start socking a few bucks away for retirement."

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