

Now is not the time for indexing

By Nigel Wilkin-Smith

In the wake of the worst financial crisis since the Great Depression, investor confidence has been shattered. Scepticism over the stability of the global financial system is particularly pronounced in the retail investment market, and has been amplified by the spectre of various well-documented scandals. These events have left many investors understandably anxious about the quality of the financial advice that they receive, and naturally suspicious about the ability of investment managers to deliver on their claims of future performance.

This sentiment has provided the ideal platform for an aggressive marketing campaign undertaken by some fund managers, aimed at convincing financial planners that they should 'index' their clients' exposure to asset classes like equities and bonds. These investments attempt to track the performance of major market indices (like the ASX 200 for example), which has traditionally been achieved by frequently rebalancing a portfolio of constituent securities to replicate their index weights. In this era of financial engineering, there are now also indexing strategies which employ futures contracts to synthetically duplicate the performance of a given benchmark. The superficial appeal of these passively managed products is their low cost in comparison to actively managed strategies, while the cynical amongst us might also suggest that some financial advisers who recommend them could then more easily ascribe poor portfolio performance to the behaviour of the market.

One of the principal theoretical arguments used to market index products is the so-called 'efficient market hypothesis' espoused by Professor Eugene Fama, a decorated economist based at the University of Chicago. This doctrine posits that all known relevant information is embedded in the price of a traded asset, and that any salient new information is immediately absorbed into this price. By implication, a self-regulating financial marketplace then efficiently and rationally determines asset prices, without need for external intervention, except to prevent collusion between, or fraud perpetrated by, market participants. Of course, while this theory assumed the status of orthodoxy during the 25 years of deregulatory economic reform which preceded (and some argue precipitated) the current global recession, recent experience appears to indicate that the behaviour of capital markets is anything but rational!

Financier and philanthropist George Soros has suggested that 'distorted views held by market participants and expressed in market prices can, under certain circumstances, affect the so-called fundamentals that market prices are supposed to reflect.'¹ In other words, human behaviour, sometimes irrational or unethical, exerts considerable influence over the trajectory of human creations like financial markets. Attempts to impose the strict theoretical rigour of the natural sciences upon social sciences like economics and finance are problematic at best, and potentially disastrous in the event that the resulting concepts are implemented too dogmatically. The events of the past 18 months serve as an object example of such overreach.

Quite aside from any esoteric debate over economic theory, however, there is ample practical evidence to debunk claims made by the advocates of indexing. The table below details the current capital value of hypothetical A\$1000 investments made on 30 June 2007 in different sectors of the Australian stock market, together with a comparable figure for the ASX 300 market index. The dispersion of performance across these industries over this time period is remarkable, and this spread of returns is even wider at the level of individual stocks. This phenomenon illustrates the magnitude of market turmoil that investors have just

¹ George Soros, *The Crisis & What to Do About It*, The New York Review of Books, Volume 5, Number 19, December 2008.

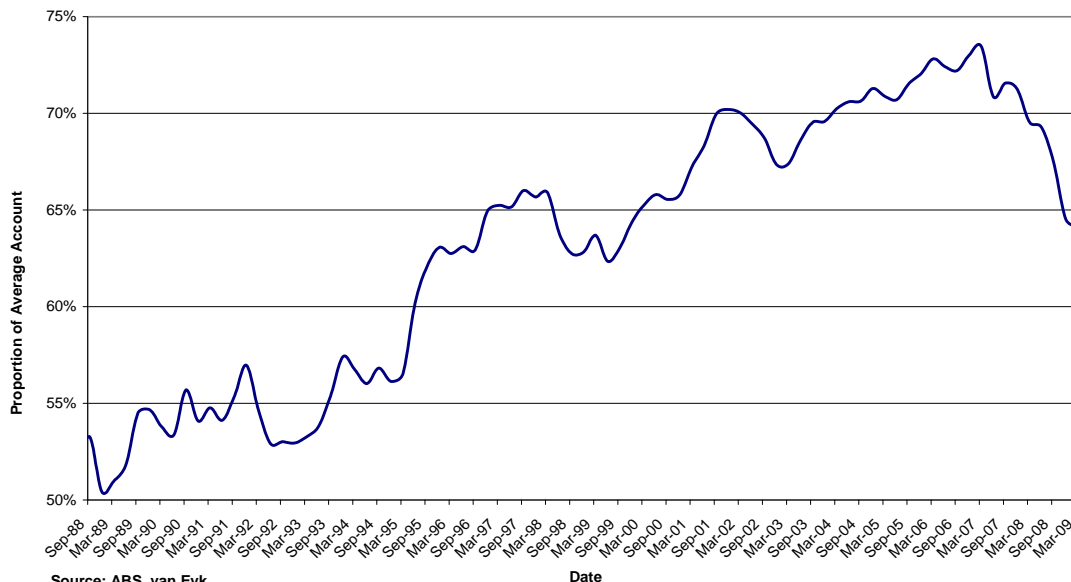
endured, where stock picking informed by sound fundamental research would have had significant potential to outperform the index.

Current capital value of \$1000 invested on 30 June 2007	
Materials	\$741
Consumer staples	\$793
Energy	\$1,021
Industrials	\$411
Telecoms	\$701
Healthcare	\$935
Consumer discretionary	\$445
Utilities	\$511
Information technology	\$667
Financials (ex-listed property)	\$575
Listed property	\$310
ASX 300	\$624

Source: Bloomberg, van Eyk

Another key consideration in this analysis of the relative merits of active and passive funds management is the composition of diversified investment portfolios, and the interrelated issue of risk tolerance. The risk aversion which has gripped investors since the onset of the financial crisis has materially affected the asset allocation of superannuation funds, where equities have been heavily sold off to the benefit of defensive assets. It is instructive to place this recent trend toward more defensive portfolios in historical context, for prior to the introduction (and even during the earliest phase) of the national superannuation scheme, the proportion of growth assets in super accounts was considerably lower than the 70% level which has been commonplace throughout most of this decade (see chart below). Indeed, the denomination ‘balanced fund’ was originally coined to characterise an investment portfolio with a roughly even split between equities and bonds.

Growth Assets as a Proportion of Total Superannuation Assets



Source: ABS, van Eyk.

While the introduction of compulsory retirement saving in Australia may have extended the investment horizon of the average investor, the increase in risk tolerance which has accompanied this process seems to have been implicit. The artificially low volatility of the domestic share market in recent years, not to mention academic theories like the ‘efficient

market hypothesis', appear to have deceived the Australian public into the belief that equity portfolios are low risk investments. This is certainly not the case, as many investors have now discovered to their peril.

The next investment cycle is likely to be characterised by far more moderate economic growth, as consumers and corporations in developed market economies with large current account deficits undertake a lengthy period of deleveraging. Such conditions will serve to dampen the performance of equity markets, which will probably remain quite volatile as they revert toward their historical risk profile. In the event that super accounts take on a more conservative flavour, investors will need to enhance the return on growth assets that they do hold. This will require adept active management of these exposures, with a focus on security selection underpinned by high quality and well-resourced fundamental research. Now is most definitely not the time for indexing.

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