Index Funds vs. Active Management

Oh, I love this topic. Let me add a few more observations. First off, the premise is FALSE! The love affair with index's kicked into high gear in the late 90's. It became gospel because the "be all and end all" of judging a good investment from a bad one, the "10 year compounded return" calculation, showed that 9 out of 10 portfolio managers had worse numbers. Now Dan Hallett I know, because of his back ground at Fund Monitor and Duff Young, that he is all to aware of how inadequate a measure of performance Compound Annual Returns (CAR) are on their own.

For those of you who are not, let's talk about it for a moment. CAR's are disproportionately <u>skewed to the most recent year’s performance</u> simply because you are making or losing on the compounded growth as well the original principal.

So how is this misleading? Well, this is why you get one hit wonders suddenly showing up as the best investment on the planet. I think anyone that has investing long enough has some idea of this concept. In practical term's if it was as simple as picking the fund with the best 10 yr. CAR to guarantee the best performance next year, 5 year's or 10 year's out, then our lives would be a lot simpler today. A much more useful way to rank funds is to look at quartile rankings for 10 yr. 5yr. 3 yr. etc or year by year quartile rankings but that is a discussion for another day.

So how does this translate back to index funds? I'm in my 20th year. The first 10-15 yrs. managed money kicked index butt. As we all now know, after going through the worst bear market in 70 years, the previous 10 or even 15 yrs. are not guaranteed to be predictive of the next 10. We have look at the last 100.

During that period, there have been other times when an index was the only investment to own. From 1969 to 1973 people were saying the same type of thing. The "nifty-fifty" were all you needed to buy. It took the S&P index 10 yrs to recover and several of the "nifty-fifty" are out of business or still below their 1973 price. This is the time frame the hedge fund hustlers want to use now as an example of why mutual funds are dead (Don't crap on me about hedge funds. I use some of them… I just get a little cranky about some of their marketing).

If you don't know any better, this can scare the heck out of you, but it shouldn't. As an investor you should be thrilled. Check the record of some of the managers who are still around now from the same time period (Cundill, Krembil, Coleman, Templeton, Brandes, etc.) and you will find returns in the high teen's and low 20's!

Now fast forward to 1995 to 2000 and you get an even more skewed world. I should have mentioned this before, and forgive me for those of you who already know this but, it is important to understand that index's are weighted to market cap. The bigger the company “market cap” the bigger proportionate influence on the index's performance. As an example (I am going from memory here so the numbers might not be exact) most of you will remember when Nortel was equal to over 30% of the TSE 300. In the fall of 1998 or 1999, for instance the TSE 300 was up 28%, or so, but the TSE 299 (ex-Nortel) was only up 2% or down 2% I can't quite remember which, but you get the point.

The same kind of thing was going on in the S&P 500 but wasn't even 50 stocks…it was more like 30. For the last two years of the market run the market breadth (advancing stocks versus declining stocks and up volume versus down volume) was negative. The valuations on the "biggest of the big" stocks were ludicrous. I remember a conference call with Bob Krembil in the fall of 1999, (because he was getting his assets redeemed by the boatload, because his Trimark Fund was only up 12% year-to-date and several other funds were up 60% ie. Select Mgrs., CI Global, etc.) and he gave some interesting examples.

I'll also admit right here that our firm also sold more than we should have of the above named funds at that time and not enough Trimark and Ivy. We did sell some that year and I can also honestly say that we did not redeem them either.

Bob Krembil took the market cap of Cisco and added up the market cap of every stock in the Trimark Fund (about 60) and Cisco's market cap was higher. Then he totaled all the profits, cash flow, etc. and well... as you can imagine they were astronomically better. He also took Dell Computer and said if you buy now looking for the same earnings growth that you had in the last 5 yrs. for next 5yrs. (which was what the current price indicated) you would have to assume Dell was going to sell 1.5 computers to everyone in the world.

Anyway, so the market and especially these exceptionally large companies were, shall we say, over priced and some are still over priced. They also make the "market" look over priced but the 450, 950, 1950, 2950, 4950...etc. smaller stocks are much more reasonably priced and this is when managers earn their MER. These very large companies could very well keep the "index's" very flat while the broader market and/or foreign markets advance.

My thesis boils down to this (incase you don't want to read my ranting above):

- -index's outperform when the "biggest of the big" stocks out perform because they carry huge percentage weightings.
- -1995-2000 the big stocks ruled the day-that made the 10 yr. CAR better than 9 out of 10 mangers.
- -media start covering investing in a big way during this period
  -the media all assume the last 5 years or the last 10 years CAR is the only way to evaluate performance because it is simple and they only do simple!
  It then becomes fact because they say it is over and over and over...again.

- -the last time index's did better than managed money(1969-1973) and stocks went down it took the index a decade to recover and the big stocks about 13 years while the broader markets had outstanding decades
- Index's outperformed 1969-1973 and 1995-2000. 8 out the last 34 years that's...oh hell let's be generous and call it a 1/3 of the time.
- If you want to underperform 2/3's of the time buy an index fund.