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Indexing and the Rise of a New Nifty 50

Low-cost passive investing has triumphed. But all stocks aren't equal, so stock-picking may return.

By FREDERICK E. "SHAD" ROWE
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Jack Bogle, the legendary founder of Vanguard, has won the argument. Time and experience have demonstrated that for most investors, low-cost indexing is the most efficient way to invest. Over the past five years, indexers have outperformed the vast majority of active managers, causing even more investors to realize the now-obvious answer to the question of what they should do with their money: index.

Can this go on forever? Highly doubtful. While indexation is efficient and effective, there has never been a really good idea on Wall Street that hasn't been taken to a foolish extreme (mortgage-backed securities, triple-levered exchange-traded funds, or smart beta). The situation is reminiscent of the old tale about the poker-game host who admonishes his friends, saying, "Let's all play our cards carefully and maybe we can all make some money tonight."

Just as only 10% of investors can be in the top decile, so inevitably the continuing rise in passive investing will create both winners and losers.

A MAJOR DETERMINANT of investment performance over time is cost. Thus, passive investing has been a net benefit to most investors, and it's widely understood that index investing should reduce three major costs: the management fees that investors pay to

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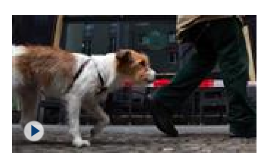

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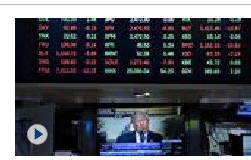

money managers to manage their accounts; the cost of managing the individual companies that make up their portfolios; and—last but not least—taxes.

Compensation of corporate managers is another cost—substantial but less publicized—borne by shareholders. Institutional investors have been reluctant to speak up about excessive executive pay for fear of losing access to the managements of the companies whose stocks they own.

Big index investors are increasingly finding themselves in a position to affect corporate governance by demanding a connection between pay and performance. It would seem obvious to most people that money managers have a fiduciary duty to maximize the long-term value of the shares held by their clients. They certainly have a duty to prevent corporate managements from ripping off their clients.

Far less turnover means less taxes. Buy and hold is an easy concept to understand but hard to put into practice. A very successful active value investor I know constantly cautions his troops, “Do not show me how hard you are working by running through a bunch of trades.”

THE CLEAR LOSERS of the indexing argument are high-cost, poor-performing portfolio managers. The days of 2% management fees and 20% of annual profits are out the window, leaving befuddled investors moaning, “What was I thinking?”

That isn’t to say all active managers have lost. In fact, as the pendulum continues to swing in favor of indexing, it should create an enormous opportunity for stockpickers. As costs go down, the attractiveness of the stock market investment game goes up. This should lift prices of stocks in general.

So where do we go from here? What’s coming next? Indexing seems to presume that all companies are equal, and most assuredly are not. As indexing becomes even more popular, the valuation spread between great and mediocre companies will continue to narrow. This development ought to bode well for long-term stockpickers, particularly those who focus on quality.

Perversely, this is happening at a time when social commentators lament how the world is becoming more and more bifurcated between the “haves” and the “have-nots.”

I believe many investors will gradually begin to recognize and embrace a few great companies, in effect creating supercurrencies. Global, world-class, cash-generating companies will be able to use their shares to acquire anything they want, accumulating more wealth than ever before for their shareholders. (To some extent, this is similar to what Warren Buffett’s Berkshire Hathaway (ticker: BRK.A) has done with its cash.)

It is often said there is nothing new under the sun. There is certainly nothing new on Wall Street. The stockpickers’ market that I foresee resembles a rebirth of the Nifty 50 idea of the 1960s and early 1970s, where a few great companies sold at enormous valuations. “OK, fine,” you say. “Weren’t the 1960s followed by the 1970s, a terrible period for the stock market?”

Of course. Trees do not grow to the sky, and the stock market will always face cycles and volatility, but investors who minimize costs and pick decent stocks will give themselves the best possible chance to both compound and outperform over time. This has been true throughout my career, even in this world of indexation. In the next world, it will prove to be even more effective and important than ever.

SINCE INDEXING has become broadly accepted, it seems that we are closer to the end of a cycle than to the beginning. Indexing has brought great benefits, enabling investors to play in a much more attractive arena. But the lack of distinction between great and mediocre companies isn’t going to last forever, so investors who seek quality growth will be well served eventually.

As with anything on Wall Street, the odds are high that indexing, too, will be taken to extremes. But I believe that we are at the end of the beginning, not the beginning of the end. We can sit back with our index funds, leavened with quality growth stocks, and enjoy what could be a very long-lasting bull market.

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Spoken like an active manager.

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Could there be benefits of indexing for companies? It could be of great benefit if major parts of the shares are held by a "silent majority" that allow the board of directors to follow a longer-term strategy compared to the situation where few major stock holders blackmail them and ask for short term activity to increase *their* wealth. But then, of course, if the silent majority doesn't exert their rights, this could cause trouble....

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Joe Farrell 13 days ago

Everything can do well while the the world is living in a debt bubble, but when they bubble pops watch out below. Did you notice this week very quietly the IMF (basically us tax payers money) handed out 1.8 billion to Greece with no strings attached, just another example of the debt bubble, moving money around the board. Now, of course, the EU doesn't really generate much in the way of growth these days. They have gotten in the habit of going after the american technology companies looking for billions in fines and taxes to fund their immigration policies, which has done nothing to increase growth in these countries, but more of taxing the government, which in turn, causes these same governments to look for deep pockets for money. I'm thinking thats how a debt bubble works, governments need more and more money to sustain there ever increasing size, which eventually leads to a point where it implodes.

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T G 13 days ago

I agree. Indexing has its place, but the greatest wealth creators I know or have known purchased high quality equities; had a set unemotional process of reviewing them (for example a dividend cut) or annually. Both had a strategy for review and adjustments. Yeah, I know there will be the boo birds out there because the process doesn't beat the index on a daily, weekly or annual basis all of the time. Yet history has shown that once something becomes popular (now it's indexing) it eventually fails. My prediction will be right when the market does little or nothing for years or we suffer a 15-25% downturn and it doesn't come back within a year. Markets change, investors never do.

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Gregory McMahan 11 days ago

@T G

Thinning of the herd? Sounds wonderful to me. I have noticed too many people of late trying their hands at active investing. I for one will be glad to see them go. In this yield-crazed, low-interest-rate, debt fueled era, they have done nothing but distort asset prices even further (all with the blessing of all-too-accommodating central banks). Spot on, T G.

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