HORIZON KINETICS

Under the Hood: The Indexation That Is, Versus The Indexation That Should Be
(An Ongoing Series — April 2017)

ETF-Based Indexation – The New Fifth Column of Investing?

We had the privilege of debating with Vanguard founder Jack Bogle a few weeks ago at the Grant's (Interest Rate Observer) Spring Conference. Though the topic was the pending Fiduciary Rule, the discussion mostly circled the advisability of index funds for the average investor. Many people are not familiar with just what "average" is. According to the Federal Reserve's 2013 Survey of Consumer Finances, the median value of financial assets (for households that actually have savings), if the head of household is between 35 and 44, is $20,400. The median household pre-tax income for that age bracket is $60,900; applying the average U.S. savings rate of 5.5%, that household can save $3,350 per year.

With 10-year interest rates at 2.35%, the lowest since at least 1925, with the exception of a few months in 1940 and 1941, a low-fee instrument like an index fund is certainly preferable. But inadequate. That head of household cannot possibly accumulate the minimum of 8x pre-retirement income, or $487,000, that a retirement planner might suggest.

There are equities, of course, but the "little guy", as Jack Bogle would say, with $20,400, cannot know which security or flavor of ETF to invest in, or when. As a matter of their own protection, he believes that their only safe choice is an S&P 500 index fund. And we agree, in principle. But reality is the rub. There are two essential problems with this entirely rational prescription.

Problem #1: Investors are not even going there – they are going anywhere but the S&P 500. Right now, only 24% of the $1.602 Trillion of assets in U.S. equity ETFs were in S&P 500 ETFS. But it's worse than that. In the first 60 days of this year, only 6.6% of the net inflows went into the S&P 500 funds.[1] Even if we include the S&P 500 functional equivalents, like the Russell 1000 funds, the Schwab U.S. Large Cap and Vanguard Large Cap funds, and so on, they captured only 7.5% of the inflows.

Why are investors not going into the broad indexes? The problem is the Wall Street incentive system. Paradoxically, it's an unintended consequence of Vanguard's strategy of driving fees on bread-and-butter indexes down to the 5 basis point range. Advisors – whether human **or** robot – are not going to guide investors there; they can't live on 5 basis points.

And since for-profit fund companies can't compete with Vanguard head to head on the S&P 500 battlefield, they will collect their higher fees elsewhere. Through product differentiation. For just an idea

[1] There were $36.5 billion of net inflows into U.S. Equity ETFs, but only $2.4 billion of that went into S&P 500 ETFs.

of the sort of indexes being peddled under the false flag of risk diversification, here are just three different classes of misrepresentation of exposure and risk. And there are far worse than these.

Country misrepresentation The iShares Italy ETF (EWI). It has collected $2.5 billion of assets, at a 48 basis point fee. Only 3 of the top 10 holdings get a majority of their revenues from Italy; the other 7 get 72% of their revenue from outside of Italy (names like Fiat Chrysler, Luxottica, and Eni, a global oil & gas giant). So, buy the Italy index; take home non-Italy.

Industry Sector Misrepresentation The iShares DJ US Industrials ETF (IYJ) has $1.1 bill of AUM at 44 basis points – see a pattern? It's described as "exposure to…companies that produce goods used in construction and manufacturing". There are at least 37 names in this index, 23% of its value, that have nothing to do with producing goods used in construction and manufacturing. That's our judgment, but the reader is invited to judge as well. How about UPS or FedEx? How about Paypal? Then there are Fiserve, LinkedIn, Equifax, Booz Allen Hamilton, Core Logic, FTI Consulting, ManPower Group, Sabre Corp. And so on.

Risk Misrepresentation The iShares MSCI Frontier 100 ETF (FM), with a 79 bp fee. A Top 10 country weighting is Nigeria – Home of Boko Haram, always in the news. How does one sell this to the Main Street investor? Well, with a beta of only 0.24[2], it's marketed as having only a quarter of the price risk of the S&P 500. It has a P/E of 12.1x, and its price/book value is also a lot lower than the S&P. Couldn't ask for a more diversifying, low-risk investment.

22% is in Kuwait – smaller than New Jersey. Surrounded on 2 of its 3 sides by Saudi Arabia and Iraq, and if a certain Crown Prince's yacht gets blown 5 miles off course in the Persian Gulf, he'll be in Iran. Why (or how) the low P/E and low beta? Partly, because 50% of the fund is in financials. Is this really a low-risk investment? By the definition of Wall Street index manufacturers, it is.

So, the Wall Street incentive system uses the idea and terminology of indexation to sell investors the very opposite: they tell you to diversify away from, or better than, the S&P 500, and at a higher fee.

Problem #2: Valuation and Age

Valuation – Using the broadest, most straightforward measures, the market is a hair's breadth away from historically peak valuations; the aftermath was disastrous.

- *Current Price-to-Earnings Ratio and Average P/E Ratio* The S&P 500 now trades at 26.75x trailing 12-month reported earnings (as opposed to analyst-doctored 'operating' earnings that exclude accounting charges and the ever-recurring non-recurring 'items'). Paying almost 27 years' worth of

[2] Source: iShares, as of February 28, 2017

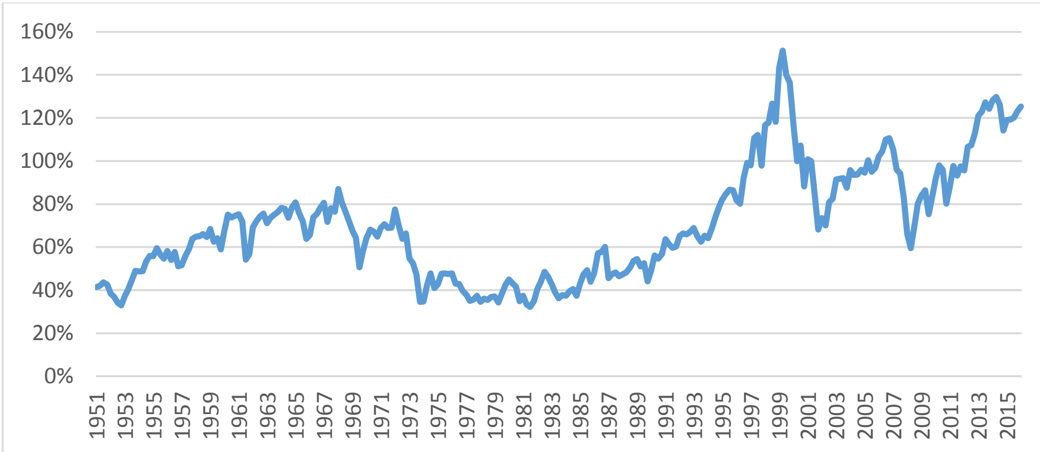
earnings for a basket of large businesses is understood to be really, really high, but has often been exceeded due to the significant variability in reported earnings in any given year.

An approach favored by many economists and chief investment strategists uses price relative to the average earnings of the prior 5 years or 10 years, in order to smooth out temporary and episodic noise; they find it more reliable. By this measure the S&P 500 trades at 29x earnings, which has been exceeded only twice before: in 2000, the Internet Bubble Peak, and in 1929.

Source: http://www.econ.yale.edu/~shiller/

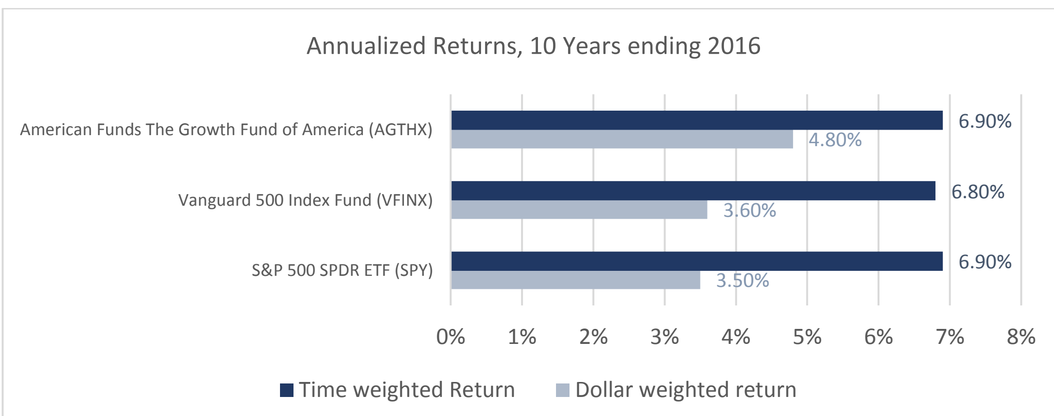
- *Total Market Capitalization-to-GDP Ratio* The market value of all U.S. stocks, as measured by the Federal Reserve's corporate equities level, relative to GDP[3], was 125% as of October 2016. Adding the market appreciation since then, that ratio is approaching the record set by the Internet Bubble in early 2000.

[3] Source: Federal Reserve Bank of St. Louis



Source: Federal Reserve Bank of St. Louis

To suggest that this will iron out over time, irrespective of valuation, is a spurious interpretation of indexation. Today, exactly 17 years after the Internet Bubble peak in March 2000, and after an 8-year bull market, the S&P 500 returned 4.7% a year. The SPDR S&P 500 ETF (ticker SPY) returned 2.7%. And only assuming everybody stayed in, which they didn't. How could they: the turnover of SPY is 1,900% a year. That's 100% every three weeks. Measured by their own money flows, the average investor gets a fraction of the index return, because they invest high and sell low.



Source: Credit Suisse Research

Age: The growth profile and earnings power of the S&P 500 and other large-cap indexes has changed beneath our feet; it is no longer what it once was, and the historical result cannot be replicated.

- *Future growth from the top of the index:* The money flows of mass market indexation have created structurally automatic bids for the major index companies. These, particularly the branded consumer products businesses like Coca-Cola and Procter & Gamble, are mature and have stagnant or even declining revenues. They represent the great bulk of the value of the S&P 500.

- *Future growth from the bottom of the index:* Historically, the smaller companies in the S&P 500 represented the future growth. While their early weightings and market capitalizations were small, they were sufficiently large relative to the balance of the index that they could ascend in position and have a meaningful impact on the index return. Today, though, the high weightings of the mature companies are largely fixed in place, and their presence suppresses the earnings growth *from the bottom of the index*.

Indexation as originally conceived by its practicing and academic founding fathers, such as Jack Bogle, Paul Samuelson, Robert Merton, Myron Scholes and Fischer Black, involved buying the entire market, a single asset-allocation decision balanced by a similar one for bonds and cash. The idea was to participate in a deliberately, rationally naïve fashion. It specifically rejected as dysfunctional the notion of being cleverer than the market – selecting and arranging and rearranging various sub-sectors in the hope of somehow being better than the market. When they started in the 1970s, the S&P 500 did, for practical purposes, statistically represent substantially most of the market.

The challenge to the rational practice of indexation is the profit motive. Index funds are, by definition, commoditized products: one S&P 500 or Russell 1000 fund can be no different than another. And it is wholly rational that the for-profit companies that promote index funds try to avoid selling near-zero-fee funds. The use of marketing to promote the sense of product differentiation to the customer in order to secure a higher price is not new: it's done for vodka, cars and shampoo. As the examples above illustrate, the ETF industry has hijacked traditional indexation and distorted it to a dangerous degree. One cannot even be sure that when one buys a country fund, one even gets that country.

Accordingly, investing must now take place outside of the indexation sphere of focus.