The dumb way to invest

Index funds can only ever produce mediocre returns, writes Roger Montgomery

WITH NEWS THAT RETAIL ownership of shares is at the lowest level since 2000, I sometimes wonder how many people still watch the market. For those who do, there hasn't been a lot to see. The S&P/ASX All Ordinaries Index is up just 5.4% in 10 years and one pundit described the past decade as the worst in more than 100 years. I question that but we should not be focused on the index at all. And we certainly shouldn't invest in it.

So this month, I am going to take on those pesky – but popular – index funds.

For now, I'll set aside a discussion about whether or not most active fund managers underperform the index. But by combining that claim with investors' disdain for paying fees, a monolithic business has emerged through such vehicles as index funds and exchange traded funds (ETFs).

ETFs manage more than $20 billion, according to a BetaShares report in November. The number of exchange-traded products trading on the ASX exceeds 100 and the number of financial advisers using ETFs has reached record levels.

Index investing promises many things – diversification, low cost, access to overseas markets – but I cannot escape the fact that these broadly diversified cap-weighted funds guarantee "average" returns, are a lazy way of investing and ensure that you will invest without regard to the quality of the underlying businesses or the price.

It is important to remember they are cheap. Generally, however, in life you get what you pay for.

Index investing is dumb investing. In fact, when Warren Buffett recommended it to the masses, he made the point that it suits the "know-nothing investor". If you are an active investor engaging with reports and articles about the market, it is clearly not your intention to be a know-nothing investor.

And if you are an adviser, your clients are paying you to know something.

However, as index investing grows in popularity, so does the blind purchase and sale of large baskets of shares with no regard to their underlying fundamentals. How such an approach can be recommended in good conscience to an investor requires careful examination.

Index investing is justified on the basis that the market is efficient and prices always reflect fair value. So index investors ride the coat tails of analysts who have done the work to determine values and disseminate that information.

As the number of index investors increases, however, so does the amount of blind buying and selling. This squeezes out sensible value-based investing and reduces the influence of the narrowing pool of analysts required to establish the valuations on which the proponents of efficient-market index investing rely.

More frequent periods of greater divergence between price and fundamental value will occur, giving active managers – such as the Montgomery Fund and the Montgomery Global Fund – the opportunity to make much larger returns for their clients. In the long run, sensible investing beats blind investing.

The example of The Coca-Cola Company makes the case for smart active investing. In 1919 it listed on the NYSE at $US40 a share, though a year later it was trading at $US19.50. What would have happened if a single share in Coca-Cola was purchased in 1919 at $US40 and held through all the subsequent economic and financial developments, including the great crash of 1929, the Great Depression of the 1930s, World War II, a baby boom, dozens of other wars and skirmishes, an oil crisis, assassinations, the fall of the Berlin Wall, innumerable recessions, booms, busts and scandals, as well as wars in Vietnam and Iraq and the market crashes of 1974, 1987, 2000 and the GFC?

Holding that single share, accepting all the stock splits and reinvesting all dividends, would have become more than 252,000 shares and the investment would have a market value, at $US40 a share, of more than $US10 million ($14 million). A $US40 investment in the S&P 500 index in 1919 would now be worth just $US540,000

Over the very long run, sensible value investing in quality businesses cannot help but beat an index. The index is in both high-quality and low-quality companies and in Australia we have more than our fair share of mediocre companies: of the 1800-odd listed on the ASX, about 1200 a year fail to report a profit.

Many advisers and commentators despair that the S&P/ASX 200 Index remains below its all-time high, some eight years later. And yet, they advocate index investing. The reason the index remains below its high despite an unprecedented amount of artificial, and temporary, support from low interest rates is that it is dominated by businesses generating poor returns on shareholder capital. Mediocre businesses generate mediocre returns and over time share prices reflect this.

The thing to remember when "investing" in an index is that if you don't care about the businesses you are investing in, perhaps you aren't investing at all.

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