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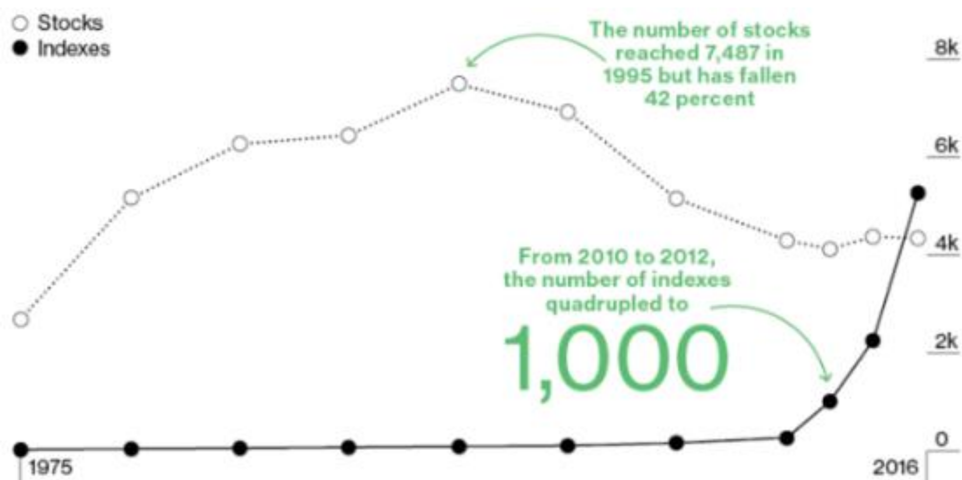
The worry about indexing is overblown

Urban Carmel | The Fat Pitch | 24 May 2017

Summary: Investors are clearly shifting away from actively managed funds to those based on index strategies. Only time will tell, but this has the look of a durable, secular change in investment management. But much of the perceived threat to market stability of indexing is overblown. Overall, the US stock market is still dominated by active management. And while the number of index products has clearly exploded, 96% of these are of insignificant size.

Bloomberg recently reported that the number of indexes has exploded and now exceeds the number of stocks in the US.

Figure 1: The rise of the benchmark



Source: Bloomberg LP (which owns Bloomberg Businessweek) and its affiliates provide indexes tracking various asset classes. Data: Bloomberg Intelligence, Sanford C. Bernstein, World Bank. Cash flows as of 31 March. Graphic by *Bloomberg Businessweek*.

This shift to index-based investing has been blamed for artificially compressing market volatility and for sowing the seeds of future stock market calamity. On balance, these claims seem hugely overblown.

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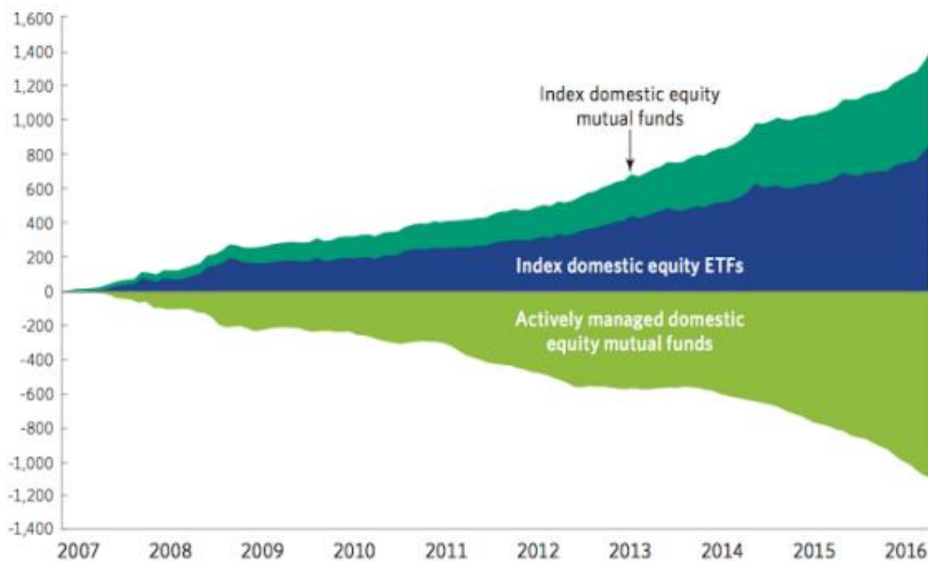
It's clearly true that there is a shift to index-based investing. Over the past 10 years, approximately $1.4 trillion has flowed into US equity index mutual funds and ETFs. About $1 trillion of this money has come out of actively managed mutual funds (Figure 2).

Figure 2: Cumulative flows to and net share issuance of domestic equity mutual funds and index ETFs*
US$bn, monthly, Jan 2007 - Dec 2016



Source: ICI. Prior to October 2009, index domestic equity ETF data include a small number of actively managed domestic equity ETFs. Note: Equity mutual fund data include net new cash flow and reinvested dividends. Data exclude funds that invest primarily in other funds.

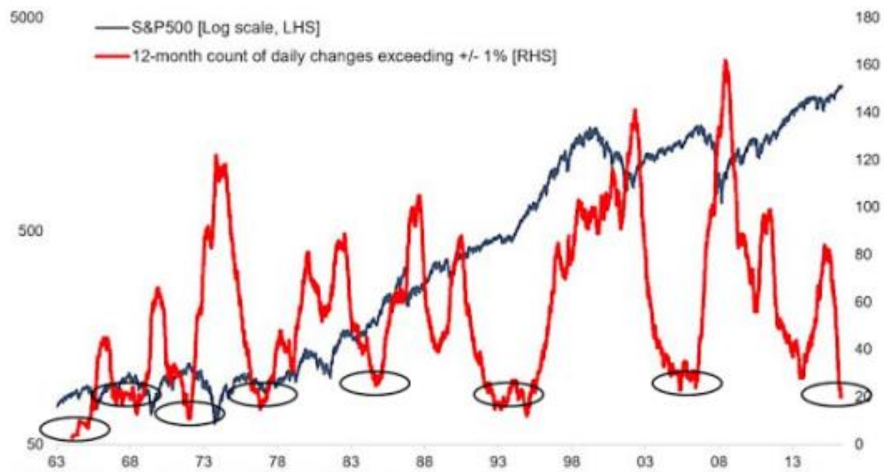
This has the look of a secular shift away from actively managed funds and into index funds - note in the chart above how fund flows did not reverse during the 2008 bear market. In other words, despite a devastating collapse in equity prices, investors ADDED money to index funds and continued to pull money out of actively managed funds. The perceived value of active professional management, even during a tumultuous environment, was poor.

The shift towards index-based investing is being associated with the low volatility of the stock market. That seems unlikely. To begin with, a period of low volatility, measured any number of ways, has been a feature of every bull market for at least 50 years (from Bloomberg, Callum Thomas and Charlie Bilello, respectively).

Figure 3: Low volatility = Low VIX
A feedback loop in equity volatility

Source: CBOE, Bloomberg

Figure 4: S&P500



Source: Topdown Charts, Thomson Reuters Datastream

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Figure 5: S&P 500: Lowest annualised volatility in the first 86 trading days
1928 - 2017

Rank	Year	Vol thru 86 trading days	Vol Full Year	Year-End Total Return
1	1964	4.4%	5.2%	16.4%
2	1965	5.0%	6.8%	12.4%
3	1995	6.5%	7.8%	37.6%
4	2017	6.6%	?	?
5	1971	7.1%	10.2%	14.2%
6	1954	7.2%	8.9%	52.6%
7	1972	7.3%	8.0%	18.8%
8	1966	7.5%	11.8%	-10.0%
9	1963	7.7%	8.8%	22.6%
10	1967	8.1%	8.3%	23.8%

Source: Pension Partners, @CharlieBilello

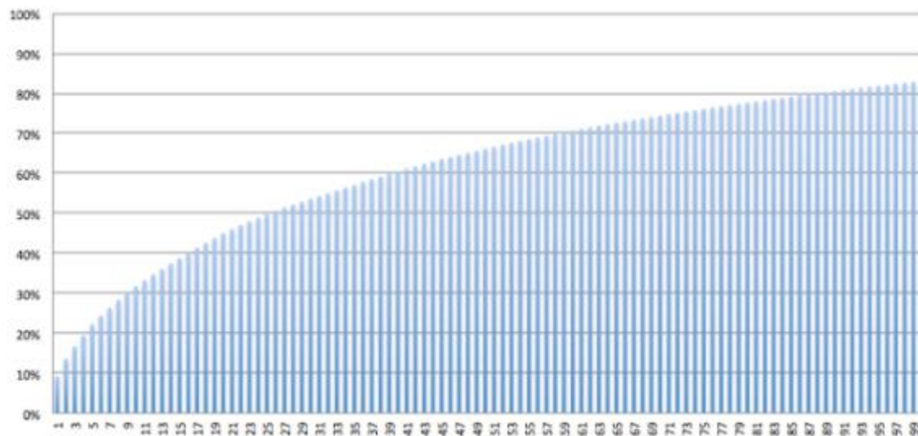
More to the point, active management still accounts for the overwhelming majority of US equity market ownership. The combined assets of all US equity index mutual funds ($2.1tn) and ETFs ($1.5tn) in 2016 equaled just 13% of the total US stock market's capitalisation. Looked at a different way: in 2016, 31% of the shares outstanding in the US market were held in mutual funds and ETFs, of which about one third was index-based. In other words, regardless of how it is calculated, nearly 90% of equity shares are "managed" not "indexed." It's hard to say that indexing itself is significant enough to compress market movements (data from ICI).

Moreover, while it's true that the number of index funds has exploded, the importance of this is massively overstated. For example, the number of ETFs has nearly doubled to 2,500 in the past four years, but:

- The top 10 ETFs (0.4% of the total number) account for one third of total ETF assets.
- The top 50 ETFs (2% of the total number) account for two thirds of total ETF assets.

- The top 100 ETFs (4% of the total number) account for 84% of total ETF assets.

Figure 6: **Top 100 ETFs**
Net assets as % of ETF total



Source: ETF Data Base

In other words, the concern over the proliferation of ETFs and index funds misses the key point that very little money is actually in the bottom 96% of them (data from ETF Data Base).

In summary, investors are clearly shifting away from actively managed funds to those based on index strategies. Only time will tell, but this has the look of a durable, secular change in investment management. But much of the perceived threat to market stability of indexing is overblown. Overall, the stock market is still dominated by active management. And while the number of index products has clearly exploded, 96% of these are of insignificant size.

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Urban Carmel is the author of blog, The Fat Pitch. He is a former McKinsey consultant and a president of UBS Securities in Asia. This article is abridged and reproduced with permission from Advisor Perspectives.