Does Indexing Meet Investor Objectives?

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As investment performance data gets released at the end of each calendar quarter, the financial press is inevitably filled with stories comparing the performance of active managers versus market indices. Framing this type of data in terms of the battle of active versus passive certainly makes sense on the surface; after all, comparing the returns of two strategies seemingly trying to achieve the same goal seems reasonable. But is this, in fact, the correct way to view performance information? Many investors assume that the sole goal of active managers is to outperform their respective benchmarks over every single time period. However, before simply accepting this assumption as fact, we believe that two very important questions should be asked.

- Does every single active manager actually have an explicit goal of outperforming a market index at all points in time?
- Is generating index beating returns over a given quarter or calendar year a goal that active managers should have in the first place?

In answering both questions, it first helps to think about the goals of the actual investors placing their money with active managers rather than the goals of the active managers themselves. While investors would certainly prefer higher versus lower returns over a given period, their goals are generally more complex. For example, individuals may be concerned with meeting their spending needs during retirement, endowments with adequately supporting their causes/institutions, and pension plans with providing benefit payments. Most portfolios don't simply have a single minded focus on maximizing returns or preserving capital, but must balance ongoing spending needs with growing the value of the portfolio over the long term.

If we assume that active managers should be focused on meeting the goals of their investors (since investment firms depend on investors for their very existence), is a sole focus on outperforming an index over every time period consistent with this objective? This leads us to two additional questions:

- What are the goals of a market index?
- Are those goals consistent with the long-term objectives of most investors?

In general, the goal of most market indices is simply to capture the returns of their designated markets. For example, the S&P 500 Index[1] is designed to capture the performance of a broad universe of U.S. (large cap) stocks. It could be argued that the ultimate goal of an index is to present information about current security prices. Thus, the index reports what investors are willing pay for various securities (e.g., stocks, bonds, etc.) but makes no judgment as to whether those prices are attractive. However, we believe that one of the biggest factors that could prevent investors from achieving their long-term goals is overpaying for securities and suffering permanent losses of capital. It is in this respect that index investing could potentially deviate from the end goals of long-term investors.

During many market environments, including the later stages of bull markets (where security prices are generally increasing) and macro driven bear markets (where security prices of most "risky assets" are decreasing), index investing may produce generally acceptable (and perhaps even attractive) results for most investors relative to actively managed strategies. That said, history has shown that during certain time periods, security prices can meaningfully diverge from underlying fundamentals (e.g., the price of a stock could greatly exceed the value of its underlying business). When this occurs, investors who purchase these securities may be facing a higher probability of suffering permanent losses of capital or, at the very least, investing in securities which may generate unattractive future returns.

However, since the index simply presents information about security prices, the inclusion of overvalued securities in its "investible universe" is perfectly consistent with its goals. For example, while technology stocks may have traded at extremely elevated valuations in the late 1990s, they nonetheless had a substantial and increasing weight in the S&P 500[1] because they represented a meaningful portion of the U.S. large cap stock universe. Likewise, even though U.S. Treasury yields remain near historical lows, Treasuries comprise approximately 35% of the Barclays U.S. Aggregate Bond Index[2] because the index simply represents the current universe of investment grade bonds.

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While, these types of “speculative” environments don’t occur on a regular basis, they can be very destructive for index investors when they do occur. As the table below illustrates, Technology and Telecom stocks suffered significantly greater losses during the market decline in the early 2000s relative to most other economic sectors.

S&P 500[1] Sector[3]	Return (04/2000 - 09/2002)
Consumer Discretionary	-16.51
Consumer Staples	9.26
Energy	-6.61
Financials	-4.63
Health Care	-2.82
Information Technology	-47.75
Industrials	-13.05
Materials	-7.05
Telecom Services	-41.61
Utilities	-14.35
S&P 500[1]	**-20.56**

Thus, if active managers are trying to meet the long-term goals of their investors, outperforming an index in all types of market environments isn’t necessarily consistent with those objectives. This is especially true when valuations are becoming extended and the likelihood of permanent capital losses (or not being adequately compensated for taking on risk) increases.

The final question investors could ask is, “Why not simply hold the market index during periods where its returns could potentially be attractive and allocate assets to active managers when the markets become overvalued?” While this type of strategy sounds promising on the surface, timing the markets has proven to be extremely difficult for most investors. Likewise, while purchasing undervalued securities has historically generated attractive returns over the long term, valuation has generally been a poor predictor of shorter-term market movements.

As such, we believe that a consistent investment process focused on discovering attractively valued securities is key to helping investors achieve their long-term goals. While active managers who employ this type of process are unlikely to outperform indices across all market environments (and may, in fact, underperform for extended periods of time), investors need to recognize that realizing index-beating returns over a given quarter or calendar year and achieving long-term objectives may not be one and the same.

Analysis by Manning & Napier.
Unless otherwise noted, all figures are based in USD.

[1]The S&P 500 Total Return Index (S&P 500) is an unmanaged, capitalization-weighted measure of 500 widely held common stocks listed on the New York Stock Exchange, American Stock Exchange, and the Over-the-Counter market. The Index returns assume daily reinvestment of dividends and do not reflect any fees or expenses. Index returns provided by Morningstar. S&P Dow Jones Indices LLC, a subsidiary of the McGraw Hill Financial, Inc., is the publisher of various index based data products and services and has licensed certain of its products and services for use by Manning & Napier. All such content Copyright © 2015 by S&P Dow Jones Indices LLC and/or its affiliates. All rights reserved. Neither S&P Dow Jones Indices LLC, Dow Jones Trademark Holdings LLC, their affiliates nor their third party licensors make any representation or warranty, express or implied, as to the ability of any index to accurately represent the asset class or market sector that it purports to represent and none of these parties shall have any liability for any errors, omissions, or interruptions of any index or the data included therein.
[2]Data based on the SPDR® Barclays Aggregate Bond ETF (LAG). The Barclays U.S. Aggregate Bond Index is an unmanaged, market-value weighted index of U.S. domestic investment-grade debt issues, including government, corporate, asset-backed, and mortgage-backed securities, with maturities of one year or more. Index returns do not reflect any fees or expenses.
[3]Investments will change over time. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property and a service mark of MSCI Inc. (MSCI) and Standard & Poor’s, a division of The McGraw-Hill Companies, Inc. (S&P), and is licensed for use by Manning & Napier when referencing GICS sectors. Neither MSCI, S&P, nor any third party involved in making or compiling the GICS or any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification, nor shall any such party have any liability therefrom.