The risks of index investing

Index investing is increasingly seen as the best way to invest, and more and more money is flowing into passive instruments. But there is a flip side to this success.

The rise of passive investing

John C. Bogle (1929-2019) pioneered index investing and is known as the "father of passive investing". While studying at Princeton University in the early 1950s, he discovered that most actively managed mutual funds underperformed after fees. This conclusion eventually led to the creation of Vanguard in 1974 and the first index fund for retail investors in 1976.

At first it wasn't very popular in America, but after a while interest began to grow. Today, index investing is the standard. Vanguard grew to become one of the largest asset managers in the world. Today, all the major asset managers have a wide range of index funds and ETFs, and the range of passive funds (which mimic an index) is huge and growing. There is a reason for this: simple, broadly diversified, low-cost investing is available to everyone. What is more (apart from the relatively low cost and full replication), the returns are the same as the broad index. Also, many active funds do not seem to beat the index[1], which is reason enough to invest in the index.

The rise of passive investing has come at the expense of active investing. More and more money is flowing into passive funds, and recently money has even been taken out of active funds and reinvested passively. In addition, active funds deviate little or not at all[2] from their benchmark. Many asset managers measure their performance against a broad stock market index, such as the S&P 500 or the MSCI World Index. This is their benchmark, which means they are doing a good job

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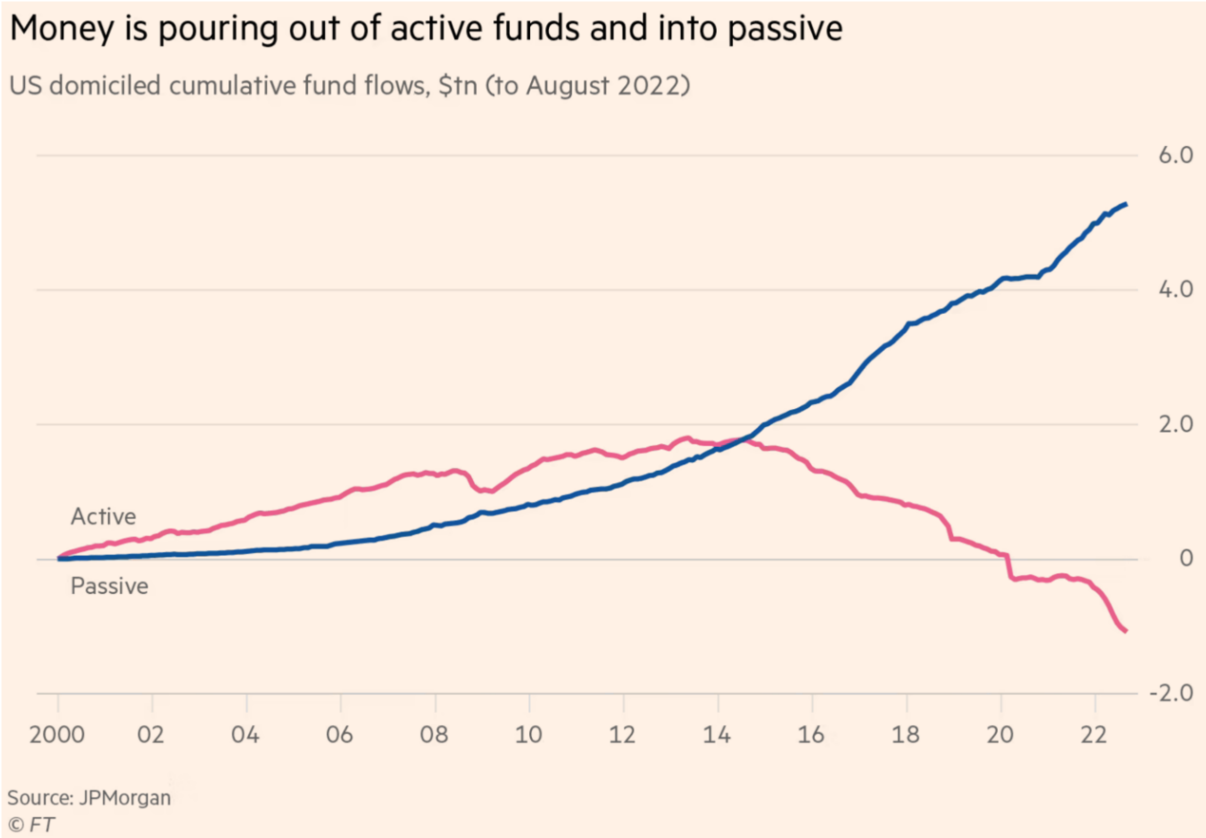
[1] S&P Dow Jones Indices (2017). *SPIVA U.S. Scorecard* (https://www.spglobal.com/spdji/en/documents/spiva/spiva-us-year-end-2016.pdf)

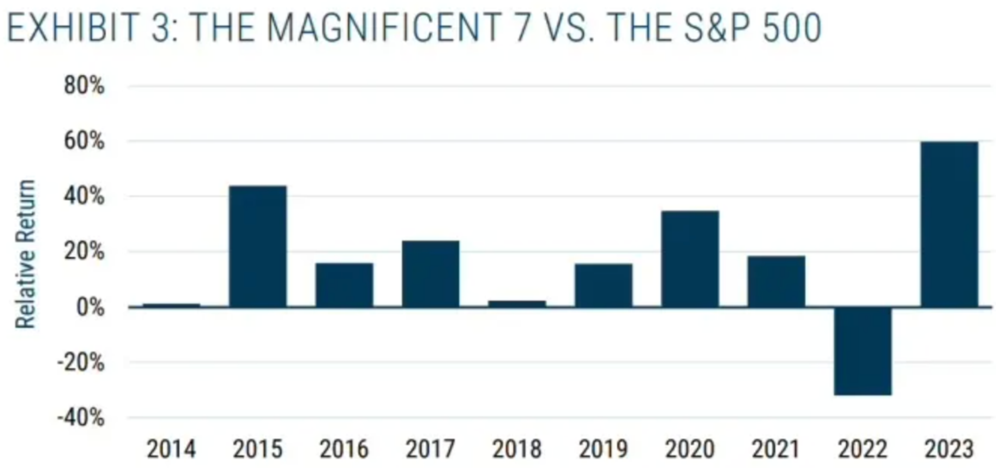
[2] Cremers, M. e.a. (2011). *The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees, and Performance*

if they outperform the index (benchmark) and vice versa. If active funds don't really deviate from their benchmark (a broad index), then investors are paying unnecessary money for an actively managed fund. They could just buy the index and pay much less in fees.



Why still deviate from the index?

There is also a reason why active fund managers are reluctant to deviate too far from the index, and it has to do with fear. If they deviate a lot from the index and, as a result, underperform the index for a while, they are afraid that investors in their funds will withdraw their money. Because of this fear, many fund managers will not deviate very far from the benchmark. As a result, they will never do much better than the index. So what's in these big indices like the S&P 500 and the MSCI World Index? Mainly the biggest companies in the world. If we look at the top constituents of the S&P 500, we see that it is dominated by the "Magnificent 7". Apple, Meta, Nvidia, Amazon, Tesla, Alphabet and Microsoft. These Magnificent 7 account for almost 30% of the S&P 500. There have been other acronyms in the past, such as FANG (Facebook, Amazon, Netflix and Google), but the principle remains the same: a few big players are heavily weighted in the index.



Data from 2014-2023 | Source: Compustat, Standard & Poors

In fact, this index (the S&P 500), like many indices, is market-weighted. This means that each stock in the index is weighted by its market value. If stock A has a market capitalisation of $2 billion and stock B has a market capitalisation of $1 billion, the weight of stock A in the index will be twice the weight of stock B. If the value of stock A goes up sharply, the weight in the index will continue to rise. And we saw this happen in 2023 and 2024 with the so-called "Magnificent 7" stocks. The market value of these stocks had risen sharply and so had their weighting in the index. As a result, the return on these 7 stocks has outperformed the S&P 500 in recent years.

Meanwhile, asset managers face a huge dilemma: do they dare to underweight these large stocks and invest less in them than their weighting in the index? Asset managers are judged on their relative returns to the indices, but fund managers will not be easily fired if they are in the big stocks if they do not perform well. On the other hand, they are likely to be sacked if they have not been following those big stocks when they turn out to be rising further. Famed investor Peter Lynch had a fitting quote on this (although you could substitute Nvidia for IBM in these times):

"There's an unwritten rule on Wall Street: you'll never lose your job losing your clients money in IBM."

The self-reinforcing mechanism

The Magnificent 7 stocks together were worth about 1/6th of the total market value of all the world's stocks combined in spring 2024. These 7 companies had revenues of about 1.7% of total global GDP. There has certainly been growth in this group of stocks, particularly due to Nvidia and the "AI boom", which could narrow this gap (1/6 of total market value, but only 1.7% of GDP), but the gap is still huge. How is this possible?

Normally, money goes to companies with good prospects that are not too expensive. But in index investing, most of the money goes to the companies with the highest weighting in the index. So large companies are rewarded for being large. This drives up their valuations and allows them to use their own shares to buy back companies and invest in future growth. This makes the "big ones" even bigger, which in turn makes more capital flow to these companies through the index funds. And this goes on until the gap gets so wide that investors start looking for more value for their money, or until the market panics and investors want to take their money out.

The knife cuts both ways

The tradability of these ETFs is usually good, especially during a bull market, but what if there is a bear market or even a market crash and many investors want to sell at the same time? This can lead to big liquidity problems and huge price differences for some of the less liquid stocks in the index. If everyone is selling the popular indices, the selling pressure will be greater on the companies that weigh most heavily in the index. The self-reinforcing mechanism discussed above then works in the opposite direction. This could create attractive buying opportunities for value investors and, if it happens, it could hurt index investors badly.

So there are two possible scenarios for value stocks:

1. All stocks are sold, including value stocks. However, these stocks do not have the largest weightings in the largest indices (such as the S&P 500), so they will not depreciate as much if everyone were to sell these indices. Moreover, with value stocks you are at least getting your money's worth, and the worst thing that can happen if the prices of these stocks fall is that the undervaluation of these stocks will only increase. Eventually, this undervaluation must return to normal (reversion to the mean), which means that value stocks must eventually rise in price. Therefore, every decline (ceteris paribus) is a buying opportunity for value investors.

2. A move from passive to active. After years of a trend from active investing to passive investing, investors realize that they have been buying yesterday's winners and chasing each other. This works as long as more money flows toward these passive funds, but once this stops, investors will have to look at what still has real value. With this, there is a very good chance that they will end up with value stocks.

Conclusion

Index investing is very popular and attracts more and more money. This money goes to the biggest companies in the index, making them even bigger (weigh heavier in the index), and this process continues until one day it breaks down, for example in a crash. This could then create liquidity problems for these indices and pose a risk for index investors, which in turn creates opportunities for value investors.