Charles Ellis on indexing

By Jeff K. Davis

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A few months ago Amazon put Charles Ellis' new book, Index Revolution, on my recommended list. I probably would not have bought it had I not heard Ellis give an extended interview on Bloomberg Radio one morning while walking the dogs. He is quite persuasive about the rationale for index funds. Although I own index funds, it is not a subject I had given much thought. Ellis is well known on Wall Street having founded Greenwich Associates, a consulting firm to financial services firms. In 1975, he penned "The Losers Game" for the Financial Analysts Journal. That was followed with a book, now in its sixth edition, Winning The Losers Game. The gist of his thesis is that market professionals cannot beat the market consistently. Therefore investors are better off investing through low-cost index funds and focusing on asset allocation to achieve their long-term investment objectives.

Ellis began his career in active management in the 1950s when markets were less efficient, in part because they were dominated by ill-informed retail investors, very slow moving bank trust departments, and uneven information flows from companies.

Ironically, the year before Ellis wrote the article for the Financial Analysts Journal John Bogle was fired as chairman and CEO of Wellington Management Co. as a result of a botched merger. Later that year (1974) Bogle spearheaded the formation of Vanguard Group Inc. with an objective of becoming a low cost mutual fund firm. In 1976 Vanguard launched an IPO for the first index fund — then called First Index Investment Trust. As IPOs go, it was an utter failure. The underwriters raised $11 million of a planned $150 million. But failure is often the seed of success, at least in the U.S. As of June 30, 2016, Vanguard reported $3.5 trillion of assets, much of which is in index funds and ETFs. Vanguard has been so successful that it has taken in more net flows than rest of the asset management industry combined for several years according to Moody's.

Bogle is probably better known than Ellis among investors because he founded the juggernaut Vanguard. Although he does not eat locust and honey or wear a hair shirt, Bogle might be called the John the Baptist of indexing — pointing the way while kicking sand in the face of active asset managers. The couple of times I have heard him speak, he came across as a bit sanctimonious. Maybe it was just me, however.

Ellis offers a softer sale in his current book. He became a convert to indexing a couple of decades ago after starting in the asset management business as an active manager. An influx of highly educated and competitive professionals who buy and sell securities from each other combined with technology and instantaneous information (Bloomberg terminal on many desks; internet connections for all) has rendered markets sufficiently efficient to make active management a losers game. Ellis points out in the book that index investing had the misfortune of having the label "passive" attached to it, which is laughable from a marketing standpoint. Depending upon the situation, "passive" can be a synonym for "loser."

Nevertheless, Ellis' point is that indexing is a means to out-performance because the vast majority of active managers underperform the market over time, while those with hot hands tend to revert toward the mean as do underperformers. He also uses the performance metrics to argue that active managers' fees exceed 100% of the return when fees are measured relative to the incremental return above indexing as opposed to the industry standard of assets under management (i.e., AUM).

Moody's recently updated its study on the adoption rate of indexing in which it estimates that active management underperforms passive investing by about 200 basis points per year before accounting for survivorship bias among active managers. Moody's also estimates about a 70-basis point cost advantage for passive strategies. It is a wide spread that compounds into a gulf over a lifetime. The rule of 72 says indexing will create twice the return vis-à-vis active management within 27 years — assuming Moody's numbers are correct, and, if so, the historical differential continues into the future.

One thought you may have (and perhaps me) is that if indexing is the glowing subject of this post, then it is trend that will peak soon. Maybe, but the trend toward indexing has been underway for a long time and has a long way to run if Ellis and Bogle are right. According to Moody's, just under 29% of U.S. assets are indexed, while markets in developed countries are lower at 5% to 15%. Moody's estimates that by 2024 or sooner over 50% of U.S. assets will be indexed. If the numbers are correct — and some think indexing could push 70% in time — then it raises the issue of whether assets will be efficiently priced. Ellis and Bogle are confident that there will be enough active managers to ensure efficient pricing, in part because active management is not going to completely disappear and because indexing entails much less turnover than active management.

What got me thinking about the topic is that the economics of traditional asset management is yet another legacy business model that is in danger. Asset management lumped with malls and bank branches. That would not be the case if active management outperformed indexing, but add much lower management fees and transaction costs and the industry is in danger of being crushed in the new economy in which faster, better and much cheaper overwhelm legacy providers.

It merits at most an asterisk in the long-running secular trend of declining costs to invest, but on Feb. 2 Charles Schwab Corp. announced another price cut by reducing the fee on its market cap-weighted index mutual funds to align with those of its ETFs to just 3 basis points for the S&P 500 index fund and 6 basis points for the small-cap index fund. The fee structure for the funds and ETFs is not remotely in the same zip code of traditional asset managers, much less the reduced hedge fund structure of 1-and-10.

Buy-side job cuts in time may rival what we have witnessed among the sell-side. A notable job cut among the buy-side announced recently was Harvard's decision to outsource a portion of its asset management operation and fire about half of its investment staff due to woeeful performance. That is a big hit to
what is presumably among the best and brightest professionals. Ellis is more closely associated with Yale, from which he received his B.A. and later chaired the investment committee as a trustee, although he has ties to Harvard, too. It is not clear to me how much a role indexing will play in Harvard’s decision to outsource.

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