The Inflating Index Fund Bubble

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The investment industry is changing fast, and we're happy to be an instrument for change. We've been clamoring to make index funds free for a long time, and we're glad to see it finally happen. Let's cover the implications of indiscriminate buying regardless of price with the observation that the number of publicly-traded companies is vastly shrinking. How long will the inflating index fund bubble last?

By Brian Nelson, CFA

Those that know Valuentum know that we stand up for the individual investor, and we work our tails off to make sure that we get the individual investor the very best of information and informed judgment. The CFA Institute via its Enterprising blog showcases a new ratio called the Skill Ratio, which divides the average rolling 5-year excess return of a fund by the average rolling 5-year excess return standard deviation.

The implications of such a ratio have been something that we have been pounding the table on for as long as we can remember. We have no qualms with the concept of index funds or index investing, in general, if that's an investor's cup of tea. However, the reality is that index funds are 100% luck, as excess returns are definitionally impossible, and therefore the skill ratio is undefined, if not 0. There is no skill when it comes to index investing, even after considering standard benchmark asset allocation.

This is why the recent news that Fidelity is now offering two index funds for free makes a lot of sense. Why would investors pay anything for a chance at luck? In some ways, any fees on index funds may be viewed similarly as a fee to place a bet at the track, just to be a part of the game. In this day and age, there's no need for that fee. The two new funds at Fidelity are described as follows:

> *Fidelity® ZERO Total Market Index Fund (FZROX)*
>
> *Seeks to provide investment results that correspond to the total return of a broad range of publicly traded companies in the US.*
>
> *There is a 0% expense ratio and no minimums to invest in FZROX.*

NEW Fidelity® ZERO International Index Fund (FZILX)

Seeks to provide investment results that correspond to the total return of foreign developed and emerging stocks.

There is a 0% expense ratio and no minimums to invest in FZILX.

For investors that believe the stock market may only go up in the long run, and that stock selection is not of paramount importance, these two index funds could be very interesting considerations. However, you and I both know that nothing in the stock market is guaranteed, and that if it weren't for trillions in new government debt, the nationalization of the banks during the Financial Crisis, negative interest rates across the globe, and several rounds of quantitative easing, indexing today may not be as popular strategy as it is.

We can't say for sure, but we just think that at some point people are going to come around to believe that buying everything at any price and holding no matter what, as in long-term index investing, may not make a lot of sense, even if it has in the past. If everyone's doing something, it seems more likely that it will end badly than continue to satisfy. History is chock-full of instances where this is true, from the most recent crash in cryptocurrencies—Bitcoin is now trading under $6,000—to selling mortgages to unqualified buyers, to flipping houses, to the dot-com mania and beyond. But how long will this indexing bubble last? Nobody can know for sure.

Another interesting dynamic that I wanted to bring to your attention is that there are an ever-shrinking number of stocks to choose from on the markets today. According to the *New York Times*, "the market is half the size of its mid-1990s peak, and 25 percent smaller than it was in 1976…in the mid-1990s, there were more than 8,000 (publicly-traded companies on exchanges in the US). By 2016, there were only 3,637, according to data from the Center for Research in Security Prices at the University of Chicago Booth School of Business." This shouldn't be a big deal, or even a problem if investors are logical.

However, index investors generally aren't, meaning that they may keep throwing more and more money at the market regardless of price. If, for example, everyone thinks stock investing is a "good thing" and puts their retirement savings and keeps adding to it no matter what, then the shrinking number of available companies to invest in and outstanding shares could drive prices indiscriminately higher. Not only are companies merging, but many are going private, and corporate buybacks have been aggressive. According to Barron's, "the total number of shares outstanding (split-adjusted) of all the companies (in the Dow Jones Industrial Average) combined has declined 15% since 2007, according to a recent report from Bespoke Investment Group."

The scenario of an ever-shrinking publicly-traded market coupled with what we would describe as "blind index investing" could further inflate the marketplace, even as we're now more than 9 years post the depths of the Financial Crisis. Markets tend to be self-correcting mechanisms (i.e. as stocks become overpriced, they are sold, driving their prices lower), but the make-up of the market is changing, particularly as passive indexing strategies proliferate. Could we be at just the beginning stages of the index fund bubble, something that may last for years and years still? We've written extensively about the hazards of a marketplace where price discovery is diminished, but does a shrinking market of stocks and shares outstanding mean the stock market is just destined to move ever higher...no matter what?

It's great to have an inflating index fund bubble as a tailwind to our long ideas, and we still believe that savvy investors can sort the good from the bad and rank risk appropriately, so a further inflating of the index bubble, at least at the present, is only serving to pad the returns of proficient stock selection. However, when we get to the latter stages of the index fund bubble, the end game could be terrible, especially for those where higher contributions may be occurring at the frothiest part of such a bubble. On the other hand, things might not end that badly. After all, the US has bounced back from every market crash in history to make new highs again, and sometimes experiencing a crash isn't as bad as if one stayed completely out a multi-year bull market just to avoid one (as in the Greenspan years).

No matter what your opinion, however, please be careful. We believe stocks are pieces of a business and should be evaluated as such. We don't think all companies should be bought indiscriminately, as in the case of index investing, and we don't think diversification, while very important, is a substitute for due-diligence. We think quantitative investing has proliferated on the back of a 30-year bull market that saw ever-declining interest rates aiding theories lacking logical substance, and we believe investors and consultants will once-again start asking the "right" questions, perhaps even the most important one: What is the company worth? An estimate of a company's intrinsic value is simply par for the course when it comes to investing. Most everything else is gambling.

Tickerized for our ETF coverage universe.

Brian Nelson does not own shares in any of the securities mentioned above. Some of the companies written about in this article may be included in Valuentum's simulated newsletter portfolios. Contact Valuentum for more information about its editorial policies.

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