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TO INDEX OR NOT TO INDEX?

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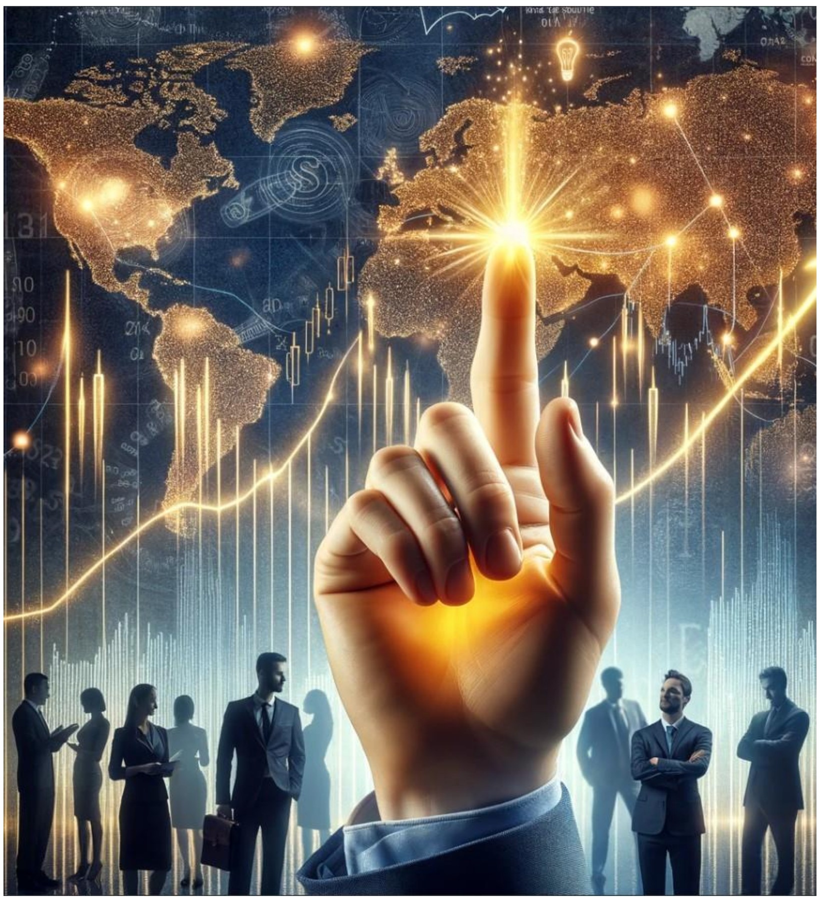
Part 1 – INDEX *WHAT*?!

It's a persistent Siren call that has grown louder over the past decade: "Invest in an index-based investment—stop underperforming, cut down on fees, and streamline and automate your portfolio!" What more can you ask for?!



You wonder—there must be something to it. After all, it has been the calling card of some of the largest and most successful investment outfits, the rallying cry of armies of DIY investors, and the advice of Wall Street legends like Warren Buffett.

Tempting right?! Let's examine it.

First, it's essential to emphasize that investors must proceed cautiously, as what's at stake here is nothing less than their financial well-being. Investing is rarely a sport; most often, it's a practical endeavor aimed at cultivating wealth to pay bills or meet funding goals. So, it is in this context that all investment methodologies, including indexing, should be scrutinized.

Second, investors must grasp that 'indexing' holds three distinct connotations, which, without precise technical separation, tend to bleed into each other, fostering understandable confusion and unintentional illusion.

Let's unpack them:

Investing is about *exposure* to markets. From a portfolio engineering perspective, exposure is specified in three successive layers—the more upstream the specification, the more restrictive it is for the portfolio:

- At the top, Portfolio Exposure can be set to Passive/Full/Constant vs. Variable/Flexible/Adaptive/Tactical.
- In the middle, Allocation Exposure specifies a fixed distribution of Assets Classes or Factors with steady rebalancing.

- At the bottom, Holdings Exposure selects Active or Passive exposure for individual portfolio holdings.

In Parts 2, 3, and 4 of this series, we will examine indexing within each of the three specifications of portfolio exposure before we offer our positioning in Part 5.

Part 2 – INDEXING PORTFOLIO EXPOSURE

Indexing Portfolio Exposure commits a portfolio to being fully invested at all times, consistently tracking an index. It's the standard prescription of those who believe the market is unknowable, random, efficient, and unpredictable.

In particular, the practice of holding the S&P 500 as a substitute for a complete portfolio has surged in the last decade. The proponents point to the index's prominence (proxying the world's leading market/economy), broad diversification, prowess (outpacing most funds), minimal costs, and simplicity (no management complexity).

Is this true?

As we noted in Part 1, far from being a sport, investing is critically about efficiency and sustainability—growing wealth to pay bills and meet funding goals. In this context, how does the S&P 500 fare?

We can definitively answer this by doing an aftcast study[1]: Since 1900, the historical likelihood of an S&P-500-indexed portfolio meeting the widely accepted 5% inflation-adjusted withdrawal/funding standard is only 83%, below the critical 90% or the aspirational 95% thresholds[1].

To illustrate how this is inadequate, consider the case of hypothetical clients Bob and Cindy. Their $1MM portfolio, invested in an S&P 500-tracking portfolio upon retiring at age 65 in 2000, ran out of money by 2016 as they reached age 81. Such failure registers in 17% of all sliding 30-year periods since 1900, which is undesirable. Where is Buffett when he is needed?

We believe an S&P 500-indexed portfolio lacks the efficiency and sustainability for adequate wealth management. The same applies to any known singular index. Champions may have fallen prey to recency bias, enthralled by that index's robust advance since 2009, while overlooking its two devastating bear markets this century alone and failing to understand that such a portfolio is inevitably careening towards its next bear market, in which they are guaranteed to participate fully.

Part 3 – INDEXING ALLOCATION

Part 2 demonstrated that indexing a complete portfolio to a singular index, like the S&P 500, is not an adequate wealth management strategy in our opinion.

But what if investors index not their Portfolio Exposure but their Allocation? This goes beyond abandoning the idea of a singular-index portfolio. When indexing Exposure, there is no deliberate control over the portfolio behavior, which is driven slavishly by the uncontrollable index. Without internal architecture, the portfolio becomes inert. With the introduction of an Allocation, portfolio management can assert control over the portfolio behavior by independently calibrating the differential behavior of its constituent parts—a fixed roster of Asset Classes/Factors with a steady rebalancing schedule.

This is the idea underpinning the popular Strategic Asset Allocation stock/bond portfolio blends—like the 80/20 (Aggressive), 60/40 (Moderate Growth), 40/60 (Moderately Conservative), and 20/80 (Conservative).

What efficiency and sustainability does this solution achieve?

Consider the ubiquitous 60/40 portfolio. Although each allocation part can be managed actively or passively through an index, here we will leap forward to Part 4, examining a portfolio in which the 60 is indexed to the S&P 500, with the 40 indexed to Barclays Aggregate (or before it to government bond yields). Since 1900, the historical likelihood of this annually rebalanced portfolio meeting the widely accepted 5% inflation-adjusted withdrawal/funding standard is 93%, better than all the above blends and above the critical 90%, but still below the aspirational 95% threshold[1].

It's an improvement over the pure S&P-500 portfolio as it places within the desirable 10% outcome range, although still below the aspirational 5% threshold. This shortcoming is not without real-life derailments. Bob and Cindy's $1MM dollar 60/40 portfolio, invested upon retirement at age 65, would now run out of money at around age 87. Closer, but no cigar.

Part 4 – INDEXING HOLDINGS

Indexing impacts a portfolio differently depending on what is indexed (Part 1)—Portfolio Exposure, Allocation, or Holdings. In Part 2, we found evidence against indexing Portfolio Exposure to a single index, like the S&P 500. Indexing Allocation, by incorporating a carefully selected mix of assets that are rebalanced regularly, tends to result in a more efficient and sustainable portfolio (Part 3), although it still leaves significant shortfall risk. Can indexing of Holdings move us further in the right direction?

At the Holdings level, investors and managers can opt for passive indices or active management. The range of choices and outcomes grows exponentially at this level. Still, the bulk of evidence suggests indexing of Holdings has an edge over active management in delivering predictable outperformance—not always, but more decisively, more frequently, and more steadily across time.

However, indexing Holdings does not guarantee a robust portfolio. Our research shows that it is a secondary factor, as the portfolio-wide outcome of indexing Holdings depends primarily on the indexing decisions made at the higher levels—Portfolio and Allocation.

Yet, the picture that emerges is clear:

Once investors abandon the idea of indexing Portfolio Exposure and adopt pluralistic Allocations that can be indexed (through steady rebalancing schedules) or not (following market-adaptive rebalancing), indexing Holdings can lend its reliability in delivering outperformance. We have embraced this approach, which we will detail in Part 5.

Part 5 – OUR PLAYBOOK

Aftcast studies (Part 2, 3) have convinced us that real-life portfolios tasked with paying bills and meeting funding goals are at a significant disadvantage when indexing their total Exposure by tracking any single index (like the S&P 500)—their shortfall risk is higher than the 10% (acceptable) or 5% (ideal) level within which sustainable management should operate.

We also don't do index Allocation. Our research has shown that fixing capital distribution across the spectrum of Asset Classes or Factors diminishes a portfolio's adaptability to market shifts. The winning asset allocations of Bullish and Bearish Market Regimes are very different, and transitional states in between require flexible Allocations. Moreover, fixed rebalancing schedules only compound this disadvantage—such schedules sell winners to buy losers during both Bullish and Bearish Market Regimes.

Yet, we are enthusiastic adopters of indexing at the Holdings level! Five decades of academic and industry research have convinced that, once investors have adaptively calibrated the amount of capital ammunition they want to deploy and the desired asset categories (Classes/Sectors) or asset behaviors (Factors) they will target, opting for indexing's 'shot-gun' vs. active management's 'riffle-shot' approach has substantial benefits. At the Holdings level, our strategies implement indexing via a carefully curated blend of ETFs.

Still, indexing Holdings does not 'automate' the portfolio. There are more than three thousand index-tracking ETFs, with multiple candidates for each imaginable holding behaving very differently. Investor beware.

So, to index or not?

Investors are advised to abandon simplistic indexing of their total Portfolio or Allocation and only opt for dynamic indexing of Holdings within a market-adaptive, risk-controlled, and tax-aware strategy that can skillfully navigate Market-Regime shifts. That's been our approach.

(1) Aftcast historical study conducted by the author using Otar Retirement Calculator program (2022). Detailed data available upon request.