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False Idols

Deep breaths are very helpful at shallow parties. -Barbara Walters

The stock market will be a lousy investment for the foreseeable future. See, I knew you were paying attention. let me explain.

I have been reading some books lately about index investing (the practice of buying a number of stocks indiscriminately and holding them for a long time because it is deemed impossible to beat the stock market over time). The first thing that strikes me about many in this camp is the almost religious zeal with which they defend their position. The second is that the core assumption of indexing proves why it is destined to fail in the coming years.

One of the high priests of indexing, Paul Farrell, author of "The Lazy Person's Guide to Investing", offers the following example as rationale for index investing. "Look at it this way: If you gave Mr. Bogle (chairman of Vanguard, the most famous index mutual fund company in business) $10,000 in 1976 your investment would be now worth $200,000". This equates roughly to a 2000 percent return from 1976 to 2002. He implies that this past performance is repeatable using indexing. Yes indeed, there is light at the end of this tunnel. Unfortunately it's an oncoming Bullet train.

The current average price earnings ratio (average price of a stock divided by it's profit per share – generally a higher number indicates higher risk) of the overall stock market is 21, already pretty high. A Chartered Financial Analyst named Harry Ward did the following calculation. Assuming a 3% inflation rate, 3% growth in Gross Domestic Product and 1.7% dividend rate on stocks (all reasonably average numbers) in order for the next 26 years to be anything like the last 26, the average price earnings ratio of a stock in 2030 would be close to 100. Since the historical market average p/e ratio is something closer to 15, and at the top of the last bubble around 40, an average p/e multiple of 100 is one very high fall from the turnip truck.

At the core of passive, or index investing, is the belief that all information relative the pricing of any stock is immediately available and built into the price so that it is impossible to get better than market average returns over time (I disagree with this premise, but more on that in a later letter). Many bright folks are suggesting, and I tend to agree, that we are in a secular bear market that may last for many years (the average is 14 years). If this is the case, then index investing will ensure full participation in every bit of pain that the stock market has to offer. As I learned racing sailboats in my youth, you can't beat the pack if you follow it.

Before I'm accused of being intolerant of indexers, I do want to say that we use index investments here quite often, but for a very different reason. They offer wide diversification for a portfolio, minimizing the risk of holding any one security, but this greatest strength is also their biggest shortcoming. If a portfolio mimics the overall stock market, it's impossible to get out of the way when things get ugly. Additionally, it's difficult to take advantage of inefficiencies in valuations that *do* exist along the way. The art is in finding the right balance between scatter gun diversification and rifle shot picks. We continue to look for the latter.