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Is Indexing Worse Than Marxism?

By Burton G. Malkiel

Index funds have long been ridiculed by active mutual-fund managers. But with index funds outperforming more than 80% of their active peers over the past five- and 10-year periods, and investors pulling hundreds of billions out of actively managed funds and putting that money into index funds, it's hard to claim that passive index investing produces mediocre results. So a new critique has emerged. It is now alleged that index funds pose a grave danger to the stock market and overall economy.

The critique that passive investing is worse than a centrally planned economy doesn't hold up to scrutiny.

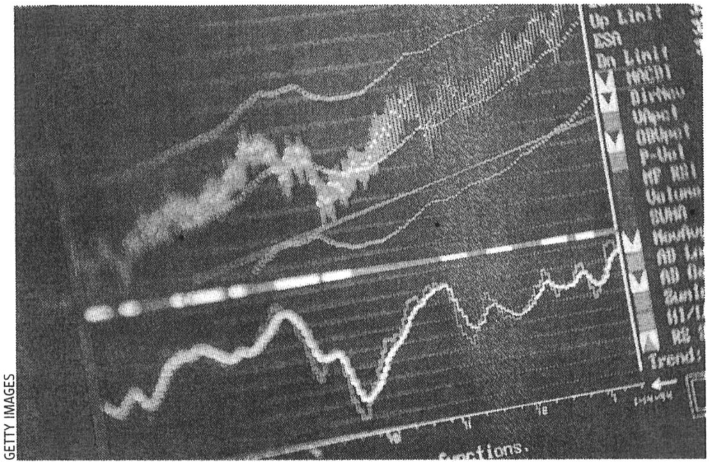
In August one of the most respected research-investment firms on Wall Street, Sanford C. Bernstein & Co., published a 47-page report with the provocative title: "The Silent Road to Serfdom: Why Passive Investment is Worse Than Marxism." Incredibly, its authors argue that a capitalist system in which investors invest passively in index funds is worse than a centrally planned economy, where government directs all capital investment.

In March financial journalist James Ledbetter, writing in the New Yorker, argued that passive indexing causes money to pour into a set of investments independent of important considerations such as profitability and growth opportunities. Mr. Ledbetter also suggested that indexing pushes money into larger firms and raises their valuations to "bubble" levels as well as producing a concentration of ownership not seen since the cartels in the late 19th century.

Let's dispose of the latter argument first. Indexing does not involve simply buying an index of large companies, such as those included in the S&P 500. There are index funds and exchanged-traded funds (ETFs) containing medium-size and smaller companies as well as those including all the major developed and emerging-market economies in the world. In principle, the index investor should buy all the stocks available in the market to achieve the performance of the entire stock market.

Indeed, mutual-fund complexes offer such funds, the largest in the United States being the Vanguard "Total Stock Market Index Fund," comprising all the stocks in the U.S. economy. Index funds also exist for the total world economy. Indexing will not lead to a bubble in any one group of stocks. If stock prices are "too high," the money pouring into both actively managed and index funds makes them so. And Vanguard is hardly the only purveyor of index funds and ETFs. BlackRock, State Street, and a host of other companies offer indexed products.

It is true that as indexing grows there may be a growing concentration of ownership among the index providers and they will have increased influence in proxy voting. They must use their vote to ensure that companies act in the best interests of shareholders. But there is no evidence that they have used or will use their vote to collude in an attempt to form cartels.



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The more fundamental criticism is that index funds might grow to such a size that stocks could become massively mispriced. If everybody indexed, who would ensure that stock prices reflect all the information available about the prospects for different companies? In a world with 100% indexing, who would trade from stock to stock to ensure that the market was efficient?

The stock market does need some active traders who analyze and act on new information so that stocks are efficiently priced and sufficiently liquid for investors to be able to buy and sell. Active traders play a positive role in determining security prices and in turn how capital is allocated.

Active managers are motivated to perform this function by charging substantial management fees. They will continue to market their services with the claim that they have above-average insights that enable them to beat the market even though, unlike in Garrison Keillor's mythical Lake Wobegon, they cannot all achieve above-average market returns. And even if the proportion of active managers shrinks to as little as 10% or 5% of the total, there would still be more than enough to make prices reflect information. We have far too much active management today, not too little.

But as a thought experiment, suppose everybody did index and individual stocks did not reflect new information? Suppose a drug company develops a new cancer drug that promises to double the company's sales and earnings but that the price of its shares does not increase to reflect the news. In our capitalist system it is inconceivable that some trader or hedge fund would not emerge to bid up the price of the stock and profit from the mispricing. In a free-market system we can expect that advantageous arbitrage opportunities are exploited by profit-seeking market participants no matter how many investors index.

To be sure, index investors are free riders. They do receive the benefits that result from active trading without bearing the costs. But free riding on price signals provided by others is hardly a flaw of the capitalist system; it is an essential feature of that system. In a free-market economy we all benefit from relying on a set of market prices that are determined by others.

Index funds have been of enormous benefit for individual investors. Competition has driven the cost of broad-based index funds very close to zero. Individuals can now save for retirement far more efficiently than before. It's been a while since I've brushed up on Marxist economics, but to me that sounds more like a transparent, well-functioning market economy than a "silent road to serfdom."

Mr. Malkiel, chief investment officer of Wealthfront, is the author of "A Random Walk Down Wall Street" (W.W. Norton), now in its 11th edition.