Is it safe to invest in equity indices ?

Imagine for a moment that you are a professional portfolio manager and are pitching for a mandate to manage the portfolio of a large pension fund. In your presentation, you introduce your model portfolio to the pension fund representatives as follows: 40% of the portfolio is concentrated into the five largest positions. The three largest sectors are IT at 57%, consumer goods at 22%, and health care at 11%. The portfolio's overall P/E is 40.

What would be your chances of winning that mandate? Zero. Pension fund trustees having the savings of pension savers under their care must act with professional diligence. They would be hard-pressed to justify bringing in a portfolio priced at an average 40 times earnings and with a highly unbalanced sector composition. Moreover, they are very probably prohibited by law from having so much of their portfolio in the five largest positions. No prudent portfolio manager would go along with such a portfolio.

Now, here's the surprising part: The characteristics of the model portfolio presented in the first paragraph are those of the Nasdaq-100 Index. This is one of the indices most frequently used for passive index investing. What does a passive investor buying such an index actually get? It certainly is no diversified portfolio. The five largest positions (Apple, Alphabet, Microsoft, Amazon, and Facebook) really comprise a little over 40% of the portfolio. More than half of the index is from the IT sector and certain important sectors such as financial services or energy are not represented in the index at all.

So, the index does not provide diversification.

What else might it provide? Well, it doesn't offer a bargain price either. Although the materials for an ETF named QQQ and which copies the Nasdaq 100 state that the index's P/E is 22, they do not mention the way that P/E is calculated. In fact, it is calculated in a manner that boggles the mind. First, all companies that are in loss are excluded and then the influence on the overall result of companies with too-high P/E is substantially limited by the method for calculating the overall P/E.

Facebook, for example, has a P/E of 38 and therefore markedly contributes to the high P/E of the index. If, however, Facebook would be in loss instead of having earned approximately USD 13 billion in the past 12 months, then the index's P/E would decrease because Facebook would be excluded on account of its loss. Theoretically, there can also occur a situation wherein the sum of profits in all the companies is negative but the index's overall P/E would be low and positive.

This calculation of the index P/E is truly unusual and distorts reality. When it is calculated properly – that is by including companies with losses – we come to a P/E of

40. That is really high and there is nothing more that needs to be said about that. How many passive investors buying the Nasdaq-100 Index know that they are in fact buying an unbalanced, narrowly concentrated, and extremely expensive portfolio? It is a portfolio no active manager would ever willingly buy, even if regulations permitted him or her to do so.

Passive investment makes sense generally for a large proportion of small investors – but not always, not at any price, and not in just any index. Getting into passive investing is in fact an active decision. The selection of an index and above all its expensiveness or inexpensiveness determine any future returns. The situation today is that we are witnessing an immense cyclical boom in passive investing, and especially so in the US market. This results in US equity indices being exceptionally expensive. There are enough attractive investment opportunities, but they are outside of the main indices and outside of US markets. In essence, we can say the present trend opens a golden era for active investment. What can be better than to compete for investment returns with an increasingly large mass of investors who give no thought whatsoever to what they are buying?

Invest with care!

Daniel Gladiš, 27 July 2017

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