Seth Klarman Investment Advice ...Index Funds Dangerous?

When people search for Seth Klarman investment advice, I bet they don't expect to find *this*. Seth Klarman is known as one of the best value investors in the world. His returns are phenomenal, hovering around the 20% mark for decades. He's been called the second coming of Graham, the true heir of classic Ben Graham investing.

Still, Klarman has developed his own independent thoughts on investing, which is why those seeking out Seth Klarman investment advice may find suggestions that run counter to better known investors such as Warren Buffett, and even Graham himself. One of those positions has to do with index fund investing. To put it mildly, Seth Klarman is not a fan. In fact, Klarman has gone so far as to call investing in index funds silly and hazardous. Why the hostility towards a strategy that Graham, Buffett and Munger have embraced?

Seth Klarman Investment Advice You Didn't Expect

Seth Klarman wrote what must now be the most expensive investment book in existence, his 1991 investment classic *Margin of Safety*. In the book, Klarman begins his attack on indexing by laying out the philosophical underpinnings of the strategy,

"Indexing is the practice of buying all the components of a market index... and then passively holding them………. matching the performance of the securities in the index.... Since the average institutional investor has underperformed the market for the past decade, and since all investors as a group must match the market because they collectively own the entire market, matching it may seem attractive. Indexing offers the additional benefits of very low transaction costs (as there is almost no trading) and low management fees (as the task requires virtually no thought or action)."

Believing that outperformance is impossible, professional investors and private investors themselves have adopted this strategy en masse. As Klarman writes, the aim is for investors not to beat the market but to just keep pace with it. While Seth Klarman was writing in 1991, the same reasons for adopting an indexing strategy are used today. But, if anything, more investors have elected to buy index funds today due to the continuing terrible performance of professional money managers. Why pay someone to underperform the market when you can at least keep pace with it while paying only tiny management fees? University professors spreading the Efficient Market gospel are largely responsible for the rapid spread of the strategy. As more students are taught the theory as part of their business degrees, they carry this prejudice with them into their careers in the finance industry and insist on index funds if tasks with stewarting institutional money. He continues,

"...many institutional investors and pension funds believe in the efficient-market hypothesis. This theory holds that all information about securities is disseminated and becomes fully reflected in security prices instantaneously. It is therefore futile to try to outperform the market. A corollary of this hypothesis is that there is no value to incremental investment research."

Obviously, there's no point in spending countless hours researching stocks if it adds no value, or likely decreases your eventual returns. With the popularity of speakers such as Jack Bogel, this worldview has even trickled down to individual investors.

Seth Klarman Investment Advice: Index Funds Have Higher Risk And Lower Returns Than You Think

But almost every popular investment strategy has to be leading investors astray somehow. Investing in general is an activity where most people (a.k.a. “The Crowd”) earn lower returns than average, and where a smaller group of astute investors earn large returns over time. Given this, following a popular strategy becomes a fool's errand. Those seeking Seth Klarman investment advice best take heed:

“Indexing ……..becomes self-defeating when more and more investors adopt it. Although indexing is predicated on efficient markets, the higher the percentage of all investors who index, the more inefficient the markets become as fewer and fewer investors would be performing research and fundamental analysis. Indeed, at the extreme, if everyone practiced indexing, stock prices would never change relative to each other because no one would be left to move them.”

Here, Klarman does a good job of pointing out an inherent contradiction in indexing. As fewer people spend time picking stocks that they believe provide a more compelling investment opportunity, markets become more inefficient, creating longer lasting gaps between price and value or even creating more price-value discrepancies. This should theoretically help the value investor find undervalued securities but lengthen the time it takes for a value investor to realize profit. But, there’s an even bigger concern today: larger and longer lasting bull markets. As more and more people pile into index funds, prices are pushed higher, possibly to terrifying levels. Since fewer investors are selling based on valuation, they’re more likely to hold on to expensive assets, which reduces downward pressure on asset prices due to selling. Unfortunately, fear and greed are still fundamental features of investor psychology, so investors who want to capitalize on great returns invest more money into rising indexes, pushing prices even higher. Some fear that this trend could reverse in an ugly way. As Klarman explains,

“...indexing will turn out to be just another Wall Street fad. When it passes, the prices of securities included in popular indexes will almost certainly decline relative to those that have been excluded. More significantly, as Barron's has pointed out, “A self-reinforcing feedback loop has been created, where the success of indexing has bolstered the performance of the index itself, which, in turn promotes more indexing." When the market trend reverses, matching the market will not seem so attractive, the selling will then adversely affect the performance of the indexers and further exacerbate the rush for the exits.”

It’s a scary thought. As fear takes over and investors start to sell during a bear market, managers have to raise cash to fund their exit. This means more fear and more selling, pushing indexes lower, which encourages more investors to sell. Is this where the markets are heading in 2018? Maybe. Unfortunately, nobody can predict market moves in advance consistently over time. The last crisis’ market timing guru is usually absent and soon passes from the public’s memory. Being out of stocks due to market timing while the market advances, at least according to Tweedy, Browne, or Peter Lynch, has historically lowered returns.

Seth Klarman Investment Advice: Avoid Index Funds Because Managers Buy High, Sell Low

But, in the meantime indexers face another paradoxical disadvantage -- the tendency for fund managers to buy high and sell low. Ironically, this is the same behaviour that individual investors try to avoid by buying an index fund. Rather than meet their objective, the structure and popularity of index funds ensures that stocks are purchased for higher than a prudent investor would buy them for, and sold for an unwarranted loss. Those seeking Seth Klarman Investment advice should take note of this structural disadvantage.

“Because indexers want to be fully invested in the securities that comprise the index at all times in order to match the performance of the index, [a] security that is added to the index as a replacement must immediately be purchased by hundreds or perhaps thousands of portfolio managers. ……..Yet even very large capitalization stocks have limited liquidity at a given time. Owing to limited liquidity, on the day that a new stock is added to an index, it often jumps appreciably in price as indexers rush to buy. Nothing fundamental has changed; nothing makes that stock worth more today than yesterday. In effect, people are willing to pay more for that stock just because it has become part of an index.”

Delisting from the NASDAQ to the OTC market, for example, is not a real practical concern for individual stock pickers. While small investors often fear their stocks being booted off of a big board, investors can buy and sell the stocks without issue. Any increase in a stock’s bid-ask spread can be handled using limit orders, so theirs little additional cost here due to reduced liquidity. But, despite the trivial differences between the two listings, stocks are hammered when booted off of an index, as institutional constraints force managers to sell all at once. And, this phenomenon doesn’t just occur when a stock is booted off of a major index, or added to an index. While small stocks have a big reputation for outsized returns, those buying indexes small or micro cap stocks face additional problems. He continues,

“Such stocks usually have only limited liquidity, and even a small amount of buying or selling activity can greatly influence the market price. When small-capitalization-stock indexers receive more funds, their buying will push prices higher; when they experience redemptions, their selling will force prices lower. By unavoidably buying high and selling low, small-stock indexers are almost certain to underperform their indexes.”

...a fact that a lot of index fund buyers aren’t aware of. It’s ironic to think that your index fund portfolio can drag behind the index, even excluding fees, when your aim is to just match an index’s returns. It seems that small investors are doomed to earning much less than the market indexes over the long term, and subject themselves to major market advances and declines over their lives. What would Seth Klarman have individual investors do?

Seth Klarman On How Small Investors Should Invest

As with most Seth Klarman investment advice, the recommendation is highly practical. It really pays to know which investment strategies produce great long term performance and then stick to those strategies.

"By contrast, value investing is predicated on the belief that the financial markets are not efficient. Value investors believe that stock prices depart from underlying value and that investors can achieve above-market returns by buying undervalued securities. To value investors the concept of indexing is at best silly and at worst quite hazardous. Warren Buffett has observed that "in any sort of a contest-financial, mental or physical-it's an enormous advantage to have opponents who have been taught that it's useless to even try." I believe that over time value investors will outperform the market and that choosing to match it is both lazy and shortsighted."

The price and value of a stock often deviate by a wide margin, allowing investors to capitalize on the discrepancy. Finding a company trading well below intrinsic value with a solid reason for it to advance back up to full valuation is like finding a nugget of gold in a stream. All an investor has to do is reach down and pick it up. Investors who invest in index funds have essentially chosen not to compete for these gold nuggets increasing a value investor's ability to find and capitalize on them.

Investors, so long as they take a value investing approach to individual securities, can dramatically outperform the crowd. But, it takes a solid investment strategy -- the type Graham would advocate small investors adopt today. Here, Klarman had a solid piece of investment advice as well:
".........ample investment opportunities may exist in the securities that are excluded from consideration by most institutional investors. Picking through the crumbs left by the investment elephants can be rewarding."

Unfortunately, individual investors cannot simply abdicate their responsibility for investing and expect to earn good investment returns. As always, investing takes effort, the willingness and ability to learn, and a solid strategy. We've found that classic value strategies such as Graham's Simple Way, Ultra stocks, Acquirer's Multiple, Pay Daddy net nets, and even Negative Enterprise Value investing to be very rewarding long term.
But, while an investor may have the technical skills to do well, he must also have a long term perspective (able to withstand long periods of underperformance), and the emotional fortitude to weather the market's storms. I've spent considerable time developing this inner game and the results have been fantastic, partly due to Seth Klarman Investment advice.