

WHY DOES “CLOSET INDEXING” EXIST?

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“The person who goes farthest is generally the one who is willing to do and dare. The sure-thing boat never gets far from shore.”

-Dale Carnegie

“Some men are born mediocre, some men achieve mediocrity, and some men have mediocrity thrust upon them.”

-Joseph Heller, “Catch 22”

If presented with the two statements above, our guess is that the vast majority of the populace aspires to the first. Yet, in investing, things are not so simple. The first quotation seemingly describes the mission of an “active” money manager: seek undervalued securities and when successful, far exceed the average return of the market. The second appears to describe a “passive” or “index” approach to investing: be perfectly content settling for average. However, “average” index returns are often far better than “mediocre” because index returns are not burdened by the comparatively high costs associated with an active manager. The index does not have management fees, and its low turnover greatly reduces the impact of trading costs and taxes.¹ Advocates of indexing often cite statistics that the majority of actively managed funds fail to beat the return of an appropriate index after fees and taxes. To them, striving for mediocrity is a blessing not a curse. Those “willing to do and dare” bear the burden of proof that venturing “far from shore” (the index) will not result in the financial equivalent of being swept out to sea and never heard from again.

The theoretical support for indexing comes from the efficient market hypothesis (EMH). EMH postulates that capital markets are so competitive that mispriced securities cannot persist for long. This competition is driven by diligent investors, sometimes called “rational profit maximizers,” who try to ferret out the true worth of an asset. Indexers, then, are able to benefit from a free rider effect. A free rider is a person who consumes a good without having to pay for it; in this case, the “good” is the assurance that the price paid for a security is “fair” because it reflects all available information.

First, we do not believe the market is that efficient. Investors are not always rational, nor do they always process information efficiently. But even if the market were fairly efficient, it is important to recognize the paradox that underlies the indexing argument. If all investors elect to index, no one will be left to set prices. An index advocate might agree that there may be a “tipping point” when it will be worthwhile to diverge from the index and search for bargains, but argue that we are far from that point considering that the U.S. stock market has an aggregate market value of approximately \$12 trillion and less than half that amount is currently indexed. But what if investors are no longer working diligently to determine the true worth of the securities in the marketplace? What if investors, including professional advisors, have abdicated the role of trying to determine the true value of a company in favor of playing a game of relative performance or in some cases “closet indexing”? Closet indexers are managers who construct portfolios that align very closely with a designated benchmark, then make small “bets” by slightly over- and under-weighting index components. In our guesstimate of where that “tipping point” lay, wouldn’t we need to count both indexed assets and those managed by closet indexers?

Diamond Hill Capital Management, Inc. is an active investment manager charging active management fees. In this regard, we are akin to the person in Carnegie’s statement. Our mission is to provide economic value to clients and fund shareholders. We cannot accomplish this goal by merely matching the performance of a passive benchmark. We must surpass this index return by an amount greater than our incremental costs. Yet, we do not view our activity as “daring”. We are not different for the sake of being different. We recognize that to add economic value, we must be both *different* and *right*.

¹An interesting aside is that when an “index” approach is mentioned, the first thought is often of the S&P 500 because it is the index to which most dollars are indexed. However, in 1999 and 2000, there were 44 and 57, respectively, changes made to the S&P 500. Thus, there is an active component to the S&P 500 Index that somewhat mitigates the benefits of having low turnover in an index; this is not as problematic in a broader market index such as the Wilshire 5000.

Furthermore, we do not “set out to sea” for the thrill of adventure, but with the purpose of getting somewhere. As Warren Buffett stated in a 1965 letter to limited partners of the Buffett Partnership:

It is unquestionably true that the investment companies have their money more conventionally invested than we do. To many people conventionality is indistinguishable from conservatism. In my view, this represents erroneous thinking. Neither a conventional nor an unconventional approach, per se, is conservative. Truly conservative actions arise from intelligent hypotheses, correct facts and sound reasoning.²

We could not agree more with Buffett’s sentiments. We believe that all too often indexing and closet indexing are thought of as conservative. There is nothing inherently conservative about the index. It is not a birthright that the index must provide investors with an 11% annualized return. We have analyzed the probable return from investing in a broad market index and do not believe we can meet our objectives following an index and especially a closet index approach. An investor may remain unconvinced that an active manager can outperform the index over a long period after factoring in costs, or at least unconvinced that such a manager can be identified in advance. We believe it is possible. Yet, we believe a rational investor should consider the expected return of the index when making the “active” versus “passive” decision. Diamond Hill Capital managers have significant amounts of their personal net worth invested in our funds and none of us wishes to be “daring” with our money. Of course, just as Buffett conveyed in his letter, this demonstrates only the sincerity, not the validity, of our view.

While we are not unique in our approach, we believe it is far from the norm in the investment management industry. In particular, we believe closet indexing is more ubiquitous than investors realize. Why does closet indexing exist? The primary explanation lies in the economic incentives of the investment management industry. Investment managers charge fees based on a percentage of assets under management, rather than a percentage of the economic value added. There is some logic to this arrangement. A manager that increases the value of the portfolio stands to receive greater management fees. Thus, the interests of manager and shareholder are often better aligned than the arrangement found in commission based systems. The key to fund profitability is to garner and then retain assets under management. Obviously, the easiest way to garner assets is to experience a period of marked outperformance, providing a “story” to tell potential investors. Additionally, sponsors of employee benefit plans are likely to take notice and include the advisor as a manager. Yet, once a fund is established, incentives often change. The asset base becomes a recurring revenue stream. The upward bias of the market over time provides a growth component. Investment advisors recognize that clients and shareholders typically will stay with a manager as long as performance is not abysmal. Thus, the fund has the allure of becoming a “cash cow” to be milked for all its worth. Plan sponsors want to avoid being in the position of having to explain why their “large cap value” fund, which they selected as the option for that “style”, badly trailed the large cap value index. For both the manager and the plan sponsor, then, “average” results can be perfectly acceptable.

Why is closet indexing a cause for concern? An investment advisor owes a fiduciary duty to shareholders to act in their best interest. This fiduciary duty does not end because the manager at one time performed well for shareholders. Intentionally delivering what is for all practical purposes an index fund and charging active management fees is seldom in the best interest of the client. Of course, the fund advisor has a convenient excuse to fall back upon. Namely, the advisor can claim the strategy is a diversification effort to reduce risk for shareholders. Seemingly sophisticated programs measuring “tracking error”, or how far from the benchmark the portfolio is likely to deviate, are instituted. We believe a wise shareholder should ask himself: whose risk is being diversified, the shareholder’s or the fund manager’s?

And yet, because of the strength of the market averages in the latter half of the 1990s and early 2000, an environment in which many active managers had difficulty keeping up, closet indexing did not appear to be such a bad investment strategy. We believe that environment is unlikely to return. Further, we think the failure to employ a sensible investment strategy will likely result in disappointment for investors.

“Some men are born mediocre...

We believe that a business has an intrinsic value, equal to the present value of all future cash flows, independent of its market price. We estimate the intrinsic value and invest in a company only when the market price is significantly below this estimate. By doing so, we adopt the mindset of a business owner. This is the only approach that makes sense to us. We believe that investors who rely on the greater fool theory, strategies such as market timing or

“momentum” investing that attempt to guess investor psychology, simple accounting-based methods like low P/E or low P/B, or faulty models such as the PEG ratio are destined for mediocre results at best.

Another misused investment tool, in our opinion, is relative valuation. In a relative valuation framework, the market value of one company is compared to that of other comparable companies, either because each operates in the same industry or because the companies share similar financial characteristics. If the price of one appears out of line or “cheap” compared to the other(s), then it is purchased. This, however, does not allow for the possibility that the company used as a measure of comparison is greatly overvalued. To us, relative valuation is analogous to the man who goes into the pet store and upon seeing a run-of-the-mill dog priced at \$5,000, decides to buy two \$1,000 hamsters. While we do consider relative valuation, we would never make an investment that was not attractive on an *absolute* as opposed to a *relative* basis.

... some men achieve mediocrity...

We believe adopting the mindset of a business owner is a necessary, but not sufficient, requirement if one hopes to add economic value over a sufficiently long period of time. There is still significant work to be done in forecasting cash flows, understanding business economics, and evaluating management. We believe an investor must also apply intelligence, including the ability to integrate other disciplines in the analysis and recognize interrelationships, diligence (evidenced by a solid work ethic), and a small degree of prescience. In addition, an investor must possess the temperament to adhere to convictions until evidence emerges that contradicts the original thesis, especially when the market temporarily disagrees. In some cases, this will require the disposition to act contrary to conventional wisdom. If these ingredients are present, we are confident the probability for success is high. If these qualities are lacking, even mediocrity might be difficult to achieve.

...and some men have mediocrity thrust upon them.”

We believe there are several reasons a portfolio manager may be forced into mediocre results. The first is the institutional mindset, which is manifest in several ways. In most investment organizations, the reward for outperformance is not symmetrical with the penalty for underperformance. Fund managers may receive a bonus for outperforming the benchmark, but compensation is more heavily tied to the fund advisor’s profitability. The manager recognizes that the biggest mistake he could make is to significantly underperform the index and lose a large number of shareholders. Thus, the manager of a large fund faces this proposition: stay reasonably close to the index and a sizable bonus awaits; significantly underperform the index causing investor redemptions, and risk losing your job. No wonder so many investment managers choose to stay close to shore.

A second limitation is the demand by fund company executives, consultants, fund analysts and others for style purity. A manager who is constricted to a narrow universe has a limited number of options to add value.

A third factor likely to lead to mediocre results is asset size. A fund with tens of billions of assets to invest will have a difficult time straying from the large capitalization companies that dominate capitalization weighted indexes. Consider Fidelity Magellan, an \$86 billion mutual fund managed by Robert Stansky. Below are the eight largest “technology” holdings in the Magellan Fund as of September 30, 2000, the most recent complete holdings list available. What we find interesting is that seven of the eight positions are actually underweight compared to the S&P 500 Index. Given the consistency of the underweights, it would be hard not to conclude that Stansky had difficulty justifying the valuations of these stocks and quite likely believed them overvalued. Yet, he still devoted over 13% of the fund’s assets to them. As far as *relative* performance is concerned, Stansky would be better off if ten of Magellan’s largest twenty-five positions would *decline* when Pfizer, Wal-Mart, and Merck are included with these tech stocks.

As of 9/30/00	Fidelity Magellan (FMAGX) % Weighting	Fund Position Rank	S&P 500 Index (SPX) % Weighting	Relative Over/Under Weight in Percentage Points
Cisco	2.93	(3)	3.10	-0.17
EMC Corp.	1.97	(8)	1.70	0.26
Intel	1.73	(11)	2.21	-0.48
Microsoft	1.58	(12)	2.51	-0.93
Oracle	1.50	(14)	1.76	-0.26
IBM	1.38	(15)	1.57	-0.19
Sun Microsystems	1.34	(16)	1.47	-0.13
Nortel	0.94	(24)	1.41	-0.47
TOTALS	13.37		15.74	-2.37

Assuming Stansky felt these stocks were unattractive, has being underweight these stocks substantially rewarded Magellan's shareholders given their precipitous price declines? Presumably, the answer is no. From 9/30/00 to 3/31/01, the Magellan Fund declined 20.6% compared to the decline of 18.7% of the S&P 500 Index. Granted, we are not offering much insight into what we would do differently if we were faced with putting \$86 billion to work, predominantly in the U.S. equity market and entirely in non-control positions, but that is the crux of our point. Excessive size is a debilitating factor on investment performance.

Diamond Hill Capital Management is unwavering in who we are: an active investment manager with its sights set on a course far from shore (the index) and an idea of how we intend to add economic value for clients and shareholders. While our approach does not guarantee success, we believe it certainly makes more sense than a closet indexer saying, "We have to own GE, Cisco, EMC, and Intel, *regardless of price*, because they are significant weightings in our benchmark."

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