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# The Good & Bad of Stock Index Funds

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Over the last several years Billions $ flowed into Stock Index Funds, the Standard & Poor's 500 being the largest recipient. Indexes are easy to invest in whether for IRA or personal monies, and most 401-k's offer various options too. ETF's are the latest iteration.

It's worth noting that all investments have both good and bad features, and the success or failure of them can be significantly altered by the timing of buys and sells. Some thoughts.

The Good:

Indexes provide diversification, i.e., not all your stock eggs are in one basket. The S&P 500, in particular, includes many of the biggest and best companies in the world. Other indexes can have fewer or more stocks and cover specific size companies, sectors, international, etc. There are lots of index options.

Costs are low:

Since all the Fund Managers do is invest any $ in pre-determined securities, they spend no time doing research. This allows their annual expenses to be low.

The Bad. There are three main disadvantages:

Indexes can become overpriced. This is the biggest risk index investors face. Even the highest quality asset will show a poor rate of return if you pay too much. Inside the S&P 500, for example, are stocks trading at very high multiples (price to earnings, price to book, etc.) and ones that are low. You get a piece of all of them. Several publications publish weekly the 'average' P/E ratios. Even this is misleading since, in many indexes, the allocation of $ is based upon the size (market capitalization) of the included stocks. Often, more money is invested in larger companies and less in smaller ones.

Liquidity can be a problem. Vanguard, for example, manages the largest Index Fund in the world, their S&P 500 fund worth some $ 300 Billion +. Due to their size they are the largest owner of 496 of the 500 stocks in the S&P 500. This issue affected Janus Funds investors in 2000. Once prices started to fall, and Janus tried to sell to meet redemptions, their volume was much larger than the buyers, and prices plummeted. In addition, Index Funds, being fully invested, essentially, have no cash. So when redemptions begin then have to sell holdings to provide cash to send investors their money. In a volatile market sell-off this amplifies prices to the downside. Plus Vanguard won't be the seller.

You get the good with the not-so-good. This relates both to the underlying quality of the assets, and to their pricing. It doesn't make investing sense to voluntarily put your hard-earned money into investments with less than stellar characteristics.

Summary: Like most investments, Index Funds are neither inherently good nor bad. Diversification can prevent you from making mistakes, but reduce your potential rate of return by mixing lower and high quality assets. Similarly, you'll own some assets trading at low multiples and others trading high.

Investors are 'piling into' Index funds. This is driving prices higher and tempting more to pile-in. By our standards the P/E and other valuation ratios of most of the popular Indexes have gone way above prudent levels. We believe this is helping create a bubble of huge proportions, and bubbles always burst, to the detriment of the participants. This is typical, following the crowd in investing usually ends badly.

Our advice: at these levels, be very careful !

# The Paradox of Thrift (Eurozone edition)

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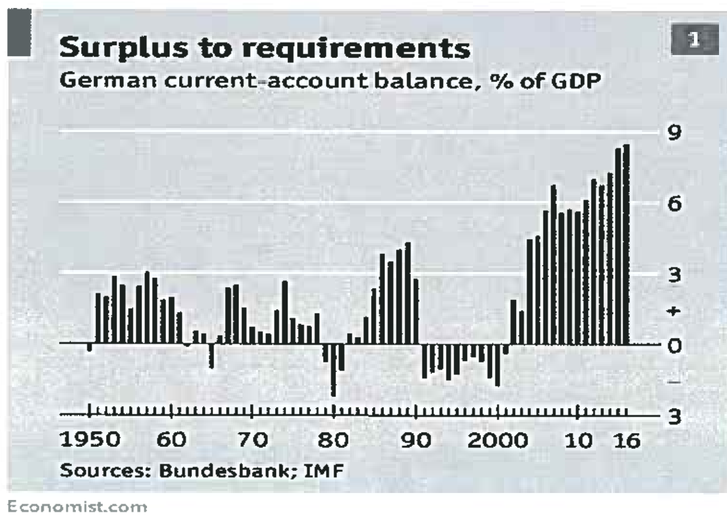
I was a bit surprised when a recent issue of The Economist, a well-regarded financial weekly, published with the cover story titled ***The German Problem – The country saves too much and spends too little.*** The focus was on why Germany's national trade surplus of $300 billion is a bad thing. Then I realized, of course, today's conventional financial wisdom teaches us saving BAD, spending GOOD, and if your income won't cover your spending you just borrow – duh!

Bill Connors wrote about the Paradox of Thrift – as popularized by legendary British economist John Maynard Keynes - in this publication last year, stating that what might be good for an individual or a family isn't necessarily good for an overall economy. After all, one person's spending is another's income, and when many choose to save en masse, recessions can and do occur. In the Great Depression, Keynesian economics was born of this concept - i.e. government should borrow & spend when the private sector won't in order to reignite growth.




Trade imbalances have been a central theme of populist politics recently, though during the campaign candidate Trump attacked China and Mexico as the primary villains. Now Germany is one of President Trump's targets, which may have contributed to the Economist's decision to run this piece. The country's persistent and rising surpluses since reunification with E. Germany in the post-Soviet era are clearly shown here.

So why pick on Germany now? They've already been painted as the bad guys by the Eurozone's "Club Med" for insistence on austerity as a condition for bailouts of those southern EU countries (esp. Greece) that blew up after the global financial crisis. Don't thrifty Germans have a strong case against the free-spending (and heavily indebted) Greeks, Italians and Spaniards? Besides, if you produce high-quality autos (Mercedes, BMW, Porsche), machine tools and other sophisticated products the world demands, what's so bad about having a big export sector? It's certainly kept many more Germans employed in well paid manufacturing jobs @ nearly 20% of the workforce vs. approx. 10% in the U.S. Their vocational trade school/apprenticeship system is widely praised with other countries seeking to emulate it. You might say that sound labor & training policies "made Germany great again" in the new millennium.

The problem lies not with what Germany has done right, but with what the Eurozone has done wrong in creating a single currency for a continent with widely differing national economies. When the crisis came, there was no way for competitive devaluations and interest rate adjustments to rebalance weak (south) vs. strong (north), as was the case before the euro currency was adopted. Now German dominance in Europe and globally is becoming an ever-larger political issue for an aging, over-indebted, and growth starved world. Obviously, they must be engaging in "unfair" trade practices. So, let's figure out how to make 'em save less so they'll buy lower quality stuff they don't want or need from the rest of the world. If the German deutschmark still moved freely against the French franc, Italian lira, Greek drachma and other regional and global currencies, this would self-correct via relative prices. But, as we know in the modern financial era, govts. and central banks know better than free markets what's best for us all. Until the unintended consequences become too great to ignore.

# The Risks Outweighs the Rewards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In my 10 years or so as a financial adviser, I have been taught and studied many ideas regarding value and strategy, but perhaps most important, I have learned if something seems too good to be true, it probably is.

I feel this holds very true regarding the overall valuations and record highs the General Stock Market has experienced over the last few years, and more specifically, since Trump took office. The market has assumed an agenda formed around 'Think America First' as if tax & regulation cuts are already in place, and have priced their impact into the market.

One glaring problem is most of these policies haven't begun to take shape. In fact, many would argue the promises made during Trump's campaign are not feasible and will never come to fruition. Yet since his election win, the market has enjoyed historic highs and the Market 'cheerleaders' are trying to downplay the bubble risks that we feel have become even more evident. As a firm who looks for good value for our clients, the pricing of the general market has us playing defense as we feel the downside risk drastically outweighs the upside potential return.

Just as before the Market correction of 2008, many investors have lost sight of the risk they are taking because their account statements continue to see increasing balances. However, unless the investor 'locks-in' these gains, they are likely to see their values drop once the market gains its sanity back. Many investors close to retiring took huge hits to their portfolios and had to change their retirement plans; we think that will happen again.

This run over the last 6 months has only cemented our concerns about the stock market; the fundamentals left a long time ago. The weak state of the economy, lack of wage growth, and the true participation of the workforce seem to get lost in the noise, and yet investors continue to pile into an overpriced market hoping the streak continues. Hope is not a strategy.

We continue to warn investors of the irrational exuberance of the stock market. We feel this opinion becomes more validated as time goes on and these factors get worse. Many investors are not fully aware of the risks they are running in their portfolios. If you would like to take a sober look at your portfolio, and discuss areas we feel may be an opportunity for you, please feel free to call me for a free consultation: (303) 770-3030.

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**Older comments from Warren Buffett that are timely today.**

" When investing, pessimism is your friend, euphoria the enemy ."

" What I do is invest in good businesses managed by good people. And I buy more when other people are afraid or selling out ."

" ... a new wave of investors learns some very old lessons. First, many in Wall Street - a community in which quality control is not prized - will sell investors anything they will buy. Second, speculation is most dangerous when it looks easiest ."

# "Instead of buying low and selling high you're buying high and crossing your fingers."

Bill Gross

The warnings are everywhere and it seems they are only meant to be ignored right now. Below are some comments from some of the best investors ever. Bill Gross and Bob Rodriguez are the only 3 time winners of the Morningstar Fund Manager of the Year awards. The warnings are also coming from Federal Reserve members now as well as some of the major investment banks. As a value investor my responsibility to all of you is to attempt to buy low, cheap assets, not buy high and cross my fingers. Below are some comments that I consider critical and the warnings are dire.

**Bob Rodriguez**

Bob Rodriguez had the following to say in a June 22 interview in Advisor Perspective: "If I were managing money, or given my background of pain-and-suffering and being redeemed, my liquidity allocation would be north of 60% today.

"Now we have a clueless Fed, in my opinion, that has never known what a bubble is beforehand. It is accentuating one that has been developing as a result of its policy insanity of QE. Markets are going straight up predicated on it.

"Looking at the two prior major cycles, it is far more difficult for a value manager to hold liquidity today in light of the policies that are being deployed. "These are the worst policies both fiscally and monetarily in human history.

"When the markets finally do break, as they always have historically, ETFs and index funds will be destabilizing influences, because fear will enter the marketplace... Investors will hit the 'sell' button. All you have to ask is two words, 'To whom?' To whom do I sell?"

**David Stockman**

David Stockman had the following to say in a Fox Business interview on June 17: "This is the most hideously valued market in history. It is trading today at 25 times the $100 a share that the S&P 500 earned in the period ending in March. I go back 10 years to June 2007, the S&P 500 earned $85 a share. That's 1.2% growth in 10 years and you want to pay 25 times earnings going into a world where the Fed said the other day 'we're going to shrink the balance sheet by $2 trillion over the next several years', where we have a government that is in total chaos, a president they are trying to unseat, a debt ceiling that can't be raised, a tax bill that will never pass...

On July 7 he wrote the following: "It's better to look like a fool before the bubble pops than to be one afterwards."

**Bill Gross**

The following comments are from Bill Gross' June Investment Outlook: "But asset prices and their growth rates are ultimately dependent on the real economy and, the real economy's growth rate is stunted by secular forces which monetary and even future fiscal policies seem unable to reverse. In fact, as I have mentioned many times in prior Investment Outlooks, monetary policy may now be a negative influence in terms of future economic growth."

Jeff Gundlach, the head of DoubleLine Funds, indicated on June 13 that economic growth in the not concluded decade beginning 2010 is only 2.09% which is barely above the 1.33% growth rate of the 1930s. Going back to 1790 the only time there was were worse decades than now was the 1930s and 2000s.

Gross also made the following comment in a Bloomberg interview on June 7: "It's not an attractive situation. Instead of buying low and selling high you're buying high and crossing your fingers."

**Jim Rogers**

Remarkable investor Jim Rogers made the following comment in a Business Insider interview on June 9 regarding a coming stock market crash: "Later this year or next... It's going to be the worst in your lifetime. It's going to be the biggest in my lifetime and I'm older than you. No, it's going to be serious stuff."

I will remain conservative and wait for cheap assets. The current investors will panic sell.


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