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Sharpe (& Bogle) vs. Arnott (& Siegel)

The October issue of the AAII Journal published by the American Association of Individual Investors (AAII) has two articles of interviews with noted authors who have conflicting views about how investment portfolios should be managed. One, which is the second of two parts, is with Noble laureate William Sharpe who believes that once a portfolio has been put in place owning a broad index fund of stocks among its holdings that no further action, even rebalancing, is a good idea. The other is with Robert Arnott who has written extensively about the superiority of "fundamental indexing" to buying and holding index funds such as those that essentially own the S&P 500 index.

John Bogle, the founder of Vanguard funds who developed the first index fund, the Vanguard Index 500 Fund (ticker VFINX), which closely tracks the S&P 500, has views similar to Sharpe's although from a somewhat different point of view. Bogle points out that the totality of mutual funds and other managed accounts is essentially "the market." Because there are costs to active management, the average return across all active managers must be less than that of the unmanaged market. Extensive data show that something like 80% of mutual funds do worse than their benchmark indices, so there is a lot of truth in what Bogle claims. I will look at Arnott's rebuttal in a bit.

Sharpe's claim is that any attempt to do better than the market depends on finding "mispricings" or "mistakes" by the market. While he says they may have occurred in the past, they are unlikely to persist. Examples are small capitalization stocks or low price-earnings ratio stocks. Either because the market will correct for these or there are risks that are not apparent in the historical data, one can't consistently outperform the market over the long run by trying to take advantage of the presumed mispricings. He goes further by saying when one trades he or she believes they are smarter than whoever is taking the other side of the trade, who will have the same feeling. Both can't be right, so why do you think you are going to be the winner and the other guy the loser?

[I feel the need to comment on this. He seems to ignore that trades are made for many different reasons and anticipated holding periods. If A sells a stock and B buys it, can both come out ahead on the trade? That is certainly possible

because B may be a short-term trader who takes a profit in a week or two if the stock rises while A was reducing or eliminating the holdings in the stock as a risk control measure or for some other reason. If the stock drops after B has sold to a price below the initial transaction, then A has also "won" on the trade because in practice or in theory the stock could be repurchased at a lower price. Similarly, both may end up as "losers."]

What Sharpe says is essentially the efficient market hypothesis (EMH), which says stocks and other instruments traded on open markets are "fairly priced' because they reflect the consensus of all the currently known information. As such there is no way to consistently achieve above market returns without taking above market risks. I have discussed this line of thinking in a past perspective and do not really agree with it. Neither do Arnott and other noted writers such as Jeremy Siegel, author of *Stocks for the Long Run*, now in its fifth edition, who is associated with Wisdom Tree, a provider of ETFs that implement his work as part of its line of fundamental indexing, sometimes called "smart beta" offerings.

Arnott and Siegel claim that an index that is weighted by market capitalization, such as the S&P 500, gives too much weight to "overvalued" issues and too little to "undervalued" issues. They are saying the market has made an error or mispricing by bidding up those with larger market capitalizations and vice-versa. Sharpe and others who believe in EMH say that is not so because there is no reason why an increase or decrease in relative market capitalization indicates anything about the relative value of the stock.

Arnott and Siegel believe that weighting based on fundamental measures such as price-to-earnings, price-to-book value, and price-to-sales will outperform market capitalization weighted indices because of the incorrect weightings described above. Arnott in effect claims that any other weighting scheme is better. He cites a study he did that looked at various fundamental weighting strategies and asked what would happen if the weighting were turned upside down. The issues that should get the most weight according to a method got the least and the other way around. He found the inverted strategies also outperformed the capitalization weighted indices and sometimes did better than the corresponding "right side up" weightings. The key was avoiding the systematic over and under weightings due to capitalization weightings.

The AAII article with the Arnott interview has a chart showing the excess return over the S&P 500 for the 1967-2011 period for several different weighting approaches that was produced by his firm, Research Affiliates. The superior performance for the fundamental indexing ranges form 1.53% for one that emphasizes lower volatility to 2.15% for one produced by his firm, which

should not be a surprise. Interestingly, the equal weighted S&P 500—each stock gets 0.2% of the weight—does even better at 2.42% excess return. The latter is available through the Rydex Equal Weight 500 ETF (ticker RSP). (I use that fund when my model for trading the S&P is on a buy signal.). So the simple-minded approach of equally weighted does better than the more sophisticated "fundamental indexing."

[Neither the chart nor the article discuss whether transaction costs or other expenses are included in the calculations, which must be at least somewhat hypothetical since there was no way to own any of the alternative weightings (or even the S&P 500 as a practical matter) in 1967. It also does not compare the volatility or other risk measures to that of the S&P (although I suspect most of the comparisons would be favorable). I also wonder why the analysis stops in 2011 and does not include the strong stock market since then. I suspect that most fundamental indexing does better than the S&P in weak markets, but underperforms in strong markets. My research has shown the opposite to be the case for equal weighting, which is the primary reason I buy it rather than an index fund when the model I use says it is time to own the broad stock market.]

Whose views are correct? My leanings are toward Arnott's. Ten years ago, one of my perspectives was about EMH (http://www.pankin.com/persp041.pdf), and I pointed out what I thought are a few serious shortcomings. However, I have a much more important issue with both of the camps. Namely, they advocate keeping one's allocation to stocks fully invested at all times, and I think that is a recipe for underperformance over the longer term and involves a higher level of risk than is needed or is appropriate for many, if not most, investors.

As you likely know, I am a market timer when it comes to trading stock market indices. That does not mean I expect to buy at or very close to the bottom or sell near the top, which is impossible to do consistently. I have methods based on trend following designed to keep us on the right side of the major trends. The signals will be far from perfect, but they are designed to prevent meaningful drawdowns, and their performance in that regard has been excellent.

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