

The Superiority of Indexing

A D K I N S C A P I T A L M A N A G E M E N T , L L C

SPECIAL POINTS OF INTEREST:

- Index funds have a significant structural cost savings advantage
- The mission of the secondary capital markets give index funds a performance advantage
- Regulatory guidelines hinder the investment performance of active management
- The evolution from active to passive market share favors indexing strategies
- The fruits of security analysis are best born by indexing strategies

CONTEMPORARY INVESTMENT WISDOM FOR ASTUTE INVESTORS

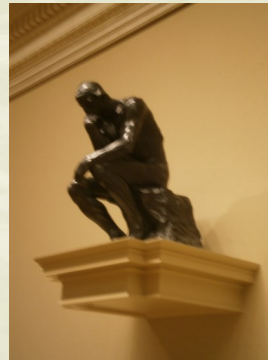
One of the most important lessons that an investor can learn is the advantage of index investing.

The difference between indexing and active management is paramount to investment practice and has been debated for more than a quarter of a century by the most experienced financiers in the world.

The purpose of this article is to explain to novice investors the six reasons why indexing

strategies offer the best long-term investment performance.

As you contemplate the points made in this article, think about the implications of what you are learning and how they differ from what you hear every day on the financial news networks and by institutional investment consultants.



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INDEXING STRATEGIES VERSUS ACTIVE INVESTMENT MANAGEMENT

Investors that utilize indexing strategies concentrate on the replication of the investment performance of a given benchmark proxy in order to generate average investment performance.

In contrast, actively managed investment strategies use research in conjunction with

knowledge, skills, and experience in order to make investment decisions that are expected to generate above average investment performance over time.

The distinction between these two types of investment methodologies cannot be more polarized, as indexing strategies ignore most

of the qualitative and quantitative variables that are typically believed by active managers to give them an advantage in terms of making profitable investment decisions.

Given the vast difference between passive investing and active investing, a logical investor should expect

strategies based upon robust active investment management to outperform their simplistic indexing counterparts over time.

Ironically, the empirical evidence proves that the contrary conclusion is verifiably the case, as recently proven by a 10-year gentlemen's bet that was made between the famous financier Warren Buffett and hedge fund manager Ted Seis. The term of

their bet has now come to fruition, and Buffet's passively managed index fund earned 7.1% per year, in comparison to Seis' hedge fund, which earned just 2.2% per year.

In dollar terms, the difference in these two investment strategies would have yielded a net benefit of \$634 thousand dollars to those investors that selected the indexing strategy

instead of the hedge fund.

With this example in mind, many people ponder how passively managed index funds are able to outperform investment strategies that utilize comprehensive active investment analysis. Based upon our research and experience, here are our conclusions that explain this analytical conundrum.



COST SAVINGS ATTRIBUTED TO THE UTILIZATION OF A FREE-RIDER METHODOLOGY

"Cost savings give indexing strategies a significant structural advantage over actively managed funds"

A very important component to understanding the performance advantage of passive management stems from the fact that indexing is a free-rider methodology that requires minimal resources to employ and therefore has significant operational economies and efficiencies over their higher cost actively managed counterparts. This in turn makes indexing strategies more effective over time.

In order to understand this premise, it is important to recognize that an index committee (e.g. Dow Jones) conducts a comprehensive analysis of every company that it considers

for their benchmark proxy (e.g., Dow Jones Industrial Average) and the index committee monitors the selected companies on an ongoing basis in order to determine if any changes in the benchmark constituency needs to be made.

Indexing strategies are able to gain cost advantages because they simply use the recommendations of the index committee as free sell-side investment research in order to construct their index fund portfolio (e.g., SPDR Dow Jones Industrial Average ETF).

This in turn cuts out all of the costs associated

with the qualitative and quantitative analysis that needs to be conducted by an active investment management team, which in turn gives indexing strategies a very strong cost savings advantage over time.

In addition to the costs savings associated with using indexing strategies, investors need to understand that there are five structural, regulatory, and investment analysis factors that give index funds a material investment performance advantage over time.

Let us examine over the next sections of this article the following five factors that promote the use of indexing strategies.

FIVE FACTORS THAT FAVOR INDEXING

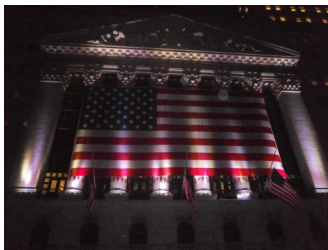


- ◆ The mission of the secondary capital markets
- ◆ The prohibited use of material non-public information
- ◆ The mandates set forth by Regulation Fair Disclosure (Reg FD)
- ◆ The implications of index funds gaining larger market share
- ◆ The manner in which investor returns are generated

THE IMPLICATIONS OF THE MISSION OF THE SECONDARY CAPITAL MARKETS

Investors need to have an understanding of the structure of the secondary capital markets in order to conceptualize how the markets give an investment performance advantage to indexing strategies.

Investment funds like actively managed mutual funds, index mutual funds, and ETFs are made up of company securities that trade on an exchange such as the NYSE or the NASDAQ.



In the case of the Dow Jones Industrial Average, 30 companies that trade on one of these exchanges make up the index. Apple, Exxon,

3M, and Walmart represent four of the 30 constituents that make up the index.

The common stock for these companies are said to trade in the secondary capital markets.

With this general understanding in mind, investors can start to glean the many structural advantages associated with the use of indexing strategies.

To begin, indexing strategies have a performance advantage due to the mission of the secondary capital markets.

In essence, these markets provide liquidity and transparency of trade completion.

For these reasons, security prices listed on these secondary markets typically trade at a relatively accurate price.

This premise is true because the secondary capital markets were created in order to allow companies to maintain long-term access to capital that they received through an initial public offering (IPO), while allowing investors that supplied the capital to have a market that will allow them to exit out of their investment in a timely manner and with minimal price impact.

Given this mission, it stands to reason that the secondary capital markets must maintain a level of stock price efficiency in order to maintain investor confidence in the system.

If this trust breaks down, the secondary capital markets will lose credibility, and ultimately cease to function in a beneficial manner for both the management of the companies needing capital, and the investors that are willing to provide the capital.

“Market efficiency favors indexing”

With this in mind, the company stock that trades in the secondary capital markets should trade within a reasonable band around the accurate stock price for the company.

Since this premise typically holds true, the secondary capital markets system gives a structural advantage to index funds, because indexing strategies simply strive to replicate the performance of the index.

In contrast, actively managed funds strive to generate abnormal returns based on the anticipated impact of some type of qualitative or quantitative



information about a company that may or may not have an impact on the investment performance of the company over time.

However, given the mission of the secondary capital markets, the performance goals of active managers is negated, because market efficiency puts a band around the performance of stocks, which in turn limits the ability to generate abnormal returns.

“The secondary capital markets system gives a structural advantage to indexing strategies”

REGULATORY CONSTRAINTS AGAINST USING MATERIAL NON-PUBLIC INFORMATION

“Regulatory guidelines that prohibit insider trading curtail the value of active investment management”

Indexing strategies do not try to discover qualitative or quantitative information that facilitates the generation of superior investment returns.

In contrast, active investment strategies seek to uncover important qualitative and quantitative information about a company that is not currently reflected in the price of the company's common stock securities in order to generate superior investment returns.

Unfortunately, the type of information that is

needed by active investment managers to achieve this type of goal is typically classified as material non-public information, and it is illegal for investment managers to buy or sell securities based on their access to this type of privileged information.



Therefore, active investment managers are curtailed by this regulation from generating abnormal investment returns through the use of investment analysis.

As a result, investment managers are better off simply trying to replicate the performance of the market by using an indexing strategy.

With this in mind, the regulatory guidelines surrounding the use of material non-public information gives an important regulatory advantage to the use of indexing strategies.

INVESTMENT PERFORMANCE CONSTRAINTS OF REGULATION FAIR DISCLOSURE



In October of 2000, the Securities and Exchange Commission (SEC) implemented Regulation Fair Disclosure. Reg FD mandates that material public information about a company be disseminated in a timely manner and to a wide audience of investors. In addition, Reg FD helps mandate transparency and helps promote

“Reg FD minimizes the usefulness of qualitative and quantitative analysis”

strong ethical standards in the secondary capital markets. Reg FD also helps promote market efficiency. However, the regulatory requirements of Reg FD give indexing strategies an investment performance advantage, because it minimizes the amount of time that active managers can capitalize on material public information that they may uncover by conducting their qualitative and quantitative analysis. Moreover, Reg FD particularly hinders active investment managers that want to use material public information in order to make multiple purchases of a security over time. As a result, the regulatory guidelines of Reg FD gives another performance advantage to the use of indexing strategies.

IMPLICATIONS ATTRIBUTED TO THE EVOLUTION FROM ACTIVE TO PASSIVE MARKET SHARE

Indexing strategies have gained significant popularity over time, and many experts believe that going forward there will be a greater shift from the use of actively managed funds to the use of index funds.

The implications of this change in market share from active strategies to passive strategies is that it will be more difficult for actively managed funds to outperform index funds.

This premise is true because as more and more of the assets invested in the secondary capital markets are invested according to indexing

strategies, the factors that are used to allocate capital to the purchase or sell of company stock will be completely different from the qualitative and quantitative factors that active investment managers use to make their investment decisions.

As a result, the evolution in market share that is gained by indexing strategies at the expense of active market share will give indexing strategies an advantage in terms of generating future investment performance.



“The implications of the change in market share from active strategies to passive strategies is simple... it will be more difficult in the future for actively managed funds to outperform index funds”

“Passively managed assets under management now represent 29% of the U.S. market”

“According to Moody’s, the amount of U.S. assets held in passively managed index funds will surpass the amount of actively managed assets under management in the year 2024”

IMPLICATIONS OF INVESTMENT ANALYSIS

Investors may use active investment management to precisely determine the price of a company's common stock using their proprietary top down or bottom up analytical methodology.

However, if no one else is using their method-

ology to analyze companies in that manner, then their methodology will not add any investment value in terms of generating superior investment performance.

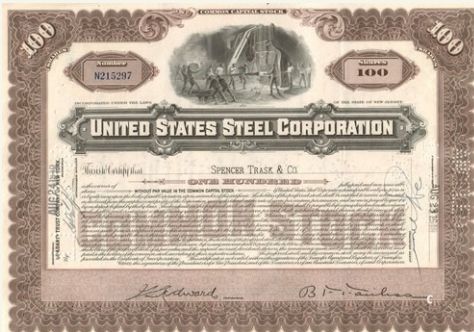
Therefore, the key to active investment management should be to determine how current and prospective investors make their investment decisions, and then act according to the anticipated actions of those investors. This in turn will allow the active investment man-

ager to generate strong investment performance based upon what the totality of the actions taken by the market investors decide to do with regard to the purchase or sale of a given security.

Unfortunately, it is impossible to know how current and prospective market investors are going to make their investment decisions.

Therefore, active investment managers are simply better off buying the overall performance of the market via an index fund.

"The investment actions of large market investors determine investment value"



CONCLUSION

The answer to the debate surrounding the superiority of indexing strategies is clear to those investors that understand the keys to generating strong investment performance.

While the value of active investment management will be touted by financial pundits in the financial news media and by many institutional investment consulting firms, the reason why these groups of people take such a position is because they are promoting their business industry and protecting their liveli-

hood.

In a country that is becoming more aware of the concept of fake news, prospective investors need to know that deceptive tactics have been prevalent in the financial services industry for well over a quarter of a century, and have likely taken place since the first

trade was made in 1792 under a buttonwood tree on Wall Street in New York City.

With this in mind, it is important to be clear and concise about the passive versus active debate.

Let there be no confusion. For every asset class in which there is an index fund that is available to investors, the indexing strategy will always offer the best net-of-fee investment performance on a consistent basis over time!

"An index fund will always offer the best net-of-fee investment performance on a consistent basis over time"





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**“Helping Prospective Home Buyers Make
A Prudent Home Purchase Decision “**

The founder, owner, and CEO of Adkins Capital Management (ACM) has more than 10-years of institutional investment consulting experience and more than 20-years of investment analysis experience. Mr. Adkins has written 25 investment- financial- retirement- and real estate- articles that have been published by companies such as Forbes, Investor’s Business Daily, Yahoo Finance, and Investopedia, as well as more than 200 newspapers throughout the U.S. and its territories.

Adkins Capital Management is a digital startup company. The mission of ACM is to bridge the gap in the residential housing market, where deficiencies in education, public policy, regulation, product structure, and personnel have created an environment where prospective home buyers need assistance with making a prudent home purchase decision.