

Adviser: Get Out of Index Investing

By *Kirk Shinkle*

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J. Michael Martin, president and CIO of [Financial Advantage](#), a Columbia, Md., fee-only financial planner, says there is still lots of risk in the market and that now isn't the time to be lashing your investment future to U.S. stock indexes. He argues that when markets are in bad shape for a long stretch, it's more important to target healthy bits of the market rather than seek safety by playing the whole field.

His typical portfolio is up an average of 7.2 percent over the past eight full years, compared with 1.7 percent for the S&P 500, and he offered the edited comments below on his cautious stance:

We've had a little recovery in stocks this month. Why aren't you optimistic?

Everyone is saying the future is so unsettled, but I think it's much clearer than it usually is. If you think about the credit problems bigger picture, what you see is really clear. The current turmoil is just a symptom of a huge macro change that's going on. For a generation, credit has been very easy. Markets over the last 25-year cycle have been productive with modest volatility. It's been a great time to be an American citizen. You didn't have to save because your house was increasing in value. You could spend more than you make, and that's exactly what we did. Our wealth still increased due to the rising value of our real estate.

In that environment, passive investing became the standard. If you owned a little bit of everything, then lo and behold, you had double-digit total returns and made money almost every year. It was wonderful. In that environment, the best thing you could have done is own index funds. It was popular because it worked.

Passive index investing has a pretty sound long-term track record. Why is going with a more active management style a good idea when markets are in flux?

So much has changed now. Economic growth is becoming harder because of credit turning

from easy to more expensive and harder to get. The collapse of all the "stupid" loans was just the start of it. Now commentators are saying we're almost finished, but I say those bad loans—which were \$400-to-\$500 billion write-offs globally—were just the turning point. Eighty percent of banks are tightening [credit] now. Now it's the reversal of a generation-long expansion of credit. The market is not ready for that.

It's the opposite of what you want when you own indexes. When you own an index, you necessarily own the most competitive companies and the least competitive ones—the ones who do OK because the environment is easy. When the business environment is more competitive, it starts to separate the men from the boys. It's not an environment where you want to have to own the least competitive companies. When they're all priced similarly after a long period of a good economic environment, the market doesn't distinguish between the weak and the strong. A shakeout period does make that distinction. Even though it worked for 20 years, now you want to be selective. "Active" investing doesn't mean trading a lot. It means being selective.

Will index funds beat inflation over the next five years?

I think not. The Federal Reserve is far, far more concerned about letting a deflationary economic environment get under way than it is about inflation. It'll make efforts to stop a slowdown in economic activity. My concern, then, is more inflation. Inflationary times like the '70s were not good for stocks or corporate earnings.

Earnings expectations have come down quite a bit, though.

The real question is what about the [earnings] part of the [price-to-earnings] ratio. There's a lot of risk in broad corporate earnings because the business environment and consumer spending will be much more competitive. Profit margins are at all-time highs, and they've always cycled down. [Profit margins](#) [for the S&P] averaged between 5.5 percent and 7.5 percent over the last 50 years. Recently, they've been around 8.5 percent. They're unsustainably high, and if they do their usual reversion to the mean, there's a lot of room on the downside for earnings that is not in the expectations.

Should investors still be in "protection" mode for most of their assets?

To preserve capital when securities prices are too expensive, we try to be more discerning about being more global and less U.S. focused. It's pretty clear to us financial power is shifting in the world. That's not news to anybody, and it's important your portfolio reflects

the understanding that growth is going to be Asian. We also have just a lot less equity exposure than if we thought we were in a more ordinary time. Instead of owning everything to be defensive, we think it's more important to be selective, because the business environment is tougher.