Could Index Funds Become Too Popular?

A reader asks:

But follow that thought through - there are any number of other clever investing ideas that seemed like a good idea, and failed once the secret got out. Isn't indexing one of them?

This question was in reference to the piece I wrote called The Half-Life of Investment Strategies that looked at how competition and knowledge of a strategy can impact its performance going forward.

Index funds are all the rage right now. Almost every conversation I have about portfolios with prospects, clients, readers, family or friends touches on fund fees in some capacity. Index funds have taken in huge sums of money since the financial crisis, and rightly so in my opinion.

But this is a legitimate question. Could the popularity of index funds be their downfall?

Size is the enemy of outperformance for any investment strategy but this may not hold true for index funds. Index funds are weighted by market cap.[1] By definition, flows into market cap weighted index funds shouldn't impact the stock market because they buy stocks in proportion to their current market cap. This means you're not over or underweighting any securities. Buying or selling index funds shouldn't have much of an impact on the market because they are the market.

In many ways, this question is really asking -- why does the equity risk premium exist in the first place?

If everyone knows stocks offer a substantial long-term premium over cash and bonds, why wouldn't the equity risk premium eventually go away?

Richard Thaler and Schlomo Benartzi sought to answer this question in their 1995 paper titled Myopic Loss Aversion and The Equity Premium Puzzle. Their takeaway, which I agree with, is that it's behavioral in nature:

For index funds to become too popular everyone investing in them would have to behave perfectly. The SPY ETF turns over once every 21 days or so on average so I'm not holding my breath on that one.

Also, for every winner in the game of stock picking, there will be a loser and index funds will always be in the middle. After fees, index funds will almost always be at or near the top quartile of long-term fund performance numbers unless active funds drastically reduce their fees.

Asset allocation will still play a large role in determining the performance of your portfolio. Over- or underweighting certain segments of the market will make your performance different than the S&P 500 or a total market index fund and those tilts will have a say in your risk profile and returns.

And these styles or asset classes could be impacted by flows from investors but I don't see how market cap weighted index fund performance will become too popular from investor flows.

I'm not even going to get into the strawman argument about what could happen if everyone indexes because that will never happen. Human nature and incentives won't allow it. It's like asking the question: what would happen to the fast food industry if everyone decided to eat healthy all at once?

Indexing still only accounts for 5% of total trading volume in the markets so active managers will always have a bigger impact on setting prices since index funds trade less by their very nature.

Stock market returns could and possibly will be lower in the future than they have been in the past. But that won't necessarily be because of the growth of index funds.

Further Reading:
The Half-Life of Investment Strategies

Now here's what I've been reading lately:

- Personal finance 101 in a single picture (Alder Cove Capital)
- Why you should prioritize retirement over college savings (White Coat Investor)
- Why are stock prices volatile if markets are more efficient? (Oblivious Investor)
- Show me the incentives and I'll show you the outcomes (Reformed Broker)
- How currencies impact emerging markets (Convex Capital)
- Bad news (Humble Dollar)
- How to be a person who can make a damn decision (Mel Magazine)
- What will always be true (Dollars and Data)
- 9.2 million people own a timeshare (A Teachable Moment)
- That cocky voice in your head is wrong (WSJ)
- "The best time to prepare for a storm is when the skies are blue." (Irrelevant Investor)

[1]This isn't true of all index funds obviously but any deviation from market cap weighting is some form of active management in my mind. And even choosing which index to use is an active decision but I digress.