

Why do stock pickers keep losing to index funds and who's winning instead? That's what we're looking at today in episode 567 of Money for the Rest of Us, a personal finance show on money, how it works, how to invest it, and how to live without worrying about it. Back in December 2020, at the end of the pandemic, the pandemic still going on, I invested some money in two classic active value managers. One was Tweedy Browne, the other was Southeastern Asset Management.

Longleaf Partners was their small cap fund, and I've invested with active managers all my life. When, or at least all my professional life, it was a big part of being an institutional asset manager. As we worked with university endowments and others, we. Yeah, we would index the S&P 500, but beyond that, we used active managers with the idea that we were good enough to select those that were skilled versus lucky. So I invested in Tweedy Browne Longleaf Partners. They did terrible.

They underperformed and I have since sold them from my portfolio. Tweedy Browne a couple years ago. Longleaf Partners. Just just a month or so ago. So something's going on. When it comes to to active management, it's challenging to outperform. And we know that. But here's what you might not know. Active managers are getting worse. The level of ability to well their level of underperformance is as bad as it's ever been. And we're going to look at why in this episode and will it reverse. Will they eventually be able to start adding excess return? And if so, what? We'll need to take place for that to happen.

Finding the Easy Game

Now, someone in the investment business I've admired for a long time is Michael Mauboussin. He has spoken at FEG's investment conference in the past and and he tells the story about he had an acquaintance that was getting really into playing poker. Professional poker. One of Mauboussin's. Well, I guess it was a relative. Uncle Wally told this friend of Michael's like, I wouldn't spend my time getting better at poker. I'd spend my time finding easy games.

And stock picking is an incredibly difficult game because it depends on, well, who are you playing with? And so in the case of poker, if it's if it's a bunch of weak players, you're going to have an advantage. But if it's more skilled players, it's going to be more difficult. And the reality is active managers skill is increasing. Their ability to churn through data to gain insights is better than it's ever been. And so it's more difficult for a skilled manager to to basically do better than other skilled managers.

And Mauboussin calls this the paradox of skill. As you get more skill, outcomes depend more on luck because you can't get any type of edge. And, and that's part of what's going on in the active management space. But that's not the only thing. It's the prevalence of index funds is actually making it more difficult for active managers to outperform. And that's what we're going to explore in this episode.

Passive Is Not the Majority

Now, one of the things that we see statistics that, well, index funds are now the majority of management or a fund managers and, and you kind of have to look at this because this looks like, well, everyone's indexing. Well, that's not actually the case. Most equity investing in the US is still active. What we have to look at is, well, yeah, 52% of fund management is passive, but there's a lot of investing that isn't fund management. You have you have pension plans, you have individuals.

And so when we look at ownership of US stocks, well 19% is indexes, 11% is active. But you have these other. And by active we're talking about active mutual funds and ETFs. You have all these other owners, insurance companies, hedge funds, global and balanced funds. I mean there's a lot out there. And so there's one paper by Chinco and Sammon. They suggested that passive management, as a percent of the overall US stock market is about 34%.

So most is not passive, which suggests well, that should give active managers some type of edge to be able to outperform at least some of them and not underperform as massively as they're doing as a group and as a group is a key.

The Arithmetic of Active Management

Back in 1991, Nobel laureate William Sharpe introduced what's become known as the arithmetic of active management. And what he says is that all investors overall, they make up the market. And so in aggregate, all investors should match the market. And by definition, a passive index fund is going to earn the market. And so that means active managers collectively they are going to earn the market return before fees.

And then after fees active managers are going to underperform the market because again, the active managers and the passive index funds that makes up the market. And by definition they have to equal the market return. And so that's, you know, at FEG, our job was to figure out, well, which active managers could actually outperform other managers. And it's very, very difficult to do.

Why Sharpe's Arithmetic Can Break

Pedersen poked some holes into Sharpe's arithmetic of active management because, he points out, well, passive managers aren't always passive. And this is a point I've made. All investing is active in the sense of. As. Even if you're all an index fund, you have to decide to rebalance. And maybe you're pulling money out, putting new money in. And then within the actual index fund, there's new shares being issued, there's buybacks, there's funds that get deleted from the index.

And so there needs to be a reconstituting of those index funds. And so there is there's active movement even within passive vehicles, which means that it's possible that the that that gives an edge or at least an opportunity for active managers to, to outperform because, well, yeah, maybe passive investors don't actually match the market because of all the active changes that they're making. Just trying to keep up with what we call the market so that but still, maybe that's the case.

Fewer Rivals, Worse Results

But when we look at the actual numbers, we see that active managers, stock pickers are actually doing worse than they've ever done. There was a paper released this year by Hannah Unterberg, and it's gotten a lot of traction because it's well, it was very, very well done. But here, when we look at the level of return of active managers from 1984 to 2009 and back in the 80s, there was not a whole lot indexing going on. But the average stock funds return relative to the S&P 500 was -70 basis points.

So about the matching the index before fees and with an average fee, let's say of 70 basis points or so. I mean, they did match it. And so the arithmetic of active management held. But from 2010 to 2024, the

average stock fund underperformed by 1.8%, much worse. Why? Because that doesn't there should be fewer active managers as more have gone when is flowed to index fund. So those that remain you would think would would have continued to do well.

And what's what's fascinating about this paper is if we look at what's known as their active share, how different are they from the benchmark? And that's something that I would try to teach or talk to our board members for these endowments that I would work with when I was an institutional advisor. I would say for a manager to outperform the index, it has to look different than the index, which means it's going to have periods where it outperforms and underperforms.

And that difference relative to the index is what's known as the active share. And the active share of managers hasn't changed. They've maintained a consistent active share. So they're not becoming more closet index like. And in Unterberg found out that that their skill level hasn't really diminished in terms of their ability. There's something else fundamentally driving larger underperformance. And that's something else is index funds.

Passive Flows, Active Woes

She did an analysis and she looked at fund flows. And what she found that as we've seen more money flow from active managers to index funds, what that means is if an active manager has a fund flow, they're having to sell part of their portfolio, even some of their best ideas. Whereas in an index fund manager, they're getting money in and they're buying the market, which means more money is going into the biggest names. And, and that's pushing up their prices.

And so we got flows in to index fund. And they're, they don't care about price. They're just buying the index whatever the largest names, the Mag Seven and they're getting more flows. Whereas the active managers are being forced to sell even some of their best ideas because they're having money flowing out. Now this is across the overall market.

Where \$100 of Flows Lands

Here's an example. Let's say there's \$100 flow coming out of an active manager into an index fund. That manager, that active manager, let's say they're underweight, a mega cap stock. They have maybe a 3% weight in the in the market, the index is 7%. And so that money is flowing out. And if the manager, let's say, has a favorite mid-cap stock in their portfolio, it's about 4% weight versus the the index that it represents maybe 0.5% of the index as an active manager is selling, there's there's pressure on that mid-cap stock because they're selling it.

And, and the index fund isn't necessarily buying very much. Most of the buying pressure is going to the biggest names in the index.

Who Is on the Other Side?

And so when we look at, well, who's, who's on the other side of the trade, who's buying the, the mid-cap stock that the active manager is selling and who where are these shares coming from that the index fund is buying and that that's helping to drive what we're seeing, where the active managers are getting

hurt as index funds get larger. So when you think of that active manager having to sell, who's buying it? Who's buying the shares? Well, somebody that's looking for a discount.

They're not forced buyers of what the active fund is selling. And so that their willingness to buy that the ferocity with which they want to buy isn't that great. And so the price of that mid-cap stock could sell and it can underperform the index, whereas the index fund, it's buying the mega cap stock because it represents 7% of the index. And so it's, it's willing to buy. And what we're going to see is much of the selling is coming from companies issuing new shares.

Do Managers Sell Their Best Ideas?

But before we do that, let me look at there's been a critique to this paper and to this whole idea of the arithmetic of active management. And their critique is, well, maybe the active fund manager isn't selling their best name. Maybe they're selling the names they didn't want anyway. And so if that's the case, they're not selling their high conviction names.

And that might not necessarily lead them to underperform, even though we've seen collectively across all active managers over the past 15 years or so, that the level of underperformance on average almost 2% greater than it was back in early from the 80s to 2010. So when we think about this critique and specifically Robin Wigglesworth in the Financial Times, he said, it doesn't seem obvious that active managers will necessarily be paring back their more favored overweights when they suffer outflows.

And if we look at some of the academic papers that I saw actually found that, no, they actually sell on a pro rata basis when they're they're selling when they have outflows. And that makes sense because if they don't sell as much of their overweight as they do their underweights, then their overweights are going to get bigger. And so it actually is sort of on a pro rata basis.

And we can also see it in the data that much of this underperformance happens kind of at the beginning of the month where all this 401(k) cash going into index funds arrives, and then you have active managers having to sell. And so, and it doesn't necessarily have to be, you know, all of the overweight. It can just be some of it it you still get this impact. Is that the willingness of people to buy what active managers are selling is just not as strong. They're willing to pay more.

It's not as strong as we see sort of these price insensitive index funds, or just they got to put money in and that's what they're doing. And it's pushing up the price. And it's leading to larger underperformance by active managers.

Who Sells to Index Funds?

Now, in Unterberg's paper, she looked at, well, who's actually selling to index funds? And it's generally companies. So companies in terms of employee compensation, it could be warrants. It could be convertibles. It's new stock offerings. And so that's who's winning from this. If index funds are actually doing better relative to active managers, and those stocks are going up as more and more are bought by index funds, people selling. Yeah, it's the companies and their employees that are benefiting the most.

Who's generally not selling to them are the active funds or the pension funds and insurers, insurers, long term holders. So it's new stock issuance by companies that are primarily about 70% of of what the index

funds are buying. Now the other 30% are short sellers. These would be individuals expecting a stock to go down in price. So they borrow the shares and they sell it and they sell it to index funds.

How Does It End?

So the question is, well how does it end. Does active managers ever come back and start outperforming index funds? Well, there was an editorial in Bloomberg by Aaron Brown, former AQR head of market research and and Brown said, well, if it's going to end, it's going to end slowly because index funds aren't highly leveraged. And so they're they're just buying essentially as money comes in, they're following their formula. And so if it ends, it's going to have to be investors pulling money out of index funds.

And perhaps that's baby boomers. I mean, there's we've talked about it at the end of 2025, and I'll link to the episode. It was our retiring baby boomers. Will that negatively impact the stock market? And it turns out not necessarily. Now we could see a period where active managers outperform, but it will need investors willing to actually add money back to active managers. So they start getting fund flows and and that really doesn't have anything to do with baby boomers. If baby boomers, boomers are selling index funds, there's a bunch of younger individuals buying index funds.

The Boomer Forecast That Missed

And, and so, I mean, there's been papers for 20 years or more worrying about the retiring baby boomers are going to negatively impact the stock market. In fact, here's a paper that came out in 2011. And they they saw a connection between demographics and fund flows and predicted that by 2025, the price to earnings ratio of US stocks would be 8.3, down from 13. And we know that if the price to earnings ratio is falling, then generally that means stocks are falling.

And we know what happened. The price to earnings ratio in 2025 for the S&P 500 was 28.5. So so here we had this forecast of retiring baby boomers that it was going to lead to outflows from the stock market, perhaps into the bond market. And stocks would get cheaper where they haven't. They're more expensive because we've had well, now we have the big AI infrastructure boom and earnings per share growth has been incredibly high double digits. We talked about that last week.

And so we don't know when or even if retiring baby boomers are going to lead to a resurgence of active management. I don't think it will. These changes are so slow and many baby boomers have. They've benefited from long term holdings of stocks and perhaps not even likely to sell it. Many of the stocks are in the Roth IRA if they're doing asset allocation. You're better off having your stocks high return asset in your Roth IRA. And there's no required minimum distribution for Roth IRA.

And in many cases, they're going to give those shares to their beneficiaries, to their kids. And so we don't we can't assume that the predominance of index funds is going to end. And active managers are going to come back now.

What Investors Can Do

I mean, I've fallen into the trap. Look at me, 2020. I'm allocating the two active managers that didn't do well. Now, in all fairness, I have some active managers that have done incredibly well, but most of my portfolio is not active because of that. And so the other takeaway then what we can do is we don't have

to invest in the S&P 500, which is very, very expensive right now. A cyclically adjusted price to earnings ratio of 40.

And when it's been this expensive, the average REIT real return after backing inflation has been zero over the the next ten years. And so we can still invest in index funds and ETFs. But it doesn't have to be the S&P 500. We can invest in most of my portfolio or model portfolios their ETFs, most of it passive. But we can still overweight the areas that are more attractive such as small cap. And we can underweight the areas that are expensive like US stocks not get completely out of US stocks but underweight.

And so we can make adjustments even if we're a passive investor, which goes back to the earlier point that that all investing has some element of active to it. But the part of active management that has been very, very difficult is skilled stock pickers trying to figure out which particular holding they should own. It's gotten more difficult because of flows into index funds and out of active managers forcing these active managers to sell. Allowing index funds to buy.

And so you got sell pressure because the buyers on the other side of the trade, for the active managers there, they don't have a lot of pressure to buy, whereas an index fund, a lot of pressure to buy because that's what they do. And the shares are coming from the companies themselves in many case new share issuance. And so it's going to keep going. We've been doing this 12 years and we've been waiting for a change. Well when will active managers finally be able to to outperform.

And it's it's the paradox of skill. They're getting more and more skilled, which means it's getting more and more difficult to outperform. And then you got the pressure from the index fund.

So that's our episode today. You can learn more about what we do at moneyfortherestofus.com. We have some free investment guides on there. You can learn all about different ways to invest. And then you can even check out our premium content, \$50. You can try it for a month and see, see everything we're doing behind the paywall in terms of a monthly investment strategy report model portfolios, you can see my portfolios, my portfolio trades. You can check that out and learn more at moneyfortherestofus.com.

Everything I've shared with you in this episode has been for general education. I'm not considered your specific risk situation, not provided investment advice, simply general education on money, investing in the economy. Have a great week.