LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

Then there is the man who drowned crossing a stream with an average depth of six inches.
– Unknown

As active investors, the continued proliferation of passive, index funds has created three areas of concern in the current market: investors are increasingly relying on a flawed framework for their savings, the benefits of diversification are being overstated, and indices are distorting the underlying performance of the U.S. corporate environment. The average market observer refers to the *stock market* by an index, such as the S&P 500 or the Dow Jones Industrial Average. Increasingly, investors are shifting from not only referring to these indices as *the market*, but are placing their savings in indices without fully understanding their underlying investments.

On the surface, the statistical underpinnings of indices appear sound—but the underlying framework quickly becomes suspect in the manner the portfolios are devised. While the Dow Jones Industrial Average uses the price-weighted methodology, the most popular index products are built upon a market-capitalization-weighted indices. Market-cap-weighted indices place the largest positions in the companies whose stocks have *previously* performed the best. As such, those companies constitute the largest holdings. The trouble being that market-cap weighting works in the exact opposite direction of what we believe is prudent value investing. Investors in these indices are, by design, buying more shares of the companies whose past performance was the strongest while owning fewer shares of those companies that are becoming cheaper.

Digging deeper, we also find that the greatest benefit touted by the creators of index products—diversification—is largely overstated. Correlation of indices built upon the same market of stocks—whether they include 30, 500, or 6,750 companies—is surprisingly strong. This phenomenon teaches us an important lesson. The benefits of diversification quickly dissipate as you add more stocks to a portfolio. Additionally, owning more of the companies in an index or market means you have to own less of what you believe in the most. As an investor, you stand to benefit less and less from your best opportunities.

Finally, market-cap-weighted indices do not give you a sense of what is really happening with the *average stock* or the market as a whole. Much like the man who drowned in a stream with an average depth of six inches, the *average* picture painted by these indices is deceptive. Currently, performance of the largest U.S. companies are masking poor performance elsewhere. Interestingly, the majority of the outperformance of the market indices was due to a handful of names, sometimes referred to as the ***FANG*** (Facebook, Amazon, Netflix, and Google) or the ***Nifty Nine*** (the *FANG* plus Priceline, Ebay, Starbucks, Microsoft, and Salesforce). These few companies managed to beat the remainder of the U.S. market by more than 60%. Consequently, these names with increasing weights in investors' index-based portfolios now sport a collective price/earnings ratio of 45—double that of the S&P 500. In other words, investors in index funds are most heavily invested in shares of companies where their best performance is potentially behind them, while owning less of the companies whose valuations are becoming more attractive.

At Lawson Kroeker we always have—and always will—believe in not only the efficacy of the active, focused, investment discipline, but are increasingly encouraged by the method's ability to manage the risks in our portfolios. Rather than buying a piece of every company in the market, we look for the best companies with the most attractive investment opportunities.

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