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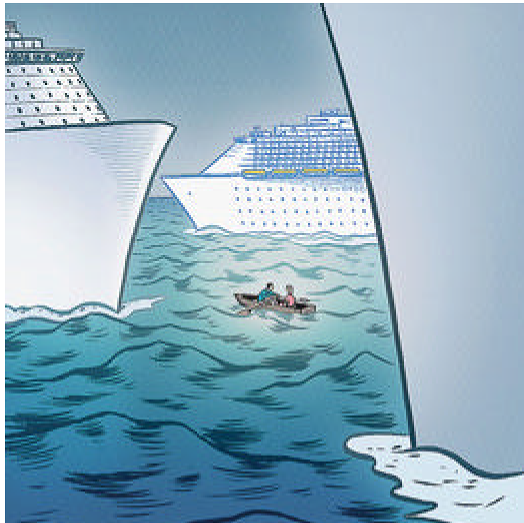
Simple Index Funds May Be Complicating the Markets

Index funds are often hailed for their low fees, solid performance and transparency.

Could they also be destabilizing the markets—and undermining the very diversification they have long promised?

Recently, leading investing experts—including Rodney Sullivan, editor of the Financial Analysts Journal, consultant James Xiong of Morningstar Investment Management and Jeffrey Wurgler, a finance professor at New York University—have been warning that index funds could destabilize the financial markets.



Christophe Vorlet for The Wall Street Journal

The rise of trading in index funds, these researchers say, is causing stocks to move more tightly together than ever before—as if they "have joined a new school of fish," as Prof. Wurgler puts it. That is reducing the power of diversification and could make booms and busts more likely and more extreme.

Unlike conventional funds run by highly paid stock-pickers who seek to buy the best securities and avoid the worst, index funds—including most exchange-traded funds, or ETFs—effectively buy and hold all the securities in a market benchmark such as the Standard & Poor's 500-stock index.

According to James Bianco of Bianco Research, 2011 was a particularly rotten year for stock pickers: Only 17% of more than 4,000 funds that invest in large U.S. stocks beat their benchmark. In most years, fewer than half do.

Considering that index funds charge annual fees about one-10th of those levied by actively managed funds, it isn't any wonder indexing has become a money magnet. A decade ago, 278 index mutual funds and 119 exchange-traded funds held $347

billion, or about 16% of all assets in U.S. stock funds. Today, according to Morningstar, 336 index funds and 1,148 ETFs hold $1.24 trillion, or fully one-third of all the money in U.S. stock funds.

That worries some analysts. "Markets work best when people think and act independently, not all together," Mr. Sullivan says. When investors add money to an index fund, it generally will buy every security in the market that it tracks—hundreds, sometimes thousands at a time, regardless of price. When investors pull money out, the index fund has to sell across the board.

"These index-trading behaviors," Mr. Sullivan says, "could interact with some unexpected event to cause significant and outsize consequences." (Disclosure: Mr. Sullivan and I coedited a book about the value investor Benjamin Graham that was published in 2010.)

Analyzing how closely the returns of U.S. stocks moved up or down together, Mr. Sullivan found that this correlation has roughly quadrupled since the mid-1990s—coinciding with the rise of index-fund trading.

Not even John Bogle, founder of Vanguard Group, or Gus Sauter, who oversees $997 billion in index funds and ETFs at Vanguard, disputes that stocks have been moving together than they used to. But, they argue, indexing isn't the sole cause. Since the 1990s, we have seen the rise of the Internet, the proliferation of electronic trading, a global financial crisis and interventions in markets by central banks around the world.

As a result, investors are equipped with the itchiest trigger fingers ever in one of the touchiest periods in history. To blame the rise in correlation solely on indexing, they argue, is shortsighted.

With active stock pickers still stinking up the joint, indexing remains the cheapest, most convenient and most reliable way to capture the returns of just about any market.

But if the only index fund you own is linked to the S&P 500, too much of your money may be riding on stocks that move in lock step. Think beyond the S&P 500 to baskets like the Russell 3000 index or "total stock market indexes" tracked by Dow Jones, MSCI, S&P or Wilshire, which hold a much broader selection of stocks.

Next, no matter how diversified you are, you probably aren't as diversified as you think. As recently as 1997, it took 20 stocks to eliminate most of the likelihood of enduring more risk than the market as a whole; today, according to Mr. Sullivan's research, it takes 40. If you hold the same number of stocks that you used to, you are about half as diversified as you were. You need to spread your bets wider.

Finally, diversify your index funds not just within but across assets. International stocks, emerging markets and investment-grade bonds, Prof. Wurgler and Mr. Sullivan say, don't yet carry much risk of index overcrowding and should still moderate the correlation of your overall portfolio.

Bond index funds, even at today's paltry yields and lower returns, can still buffer the risks. "One thing hasn't gone away at all," Mr. Sullivan says. "Bonds will still provide padding for uncertain events and times."

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