THE WALL STREET JOURNAL.

Indexing Is Still the Best Bet for Investors

History shows that even in 'narrow' markets, actively managed funds don't do as well over the long term.

BY BURTON G. MALKIEL | SEPT. 13, 2023 6:17 PM ET

Active portfolio managers claim that agile stock picking is the best way to invest. Many have lately argued that simple indexing is a bad strategy in today's environment because the stock market is dangerously "narrow." Seven stocks—Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla—constitute close to 20% of the S&P 500's value and have been responsible for almost 90% of the index's gains this year. Now these "Magnificent Seven" are beginning to falter. The simple index investor, the active managers warn, will soon be overly concentrated in a small number of stocks that are overpriced and have been hyped by the promise of artificial intelligence.

This argument is wrong. Indexing a stock portfolio through a low-cost fund remains the best way to participate in the stock market.

Critics of indexing tend to point to the late 1990s, when the promise of the internet drove high-tech stocks like Apple and Amazon to triple-digit price/earnings ratios and the market indexes to unprecedented high valuations. The market then declined sharply until 2002. Another sharp decline occurred during the 2007-08 financial crisis. The market ended the first decade of the 2000s below where it started. Index investors got banged up. Tech stocks got crushed. Even successful companies such as Amazon and Apple lost more than 90% of their value through early 2002 before finally recovering.

But did indexing really fail? The evidence suggests it didn't. From 1990 to 2009, according to the Bogle Financial Research Center at Vanguard, a broad U.S. stock market index fund outperformed the average actively managed equity fund by almost 1% a year. The total stock market index returned 8.42% annually in that 20-year period, including both the dotcom bubble and the poor returns that followed. The realized annual return from the average actively managed equity mutual fund was only 7.53%. And the best 20 active funds of the 1990s underperformed the index by more than 3 percentage points a year in the first decade of the 2000s.

There is no way to predict which active managers will be the best stock pickers. Portfoliomanager fees are the only reliable predictor of performance. The lower the fees, the higher the returns realized by investors. The quintessential low-fee equity funds are index funds. Competition has driven the expense ratio of total stock market U.S. equity funds almost to zero.

Certainly there are some similarities today to the economic environment of the dot-com era of the late 1990s. Technological innovation promises to transform our economy. The internet is revolutionizing how we communicate, access information and purchase goods and services. But changes—today, as then—occur slowly. It wasn't until the early 2000s that productivity statistics reflected internet-related technological improvements. Today, artificial intelligence promises to transform transportation, entertainment, medicine and more. But these changes won't be rapid. Stock price reactions that assume a virtually instant realization of benefits are likely to be overdone.

There is no doubt that U.S. equities are richly valued in part because of the promise of AI. The cyclically adjusted price/earning ratio for the market as a whole stands at 30, well above its long-run average in the midteens. But that multiple was over 40 in early 2000, a record high. The average multiple for the Magnificent Seven is about 50. But the multiples for Apple, Amazon and Cisco Systems, the darlings of the market in early 2000, were over 100. The average multiple for Apple, Alphabet, Meta and Microsoft today is just over 30. Only Nvidia has a triple-digit earnings multiple. It may be that hype over the promise of AI has inflated these multiples to unwarranted heights. But it is also possible that they simply reflect the enormous potential of AI to transform the way the world's work is done.

The basic idea of efficient markets isn't that prices are always correct. In fact, they are always wrong. What efficiency implies is that information is reflected in prices without delay. And the current tableau of market prices reflects the combined judgment of hundreds of thousands of investors, including those of the research departments of the most influential firms on Wall Street—as well as the galaxy of active managers who run mutual funds and institutional portfolios. It's rare for an individual manager to make correct bets against the wisdom of the market. And even when it does happen, it doesn't last. More than 90% of active managers fail to beat the market over 10- and 20-year periods.

It isn't impossible to beat the market. But if you go active, chances are you'll underperform. Years of evidence in a variety of market environments confirms the wisdom of indexing. And if you do decide to alter your portfolio from market weightings, you can do so with much less risk if your active bets are made around a core portfolio that is broadly indexed.

Mr. Malkiel is the author of "A Random Walk Down Wall Street," whose 50th anniversary edition was released this year.

Appeared in the September 14, 2023, print edition as 'Indexing Is Still the Best Bet for Investors'.