Vanguard Small Cap Index Fund: The Myth of Low Cost Indexing

A warning to long-time readers: we are about to agree with Elon Musk and Cathie Woods on something. They have come out against index funds due to the belief that they deprive investors of winners like Tesla (Ms. Woods) and that they have too much voting power (Mr. Musk). While we agree on the "too big" concept, the values underpinning our beliefs stem from simple empirical truths that we intend to make in a brutal and blunt fashion.

VSMAX Fund or the VSMAX ETF VB

Before we get to it, we want to explain our choice of highlighting a Vanguard Fund. We do so because Mr. Bogle's firm and its commitment to shareholders is beyond reproach in our view. This is a firm built on excellence, humility, and a commitment to providing a valuable product to clients at a low cost.

With assets under management having just hit $8.1 trillion, the late Mr. Bogle and Vanguard are a testament to integrity in a business that has recently suffered a bout of madness. Despite building one of the most successful asset managers in the world, Mr. Bogle passed away at 89 years of age with an estimated net worth of only $80ml. His biggest regret? Not having more money to give away.

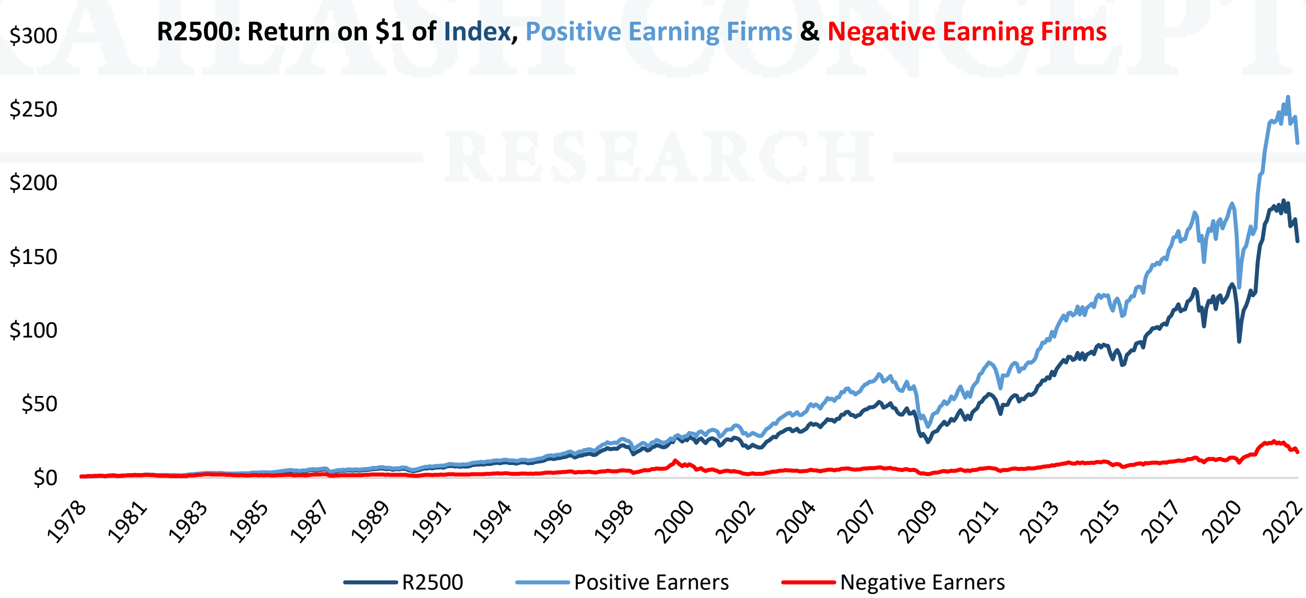
It is not hard to understand why Vanguard and passive products have become so popular, particularly in light of the many celebrity fund managers who made tens if not $100s of millions managing products that obliterated their clients. For those interested in Vanguard's Small Cap Index Fund, we are not here to discourage you. In fact, here are the links to VSMAX's Fact Sheet and the Vanguard site where you can buy the fund if so inclined. VSMAX's expense ratio of 5bps is tough to beat and we wish investors well.

What we are here to ask our readers is to put aside the index piety and THINK. This is SIMPLE.

The VSMAX mutual fund tracks an index that is nearly identical to the Russell 2500. The chart below[i] shows:

- the returns to the **profitable firms** in the R2500 compounds to $227
- the returns to the **R2500 Index** compounds to $161
- the returns to stocks of firms in the R2500 that **lose money** compounds to a meager $17

SIMPLE FACT: Profitable Firms Within an Index Crush the Index as Money Losers Hurt Performance



Source: Kailash Capital, LLC; Data from 12/31/1978 – 4/30/2022

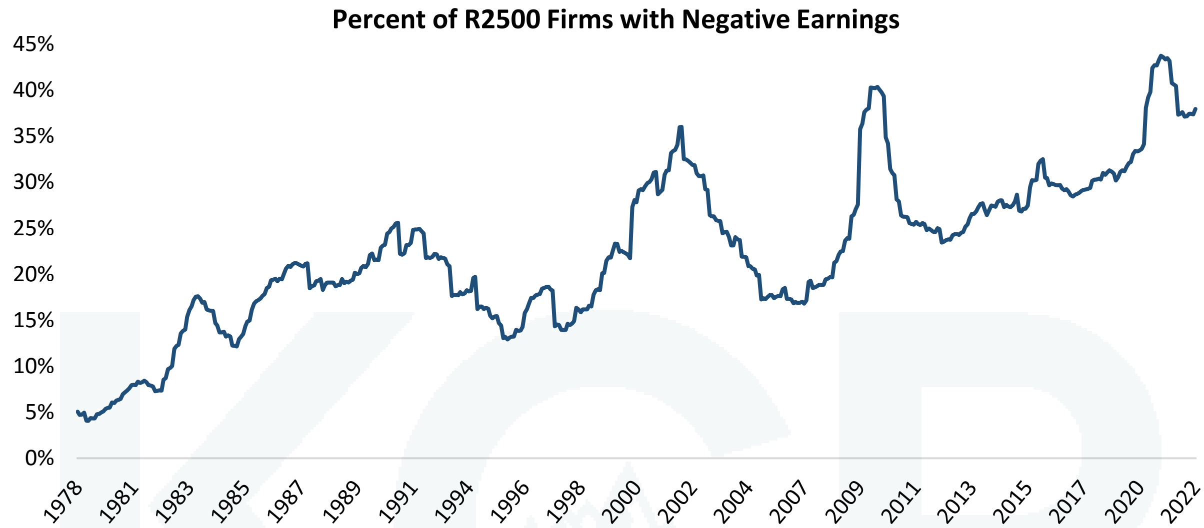
A single factor strategy of not-buying money-losing stocks crushes an index over time.

Why Does it Matter More than Ever Today?

The red line in the prior chart shows that you should just avoid buying stocks that lose money. The line in the chart below shows the **percentage** of stocks in the R2500 that lose money has **never been higher.**

So…. red line in the prior chart. Line in the chart below. Why would you ever buy an index fund loaded to the gills with loss-making stocks?

The Percent of Firms in the R2500 That Lose Money Is at All Time Highs…. Why Buy Them?



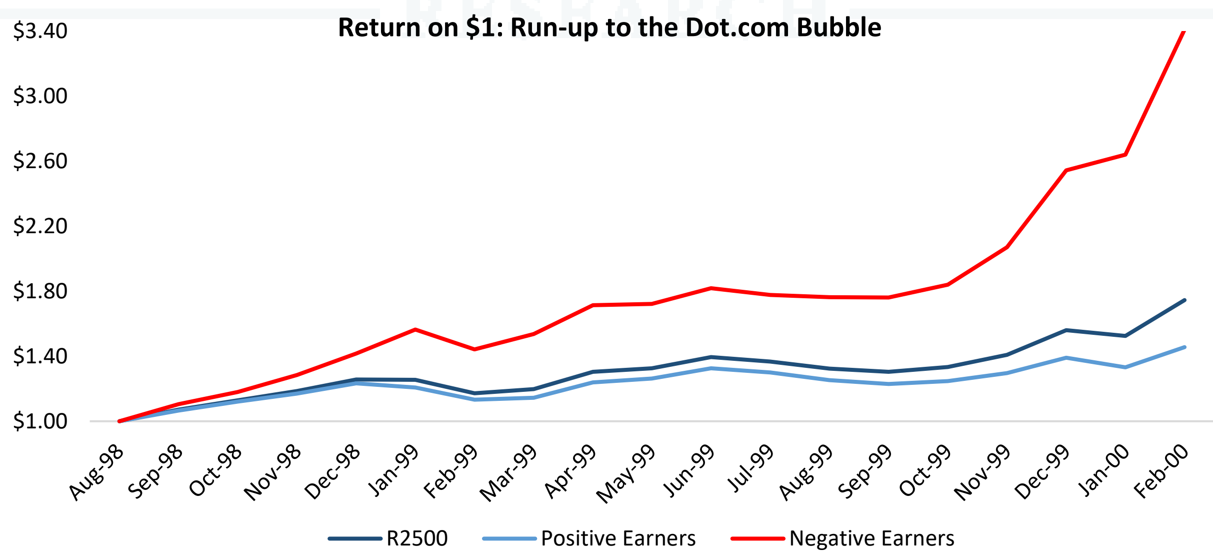
Source: Kailash Capital, LLC; Data from 12/31/1978 – 4/30/2022

Why Record Exposure to Loss Makers Matters: The Dot.com Example

Let's compare the Dot.com period to today. The chart below shows that in the run-up to the peak of the Dot.com bubble from August 1998 - February of 2000:

- $1 invested in **R2500 stocks with negative earnings** soared to $3.41
- $1 invested in the **R2500 Index** rose to $1.75
- $1 invested in **R2500 stocks that were profitable** rose to only $1.46

In Bubbles & Speculative Moments, Loss Makers Can Soar - the Dot.com Example



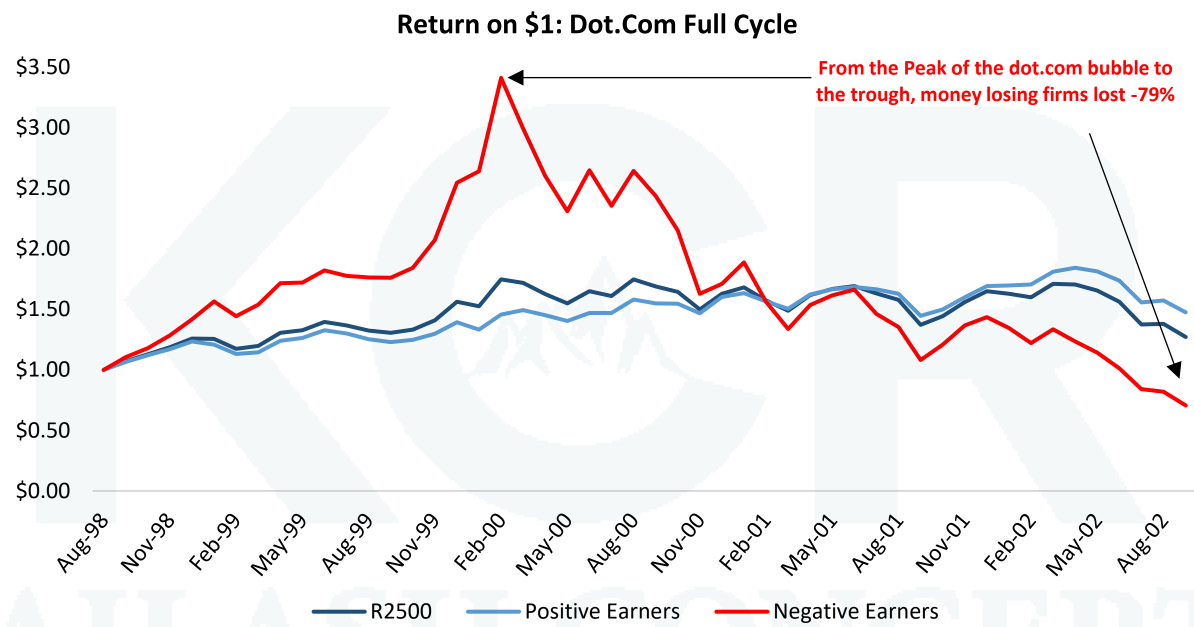
Source: Kailash Capital, LLC; Data from 8/31/1998 – 2/29/2000

The Hidden Tax of Loss Makers is Taken When Markets are Most Vulnerable

The chart below simply extends the horizon of the prior chart through August of 2002 and shows that through the entire cycle:

- The $1 in **money losers** that rose to $3.40 at the peak plummeted 80%, leaving you with $0.70
- The $1 in the **R2500 Index** that rose to $1.75 was dragged down by the money losers, leaving you with only $1.27
- The $1 invested in the **stocks of profitable firms** barely budged, and you ended up flat in the crash, leaving you with $1.47 through the full cycle

From Euphoric Peaks, the Benefits of Avoiding Stocks of Companies That Lose Money are Enormous



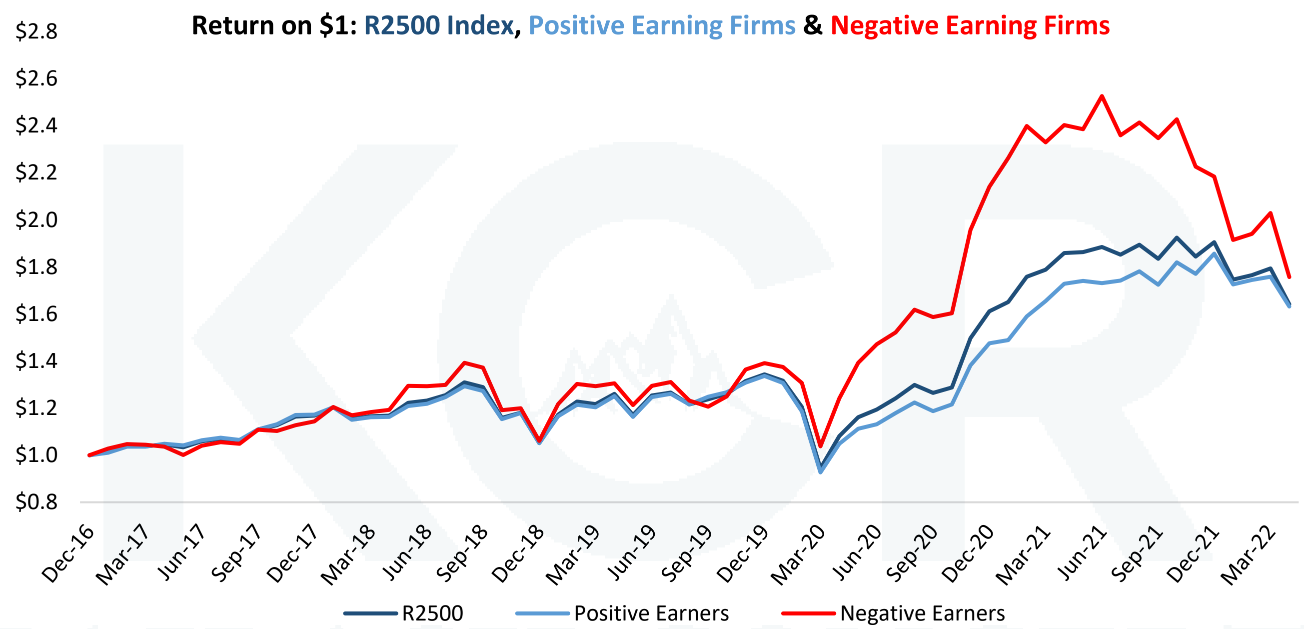
Source: Kailash Capital, LLC; Data from 08/31/1998 – 9/30/2002

Where are We Now…. In Trouble:

The chart below shows the cumulative returns of the **loss-making stocks**, the **R2500 Index,** and the **profitable stocks** within the R2500 from 12/31/2016 to today. As our research has documented, the speculative bubble we are coming out of began in 2017.

You can see the Dot.com pattern repeating itself once again. The **stocks of companies that lost money** roared ahead of the **R2500 Index** and are now in collapse. Using a single factor like "profitable" and "unprofitable" is needlessly naive, but KCR has every expectation that the loss makers will continue to collapse.

Companies that Lose Money are Imploding after a Manic Run Similar to Post the Dot.com Collapse



Source: Kailash Capital, LLC; Data from 12/31/2016 – 4/30/2022

VSMAX Dividend: Another Layer of the Onion

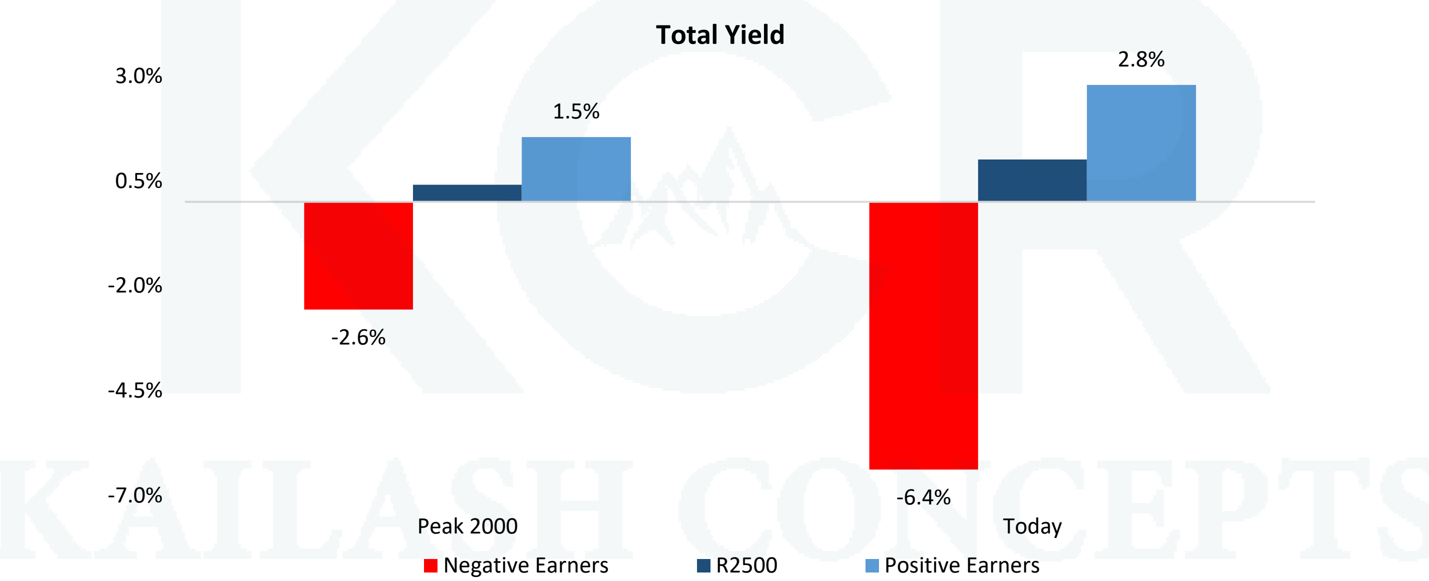
We noted above that simply classifying stocks based on being profitable or unprofitable was a needlessly simple way of bifurcating the Index. One of the things our team looks at is the total yield of stocks. We calculate this as: (dividends + buybacks of stock - issuance of stock) / market cap.

So, if we look at how much yield or dilution there is among the stocks of **money-losers**, the **R2500 Index,** and the **profitable firms** today, how does it look vs. the peak of the Dot.com bubble? **WORSE**

The chart below shows that **loss-making stocks in the R2500** are issuing so much equity to fund operations they are diluting owners by -6.4%. At the peak of the Dot.com mania, this same class of stocks - of which there were far fewer - were only diluting owners by -2.6%. In contrast, the **profitable firms** today yield 2.8% vs. only 1.5% in 2000.

Seeing these simple charts, we ask you: why would you buy a portfolio that includes a record number of loss-making stocks at exorbitant valuations? This is just common sense.

Loss Making Stocks are Issuing Vastly Higher Amounts of Equity than at the Dot.com Peak



Source: Kailash Capital, LLC; Data from 2/29/2000 & 4/30/2022

Conclusion:

- Even good ideas, when they become dogma and are taken to extremes, will backfire
- Many index funds are loaded with record amounts of low-quality, overvalued stocks that often lose money
- One of the easiest things you can do to improve client outcomes is find a small cap money manager with an emphasis on a proven process that charges low fees
- If you would like the names of some of the many small cap fund managers that have proven they can compound capital better than an index **over the full cycle,** please reach out to us
- If you would like to use one of our Small Cap or Small Cap Growth model portfolios to avoid the needless losses in these speculative firms, please reach out to us

The larger point we are making is that, given time, an active manager could beat this Index by merely avoiding loss-making firms and charging low fees.

Common Sense Conclusion:

- Many index fund products today are "free"
- It has become widely accepted that when a product is free, the consumer is the product
- So what is the motive for people to sell you a free product?

That dogma around indexing is now used as a convenient excuse to avoid regulatory risk. Charging for broad "advice", many firms now herd their investors into passive funds. These funds now have massive weights in stocks that have weak fundamental characteristics and elevated valuations that have historically led to severe losses.

In true Wall Street fashion, the industry has adapted and now actively embraces the false dogma that index funds are unbeatable. When taken to extremes, even good ideas can be bad for investors. We believe that index funds serve a valuable purpose - beta should be cheap. But we also believe the arguments suggesting they are the be-all-end-all are incredibly misleading.

These are truths born out in the history of financial data. Forgotten for the moment, the impending lesson will be painful. The path to minimizing these losses and compounding investor wealth at higher through-cycle rates of return with a safer process has rarely been more obvious than today.

Over the next several months, Kailash Capital, LLC and its affiliate, L2 Asset Management, LLC, will author a series of papers explaining the limitations of the analytical pillars underpinning the arguments that suggest active managers cannot add value vs. index funds. We look forward to what will undoubtedly be a vigorous debate around issues that many have taken for granted, like the reliance on the SPIVA reports.

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[i] For the purposes of this paper, the composition and returns of loss-making and profitable groups were re-constituted monthly. The larger point we are making is that, over time, an active manager could beat this Index by merely avoiding loss-making firms. Upon review of the methodologies followed by Vanguard's Index vendor, CRSP, we realized they rebalance quarterly. We re-ran all the data using CRSP's rebalancing dates, and found nearly identical results. If you would like these charts update with quarterly rebalancing, please reach out to info@kailashconcepts.com.