



Additional Thoughts on Index Funds and HNWI Investors

Our article last week ([View Article](#)) showing that RIAs managing funds for HNWI and UHNWI investors hold only 3.8% of assets in index funds (including ETFs), generated many responses, mostly seeking explanations of this phenomenon. Our discussions with readers centered on several themes.

Few were surprised by the data. RIAs are expected to outperform the market, and that becomes increasingly difficult with portfolios that contain large percentages of broad-based index funds. Wealthy investors are usually sophisticated investors, and if their goal is to keep pace with the Dow or S&P 500, they can do so on their own without external guidance. The guidance offered by RIAs, in the form of asset allocation and fund selection, provides returns in excess of the market.

Our data is heavily weighted to the UHNWI. In the largest accounts, which make up 94% of the assets in our universe, the average account size is \$3.7 million. An individual or household typically has 10-20 or sometimes more accounts, so the investible assets of individuals and households represented in our universe is quite high. With this demographic, the need for goal-based financial planning is low; these investors do not have to worry with making tuition payments or planning for retirement. Investment objectives are more likely to concern legacy planning and philanthropy. This will motivate advisors and investors to be more creative in their search for returns that exceed the market. Additionally, UHNWI investors do not need the liquidity offered by traditional index funds and ETFs.

The major US indices are at or near their all time highs. Only 1.0% of marketable securities are in funds tied to broad-based US indices. The trend away from US indices may represent sentiment that these markets are at their peaks. We will monitor our data to see how the indexed component of our universe changes over time.

UHNWI investors have extensive equity exposure through separately managed accounts, hedge funds, private equity, and often their own operating companies. With the market meltdown earlier this decade, many UHNWI investors have increased their exposure to absolute return strategies (hedge funds). Mutual funds (including ETFs) make up only 14% of the assets in our universe (which represent only the marketable securities held by investors), so there may be index exposure outside of their mutual fund/ETF holdings. Larger investors may be engaged in more sophisticated hedging strategies that create index-like exposure.



Indices are tough to beat, and the S&P 500 is one of the toughest. Our conversations with readers suggest that the overriding explanation for the low percentage of index fund holdings is the attraction of absolute return strategies (e.g., hedge funds) and, to a lesser degree, the returns offered by separately managed accounts. These investment vehicles offer the opportunity to achieve returns comparable to or in excess of historical index returns, with lower risk and downside exposure. We leave you with this Dilbert cartoon, from 1997, which perhaps foretold the growth of hedge funds and SMAs relative to index funds over the last decade:



www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:

<http://www.advisorperspectives.com/subscribers/subscribe.php>