



Worse Than Marxism?

Harold Hallstein

A few weeks ago analysts at Sanford C. Bernstein & Co. published a provocative paper titled *Silent Road to Serfdom: Why Passive Investing Is Worse Than Marxism*. Under most circumstances I'd dismiss this as a hyperbolic complaint from a brokerage house upset about the rise of low-fee index investing. In this case, however, the paper was reasonably well considered and the media quickly launched into a high-level discussion of capital markets, freedom, and fairness.

Jack Bogle, founder of Vanguard and progenitor of passive investing, immediately declared the paper's argument "idiotic" and "totally wrongheaded." After reviewing the details and spending many evenings pondering the topic, I think Mr. Bogle is wrong to be so dismissive. There are some very serious implications to the rise of passive investing and important lessons for us as regular buyers and owners of these passive funds.

The idea behind passive investing is simple. Basically, you take an ordinary mutual fund and fire the Mercedes driving investment manager. You replace them with a simple and well-codified investment model, keeping the fee savings for yourself. As Jack has demonstrated for decades, this approach works very well for investors – if not Wall Street. We have excellent objective evidence provided by Morningstar Research that over the 10-year period ending December 2014, three quarters of U.S. large-cap mutual fund managers underperformed the S&P 500. They underperformed by an average of 94 bps (0.94%). That number is eerily similar to their average annual management fee. Making matters worse, only 50.2% of those funds even survived the full 10-year period, adding what we call statistical *survivorship bias*, which further obscures their weak results.

In many ways this research makes our investing lives easier. We simply buy the S&P 500 index itself, or similar socially screened indices, or for small-cap stocks, the Russell 2000. This approach serves us in multiple ways. First, we pay less and get better performance than most mutual fund owners. Second, we don't need to watch over fund managers and consider how their private lives are impacting their decision making. Lastly, our own mental bandwidth is freed up to consider the much more important issues of overall portfolio allocation and investment timing – both of which have been shown to be the most critical factors in our actual final realized investment returns.

Some investors have become quite dogmatic about the style of passive investing. Jack Bogle is one of them – and perhaps rightly so – as his philosophy has made Vanguard and its fund investors quite successful over the years. But we are not simpletons. We are only pragmatists. If the data showed otherwise, we would act otherwise. We aren't driven here by dogma, but rather by statistics and facts about the past.

The danger lies in people getting carried away with this passive approach. Too much of a good thing makes you sick over time. Active investors actually play a very critical role in the economy. They are the human beings that use their knowledge and observations to set, not just follow, the prices of corporate stocks and bonds. They are the people who actually determine the price of the money/funding that businesses require. They handicap ideas based on their merit and the potential risks.

This role is called *price setting* or *price discovery*. Active engagement in buying and selling securities based on analysis rather than simplistic rules is what ensures risky companies with bad management pay more for your investment dollars and that strong companies with proven records of conservatism pay less for your dollars. Quite seriously, we all owe active investors gratitude for helping make sure the market for our money is reasonable, fair and transparent.

To see the bigger picture, imagine if *all* investors followed the passive investing mantra. Everyone would own the S&P 500 and the only thing that would determine the price of Apple's stock would be the inflows and outflows of money into the S&P 500 as guided by its

so-called *capitalization weighted* methodology. No one would be looking at the outlook for the iPhone 7, or the failure of the iWatch, or any of the factors that drive the actual value of Apple's business to society. The market for money would quickly become woefully inefficient, with risky companies getting cheap funds, and solid companies paying far too much for funds. Essentially, all firms would access a kind of average/aggregate pricing for equity dollars. I wouldn't call that Marxism, but it would certainly undermine healthy and responsible decision making by corporations.

My job is to consider these dynamics. To be shrewd passive fund investors we need to follow data about the dispersion of returns and valuations inside our key indices. If index investors have displaced active investors to a great degree in a given market, that may actually signal an opportunity in active strategies, which have a better than normal chance to provide strong returns in inefficient environments.

Currently, my research suggests our primary stock indices are fairly efficient internally, albeit overvalued. We don't need to worry about the S&P 500 in these terms right now, especially since Apple's shares entered a bear market starting in April 2015. As you might recall, I wrote about Apple shares being overvalued specifically in the Q2 2015 letter called *Investor Psychology*. It was a significant problem for our positions in the S&P 500 because Apple was the largest company in an index that selects investments based only on their relative size. Apple was being valued merely on its largeness rather than on the actual prospects for its earnings – the only thing that ultimately matters to serious investors. That situation resolved as more active shareholders began dumping the stock, leaving passive index investors over-invested in Apple at bad prices. We saw this problem arising even if our ability to avoid it was limited to reducing direct AAPL holdings or avoiding buying more of it.

We have a tougher situation in the bond markets. As you know, my general view is that bonds are also overvalued and don't compensate us adequately for their risk at current rates. Also, similar to the rise of passive investors in the U.S. stock market, in the bond markets we have another type of aggressive non-analytical investor – central bankers. Central banks around the world have expanded repurchases of their own debt for a number of years with primarily socioeconomic goals in mind. They are not making decisions based on good credit risk assessments like normal financially motivated investors would. As a result, we can make a strong case that inefficiency is rife in bond markets.

So, what do we do with that information? I think we need to turn our backs on Jack Bogle here. If we think bonds are generally priced incorrectly these days, then by default we also believe that passive bond indices are priced wrong as well. So we should replace our current index positions (Barclays U.S. Aggregate Bond, etc.) with active fixed income managers who can try to harvest this mispricing. The recent selloff in bonds created unique circumstances for actively managed closed-end funds operated by some pretty good managers. In some cases we can buy these funds for 7-11% below the current face value of

their assets. Our core U.S. bond exposure can be also migrated to a mutual fund I found that is showing notably strong performance in this unique environment despite having nearly \$47 billion in assets.

I'm reaching out to clients holding these fixed income index investments with specific instructions on how we should reposition. Unfortunately, the difference this will make to our portfolios will be somewhat small – first because we don't have a lot of bond exposure to begin with, and second because of the vagaries of how we position investments in different types of accounts. Bond interest is taxed higher than stock dividend income, so we commonly use default 401k options to get our bond exposures in a tax deferred setting. In these cases, we have limited options and can only review the so-called "menu items" available. Nonetheless, this work is worth our time and attention.

While my expectations for bond investments remain pretty low over the medium term, given current circumstances it looks like a better time than usual to use active fixed income managers who may be able to utilize interest rate volatility and bond selection to augment returns.

Best,



Harold A. Hallstein IV
Sankala Group LLC
T: (720) 310-0605



Sankala Group LLC's communications should not be considered by any client or prospective client as a solicitation or recommendation to affect any transactions in securities. Any direct communication by Sankala Group LLC with a client or prospective client will be carried out by a representative that is either registered with or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. Sankala Group LLC does not make any representations or warranties as to the accuracy, timeliness, suitability, completeness, or relevance of any information presented in this communication, or by any unaffiliated third party. All such information is provided solely for illustrative purposes.