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Passive Aggressive

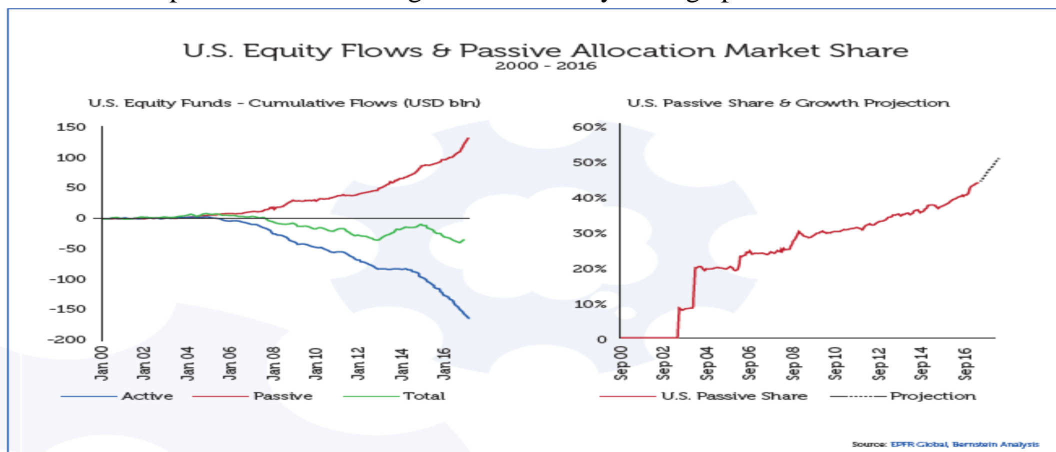
"Even the intelligent investor is likely to need considerable will power to keep from following the crowd" – Benjamin Graham

Benjamin Graham (May 9, 1894 – September 21, 1976) is widely considered the father of "value investing". One of his most famous pupils was none other than Warren Buffet who credits Mr. Graham with much of his considerable investment success. Value investing is an active process of determining a company's "intrinsic value" and then comparing it to the price that people are willing to pay. If the discount to the market price is big enough to warrant the risk, the security is purchased. When the market price rises significantly above the intrinsic value the security is sold; simple enough in theory, but difficult in practice. It is difficult for two basic reasons: first, getting the intrinsic value right is no easy feat, and second even if your calculations are correct it may take a long time (years) before collective perceptions (markets) get around to recognizing it and value it accordingly.

If there was an endangered species list for investment strategies, value investing would now be at the top of that list.

The flip side of selective (active) investing is index (passive) investing. Index investing was created in investible form by the father of passive investing, John (Jack) C. Bogle, founder of the Vanguard Group on August 31, 1976. No one, including Jack, had any idea of the impact that the launch of *First Index Investment Trust* would have on the world of investing. *First Index* was an investment designed to track the investment performance of the S&P 500, a basket of stocks widely used as a benchmark for US stock market performance. Up until that time, there was no way to replicate the performance of the index without actually going out and buying all 500 stocks in the same percentages represented in the index, an expensive proposition.

From its humble beginnings (Vanguard had hoped to raise $150 million in this offering, but fell way short, raising only $11.3 million) index investing has now come to dominate both new money inflows and trading activity versus actively managed portfolios. The meteoric rise of passive investing has come at the expense of those managers who actively manage portfolios as shown below.



According to Morningstar, Actively managed equity mutual funds experienced net withdrawals of $264 billion in 2016, more than double the amount withdrawn in the meltdown of 2008. At the same time, passive strategies took in $237 billion – the highest on record and almost double the amount in 2015.

Jack Bogle's original investment was built as a mutual fund. *First Index Investment Trust* was designed to give investors diversified exposure to the US stock market at very low cost as the transaction costs to buy and sell the securities in the index were spread over a large number of investors in the fund. Jack intended this to be something that investors would hold onto for long periods of time to experience the returns that a broadly diversified stock portfolio could deliver. Not in his wildest dreams did he imagine what was to come of his invention.

The first major evolution in indexing came in 1989 with the introduction of the first exchange traded fund (ETF) called *Index Participation Shares*. It too tracked the S&P 500, but unlike the previous mutual fund based version which was bought and sold only one time each day (after the market close), an ETF trades like a stock, and can be bought or sold at any time the markets are open. The ability to execute trades intraday changed everything.

Mr. Bogle – "Through September 2015, shares of the 100 largest ETFs, valued at $1.5 trillion, were turning over at an annualized volume of $12 trillion, a turnover rate of 864%. By way of comparison, the annualized turnover volume of the 100 largest stocks, valued at $12 trillion is running at $15 trillion for the same period, a turnover rate of 117%. Trading in the 100 largest ETFs thus represents about 89% of such stock trading, up from a mere 7% 15 years ago. Given this powerful data, it is hardly unfair to describe today's ETFs – as a group – as the modern way to speculate in the stock market."

Did you catch that? There is eight times more trading activity in the indexes than in the underlying stocks that make up the indexes.

Eligibility for the S&P 500 index is not determined by sales growth, a healthy balance sheet or profitability, but by sheer size called market capitalization (the price of the stock times the number of shares in the public's hands). Because the index does not attempt to determine whether a company is using capital effectively or not, you begin to get some significant distortions. Valuations become in many ways self-fulfilling. In April of this year, five stocks (representing 1% of the companies in the index): Apple, Google, Microsoft, Amazon and Facebook represented nearly 13% of the value of the index. These five stocks have also been some of the best performers this year, averaging as a group nearly a 25% increase in price as compared to the total S&P 500 index return of about 8.5% year to date. As more people pile into an index based product, the big get bigger as their stock prices get pushed up by the fact that these stocks must be bought by whatever index tracking investment is being bought.

Under the category of unintended consequences, here are a couple of questions to ponder. As passive investing (indexing) approaches 50% of the total amount currently invested in the US equities markets, how will companies compete for new investment when there is effectively no differentiation between good users of capital and bad? And given the fact that most of the new money in indexing is flowing into ETFs, and that the holders of these are notoriously short term (traded 8 times more frequently than the stocks they represent) what will happen to the underlying stock prices if large quantities of ETF shares are sold in the next market correction? On October 19, 1987, I sat in a brokerage firm and watched stocks drop 23% in a day led by the very thing, "portfolio insurance", that was supposed to effectively eliminate the downside risk of stock investing.

Today, by virtue of the massive shift to indexing, many individual investors are less diversified and more aggressively positioned than they realize. Investing in the S&P 500 is very different from having a truly diversified investment portfolio. Warren Buffett – "Only when the tide goes out do you discover who's been swimming naked." Swimsuits please.