ADDING VALUE

Volume 12: Edition 1 | First Quarter 2013

For this issue of Adding Value, we will explore the possibility that the indexation phenomenon may be another market "bubble" to be recorded alongside the tech bubble, housing bubble, and the financial crisis bubble. Dare we whisper such heresy?

INDEXATION – A BUBBLE*?*

Investment generalizations are irritating. Perhaps it is our fast-paced, sound-bite driven world. Perhaps it is the lack of understanding of some journalists who write the headlines. Perhaps the message is packaged in a way that seems "intuitively obvious." Perhaps it has always been that way and we are just more sensitive to the constant bombardment of data. After all, Mark Twain is known to have said more than 100 years ago: "All generalizations are false, including this one." So for the next several newsletters, we are going to look behind the generalizations and see if we can determine any "counter-intuitive" arguments. Our starting discussion will be to analyze the statement: ***ACTIVE INVESTMENT MANAGEMENT IS ALWAYS A LOSER'S GAME.***

COMPONENTS OF THE DEBATE

First, in general, professional money managers have historically found it difficult to outperform the major indexes, such as the S&P 500 consistently and over short periods of time. Markets do an unusually good job of getting it right especially in the short term. There are basically two sides to the argument of active vs passive investing. Indexing is essentially an argument that the efficient market hypothesis is true and that most participants in the market are rational and the market is always efficiently priced. On the other hand, behavioral finance (as used by active managers) stresses that many market participants are, in fact, quite irrational and, importantly, limits to arbitrage exist. That is, there are limits to what rational traders can do to offset the things that irrational traders do, especially over longer periods of time. As a result, stock prices frequently deviate from fundamental value, making markets only generally efficient. The difference between always efficient and generally efficient is night and day. Recognizing when markets deviate from fundamental value gives an active portfolio manager a way to gain excess performance. In our opinion, the last 10-12 years strongly disputes the rationality of the markets with evidence given by the technology bubble, the housing bubble, and the monumental market sell-off of March 2009.

Vanguard's paper "The Case for Indexing" has been widely distributed. Lower cost, lower turnover, tax efficiency are attributes that are widely touted. The active managers that we have used in the past have their own papers in rebuttal but they didn't keep the printing presses working overtime to spread the message. Although it is somewhat harder to

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

Wright Associates
2589 Washington Road, Suite 410
Pittsburgh, PA 15241
(412) 854-2100 (Phone)
(412) 854-2550 (Fax)

read and less elegant than Vanguard's paper, Marty Whitman, CEO of The Third Avenue Funds, has written a very compelling response to index management which we are happy to share with any interested party. In our business, we have always used low-cost, tax-efficient, no-load active managers. Based on our process, we have historical return data from 1993-2012 (20 years) for a pension portfolio with an asset allocation of 65% equity and 35% fixed income, that shows that we have outperformed a blended passive index weighted in the same manner as the active account, in all but 6 years. In other words, we have outperformed 70% of the time. Further, expressing the outperformance in dollars rather than basis points is eye-opening. An additional 1.00% return compounded over 20 years on a $2,000,000 starting portfolio is approximately $1,500,000. One percentage point doesn't sound like much but over long periods of time it adds up to a lot. This could be described as the opportunity cost of following the herd.

Second, if one were to choose an index approach, what index would you use? Investors exploring the possibilities of index funds may do well to heed Milton Friedman's advice: "There is no such thing as a free lunch." Index funds seem to offer some advantages and those advantages should be explored. At the same time, investors should be prepared to ask some tough questions about these advantages. Some questions that should be asked include: How much is too much of a good thing? What index should be used? Are there some market areas that are the hardest to beat? Are some indexes easily beaten by active managers? Where are the market inefficiencies most likely to exist? If they exist is indexing a good idea? Do you know everything you should about the index fund, i.e., how often is it rebalanced, is it cap-weighted, equal weighted, or price weighted who makes the decision on the composition of the fund, among other questions? Should you consider a fundamentally weighted index? Is the index fund decision the one that should get top priority? Perhaps a sensible look at asset allocation is more important. Are there some market environments that favor an index strategy and is that the market we anticipate will occur in the future? We raise these questions simply as reminders that any equity portfolio involves risk. And the risks will vary manager by manager, philosophy by philosophy, technique by technique. Moving from a fully managed fund to an index fund may be merely trading one set of risks for another. For example, an index investor may see good opportunity by owing Bank of America ("BAC"). Since BAC is a part of the Dow Jones Industrial Average ("DJIA"), the investor decides to buy a DJIA index fund. The thought is returns of this fund will incorporate strong gains from BAC stock. After buying, the investor sees an article stating "BAC drives DJIA index to new highs." The investor feels good about their investment. However, the DJIA is a price weighted index. This means stocks with the highest per share price have the biggest weights. The four "biggest" companies in the Dow are: IBM, Chevron, 3M, and McDonalds. BAC takes spot 29/30. BAC only holds a 0.64% weight in the Dow. So if BAC doubled in stock price in 2012 what impact does it have on the Dow? The Dow gained approximately 10% in 2012; BAC stock gained 100% (going from $5.50/sh to $11.00/sh). At a 0.64% weight that means BAC only contributed 0.64% gain to the 10% gain of the index. Our investor may seem surprised by this. This is the fundamental reason why it is of paramount importance that investors know and understand how an index is constructed and what factors affect returns.

Third, exchange-traded funds ("ETFs") are not benign investments. All domestic ETFs track indexes or baskets of securities; therefore, the performance of an ETF should directly reflect the performance of its underlying index. Because all indexes are not created equal, the performance and investment objectives of ETFs can vary substantially. Consequently, it is important to thoroughly understand the

structure, objectives, and performance of the underlying index before investing in the ETF.

MARKET EMBRACE OF INDEXATION

Since 1999, the number of ETFs has expanded from fewer than 100 to more than 1,100, even as the number of listed stocks in the U.S. has declined by one-third. The "if you can't beat them, join them" marketing slogan is being fully embraced by the public. This migration away from individual security selection was intensified by the urgency of the 2008-2009 financial crisis. In the three years following 2007, the percentage of domestic equity mutual fund assets invested in index funds rose almost 25% to 14.5%, as reported in the 2011 Factbook of Investment Company Institute ("Ici"). Expressed in dollars, the actual flow of funds into ETFs has been almost $1 trillion dollars! But digging even deeper as Murray Stahl, CEO of Horizon Kinetics has done: "one finds that the average daily turnover of both the SPDR S&P 500 ETF (ticker:SPY) and the ishares Russell 2000 ETF (ticker:IWM) exceed 50% of their market capitalization. In other words, annual turnover is on the order of 12,000%, which is a historically unprecedented phenomenon and, frankly, astounding. The dollar value of all ETF shares traded now accounts for about 50% of the total U.S. equity market trading. For 2011, ETFs alone were responsible for over $20 trillion of trading, which means that turnover for the entire group was 20x their $1 trillion of assets under management, or about 2000%." WOW! This amount of turnover equals performance crippling transaction costs and taxes… a stat <u>not</u> calculated by most.

WHAT DOES THIS MEAN FOR INVESTORS?

What does it mean for investors when the liquidity (the dollar volume of buying and selling) of a DERIVATIVE instrument such as an ETF is greater than its constituent parts? There is greater trading volume in the Russell 2000 ETF, for instance, than in many of the companies comprising it. In a 2011 testimony before the U.S. Senate Committee on Banking, it was calculated that if the IWM had to create a sufficient number of new units for the aggregate volume of short positions in IWM, it would take the ETF more than 180 days to buy all the component securities if it limits its buying to 10% of the average daily volume of each holding. Very simply put, the liquidity and daily trading volume of some of the largest ETFs now exceed the liquidity of the stocks that comprise the index. Does this sound familiar? Were the mortgage securities that were sliced and diced greater than the sum of the original mortgage? We all know this was a situation that did not end well.

AN ETF BUBBLE

An ETF is a very, very low-fee business. Therefore, a creator of an ETF must gather a very large volume of assets to make it a profitable business. Ultimately, the constraint that an ETF creator faces is the liquidity of its <u>least</u> liquid member (i.e. there is only so much of the security that can be purchased). Therefore, ETF companies choose to EXCLUDE companies with more modest market capitalizations or even large companies with limited float. The valuation discrepancy across the ETF divide (those companies that are included in major and multiple ETFs versus those that are excluded) is becoming so severe that the two groups are beginning to exhibit very different valuation and variability characteristics. It almost is like the 1999-2000 bubble period, when blue chip technology, Internet and telecommunications stocks dominated the headlines. Another situation that did not end well.

SUMMARY

Two guesses on what side of the "divide" that we find ourselves on in the great debate between indexation and active management. Benign indexation, presumed to be measuring price movement and granting broad exposure,

is in fact impacting the price of the securities it is intended to measure. This means that opportunities for active managers are increasing. We are sure another chapter of the book called "too big to fail" or "systemic risk" or "popping bubbles" will be written, the timing of which is, as usual, uncertain. The chapter may already be started based on some recent developments. BlackRock, which acquired shares from Barclay's in the last financial crisis, is the largest provider of ETFs. In emerging markets alone, it has $70 billion in assets; fees range from 35 to 70 basis points. Vanguard has begun to compete for the same assets as BlackRock and it charges 12 to 25 basis points for the very same product. BlackRock needs to protect its turf so it has applied to SEC for permission to have "actively managed ETFs" that would not disclose holdings daily. Price competition is beginning. What goes around will come back around. Meanwhile, history will record another chapter where investors could have purchased stocks at multi-decade low valuations, but missed out because of their enthusiasm for another passionate marketing spiel of indexation. Our goal, as always, is to avoid the trap even if we underperform the "efficient index" in the interim. We always try to be guided by fundamental valuation not relentless marketing.

Happy Spring!

Sincerely,

Kathleen S. Wright
A. Gregory Lintner

Wright Associates
2589 Washington Road, Suite 410
Pittsburgh, PA 15241-2564