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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

I apologize for not sending out a newsletter last week, but it wasn't for the lack of effort. The truth of the matter is, at about 3:30 last Friday afternoon, I read what I had been writing intermittently throughout the day, and thought to myself: "Really, Norris? God gave you a brain, an above average ability to express yourself, and some semblance of typing skills AND this is the best you can do?" Oh, it wasn't the worst thing I have ever put out there, but it still wasn't good. So, I simply save the half-finished file, and hit the bricks at the appropriate time.

This week, I have read any number of articles about a so-called bubble in 'passive investments.' This has both bemused and frustrated me at the same. The problem I have with the discussion is the use of the word 'bubble.' Since I have been around this industry for a long time, I can read between the lines a little. However, most people reading these articles are going to process the word bubble as 'dot.com' or 'sub-prime housing.' Those of us with gray hair might even harken back to 'Japanese banking and real estate.'

As a result, what is really a discussion or analysis about the increasing popularity of a particular method of investing becomes a worst case scenario in the mind of the reader, a la 2000-2002 and 2008. I suppose you can say there are bubbles and then there are bubbles.

One of the better columns I read on the matter came from a John Stepek, a writer for MoneyWeek in the UK. Instead of reinventing the wheel, and paraphrasing and plagiarizing in the process, let me simply cut & paste some pertinent parts of his extremely well written article. *I freely admit I changed the British spelling of certain words to American* ('Murica Baby):

> "The idea that passive investing is a "bubble" has arisen from the fact that they've become very popular and we're seeing more and more such funds popping up to take advantage of that fact…
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> The main problem I have with the idea that passive investing is a "bubble" is this: "passive" investing is not an asset class. It's just a process, or even a technology.
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> Calling it a bubble because people are using that process to invest their money, is about as logical as saying that there's a bubble in credit cards because their use as a spending tool has increased, and that check books are correspondingly undervalued. Or that there's a bubble in cars, and horses are correspondingly undervalued.
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> Just have a quick think about it. Let's say the equity chunk of my portfolio is worth £1m (not quite there yet, but let's think big). I currently have it invested in an actively managed fund, which invests in general UK-listed stocks.
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> One day I read an article on passive investing. I realize that my active fund manager is pretty much tracking the FTSE All-Share index. His top ten stocks duplicate the biggest stocks in it. His "active share" (a measure of how widely a manager's portfolio differs from the underlying index) is laughable. So I take my money out of his fund, and I put it in a FTSE All-Share tracker instead.

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> Have I contributed to passive fund inflows? Yes. Have I contributed to active fund outflows? Yes. Is this in some way a bubble? No. I have swapped an expensive form of exposure to the FTSE All-Share for a cheap form of exposure to the FTSE All-Share. That's it.”

To be sure. Asset bubbles occur when ‘too much’ money floods into an asset class due to perception of an unrealistic, and often/usually unprecedented, rate of return. The bubbles I have seen in my career have a couple of things in common: 1) if it seems to good to be true, it usually is (and was), and; 2) everyone who said ‘this time is different’ found out it really wasn’t.

Put another way, bubbles occur when greed gets in the way of common sense.

Almost by definition, passive investing doesn’t meet that criteria, if you want to call it a criteria. After all, passive investors should know their investments will track a market index less the underlying expense ratio of their chosen vehicle. Basically, the best they can do possibly hope to do is match the market’s return, not beat it. As a result, passive investing is more about saving money than it is about greed, although you could sensibly argue saving money (in fees) is a type of greed in and of itself.

So, as Stepek aptly points out or implies, shifting money from a so-called active investment to a passive one doesn’t increase the amount of money devoted to the asset class. It simply reduces the amount of money investors are paying for exposure to it. On its face, that doesn’t suggest the formation of a bubble, quite the contrary. All other things being equal, a shift to passive investing, from active, would, could or should result in the long-term reduction of volatility in an asset class, therefore reducing the amount of money potentially to be gained from it.

Let’s think about the last phrase of that last sentence a little bit: “therefore reducing the amount of money potentially to be gained from it.” Intuitively, as market volatility, returns and expectations for both diminish, actively picking and choosing stocks should be able to produce consistently better relative results than it has been able to over, shucks, really ever. At such time, investors will wisely opt out of their passive investments.

With that said, we have a long way to go to get there.

To be sure, passive investing is not without its problems. The constant drip of money from index funds means certain stocks will, and do, perform better than they would or should otherwise, even if the investor’s exposure to the broad asset class is appropriate. In other words, it fosters some measure of ‘zombie-ism’ in underperforming companies. Further, almost by definition, passive (index) funds aren’t necessarily shareholder activists. They aren’t as concerned with the day to day operations or quarterly earnings of a company as they are with ensuring the portfolio has an index weight in the stock. As a result, there isn’t any real reason for an index manager to really, well, care what goes on a particular company….meaning there is ‘nothing in it for them’ for the index manager to challenge senior management when that is required.

Frankly, this is already a real problem, as behemoth institutional investors like largely passive players Vanguard ($4+ trillion), SSgA ($2.4+ trillion), and BlackRock ($5.1+ trillion AUM) dominate global corporate ownership, in aggregate. To that end, it isn’t unusual for those three managers, alone, to own in excess of 15% of a single mega cap US company (like Apple, currently) and 20%+ of any number of midcap names. Shoot, this doesn’t even include the index options, some of them quite massive, at typically active managers like Fidelity and BNY Mellon. So, you want to create a stink about CEO pay with your 1,000 shares of XYZ? Have at it Don Quixote.

However, the biggest problem I currently see with passive investing isn’t passive investing itself. It is with the creation of passive products tracking obscure indices and/or economic sub-sectors. You know, those areas of the market which wouldn’t attract much attention or money BUT FOR some investment vehicle which purports to generate ‘index returns.’ The only problem is the underlying index might contain a single company of a small number of them which dominate its return. Worse still are those sub-sectors dominated by thinly traded names. Obviously, this isn’t as much of a problem in the S&P 500, Russell 1000, and even Russell 2000 indices, which have some measure of width, breadth, and trading volume.

As passive investing has increased in popularity, so have the number of so-called passive products employing a lot of

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clever ways to 'beat the market' and products that track the minor/thinly traded indices to which I alluded. Now, these might constitute a bubble of sorts, particularly the latter. However, I would suggest the bubble isn't in the investment strategy, i.e. passive investing. No, it is in the flow of capital into a particular sector or asset class, thereby inflating the value of the underlying index.

Care to buy an ETF tracking a 3-D printing index with which you are not familiar? You can, but I would advise against putting all of your money in it even if I am proponent of 3-D printing technology. How about one which purports to be all about health & fitness? That sounds good doesn't it, and I am sure it conjures up a certain type of stock, right? Well, how would you like 21% Nike and 18% Adidas? Clearly, those aren't thinly traded or obscure names, but would you be willing to put 21% of your money in Nike alone? That is if you had to buy the individual stock itself? How about 18% in Adidas? Maybe, but it might have been nice to know you were doing so before buying the ETF, probably thinking you were going to get something else, right?

Then, how many retail investors should really be taking down a large allocation to, say, the Qatar, Vietnam, Colombia, or Nigeria country specific ETFs? I could have named a few more, but decided not to do so. Hey, don't get me wrong, you really might be able to hit a home run with a passive investment product in an obscure part of the market. I can't argue that.

...but the issue isn't with the methodology of the investment vehicle. Nope. The issue is with the asset allocation, and the decision to deploy money into relatively illiquid markets or sectors.

I hope that makes sense.

So, a bubble in passive investing? That is almost impossible. A bubble in certain asset classes made possible by passive investment products? Now, that is a different question altogether, and the answer is very well could be. I will go one step further and suggest this indeed a probability moving forward. I mean, it isn't too much of a stretch to envision an Algerian fund or one that tracks microcap nanotechnology in Taiwan, etc.

"Okay, Norris…..I might want to consider a microcap Taiwanese nanotechnology fund at some point, but an Algerian fund? Really?" Sure, why not? The Algerian economy is larger than a lot of countries that already have their own ETF. Places like: Belgium, Portugal, Greece, Ireland, Switzerland, Singapore, Austria, Sweden, Chile, Peru, New Zealand, and Israel, to name a few. Wouldn't a handy dandy ETF or index fund be just the thing to jump start Algeria's somewhat nascent stock exchange? Of course it would, and some clever sort in NYC or Boston will cobble together some kind of product which buys shares of the few publicly listed Algerian companies and multinationals which do a large amount of business in that company.

In the end, don't lose a minute of sleep about there being a bubble in a passive investment vehicle that tracks an established index in a liquid market or economic sector. After all, the investment methodology of the product isn't the problem…..no matter what the mouthpieces and analysts at the active management firms might tell you.

While not necessarily the greatest, this week's tome is okay enough to send out.

Disclosure