MAI GUEST

VOL. XVII, NO. I | www.macro-allocation.com | AUGUST 29, 2017

Jacob Navon

I am very pleased to provide you with an original piece written by Jacob Navon. I first met Jacob when he was investing in hedge funds on behalf of Paloma Partners. Since 2003, Jacob has been a Partner at Westwood Partners, where he specializes in senior-level searches in the Asset Management, Wealth Management and Hedge Fund industries. Jacob's experience and intelligence (see his biography below his signature) make him unusually qualified to weigh-in on the practical merits and risks of passive investing. Accordingly, I have no doubt you will gain valuable insights from *Deceits inherent in Passive Investing*.

Paul Brodsky

Deceits inherent in Passive Investing

By Jacob Navon

Passive managers have been enjoying far more than Warhol's promised fifteen minutes of fame lately. In contrast, active managers have been berated incessantly for charging way too much only to deliver investment returns that have failed to surpass the market. Adoption of index strategies, consequently, has sharply accelerated in the past few years, reportedly surging past 30% of all U.S. equities, for example. Neither has investing in foreign equity markets, nor in many other asset classes for that matter, eluded indexation. Promoters are predicting that, soon, most money will be managed passively. Yet there are serious flaws in this concept that have been overlooked or, worse, deliberately hidden by practitioners, and that are not understood by their clients. There are at least nine arguments that strike at the very heart of why indexation, as commonly practiced, may not be the solution it is touted to be.

Benchmarking everyone to the same overall market performance serves no "one." A given market's performance reflects the sum total of everyone's investment activities. But investors have differing goals, objectives, investment horizons and, therefore, tolerance for risk. At 59, I am likely to start drawing down on my savings within a decade and a half at most. My children have three to four times as long before facing the same need. Should we be equally comfortable with the same equity market exposure? In addition to having different portions of our overall portfolio allocated to equities, a broad market return may be too risky for my equity allocation, and not risky enough for theirs. Perhaps I should seek to own stocks that offer me less risk, and a lower inherent return than my kids? And if our managers deliver the desired risk/return profile to each of us respectively, they will have served us both well even though I should expect my equities to underperform the broad index over time.

Volatility of returns may not be the best way to assess risk. In devising the tenets of Modern Portfolio Theory (MPT), academicians concocted volatility of returns as the risk measurement of choice. Yet they utilized this indicator as much for its mathematical tractability as for its actual practical utility. And while the insights derived from MPT have progressed our understanding of how optimally to go about investing, we ought to understand the limitations of MPT and its underlying assumptions. We humans are told that we are "inefficient," for one example, because we care more about losses than we do for gains. A whole new theoretical framework, Behavioral Finance, has been developed to account for this "deficiency." And yet, one might contend that we actually ought to care about losses more than gains due to a mathematical reality. Investors are taught to respect compounding. But they are not told it works in both directions. The bigger the loss, the more progressively hard it is to recover from. A 10% loss requires only an 11% subsequent gain to get back to even, while a 25% loss requires a 33% recovery and a 50% hit requires you to double your money subsequently. And we should care about holding on to portfolio value because we all have at least an implicit reason to be investing. Any losses from what we have today make it progressively harder to achieve that objective tomorrow. Thus assessing the likely magnitude of portfolio decline perhaps is a more meaningful measure of risk than volatility

Benchmark relative returns are a very poor measure of manager skill. Most investors, and index promoters, assess active managers by comparing their nominal returns to a relevant index over a given period**.** In contrast, MPT teaches that we should evaluate risk adjusted returns (no matter how you measure risk) instead of raw ones. Numerous active managers, moreover, seek to limit risk by investing in securities offering more upside than downside, or a higher probability of a positive than a negative return. Often, these investments lead in downdrafts but lag in rallies. Such asymmetric approaches can look bad for long periods simply because markets rally far more frequently (or for longer) than go down. This is, perhaps, the most damning aspect of the move to passive. Managers who are skilled in protecting your wealth during market declines will add value over full market cycles. It is very hard to keep that in mind as bear markets historically have been infrequent. But investors who need to access their portfolio in the aftermath of one can be devastated. This was especially true in the financial crisis of 2008-2009, yet less than a decade later, people are flocking to passive management already having forgotten the experience. At the same time, record low interest rates have caused people to up their equity exposure in a search for acceptable returns. We cannot predict for sure when the next bear will cross our path, but we can predict that the foregoing confluence of circumstances might cause it to maul many passive investors particularly badly.

Mostly, one cannot actually own the index, only replicate its returns. Beyond the foregoing more theoretical arguments, passive investing faces some practical limitations. Aside from the S&P 500, and a very few other indices, most benchmarks contain too many illiquid securities where it is not practical, or even possible, to own every underlying investment at its proper weighting (the Barclays bond index, for example, contains hundreds of illiquid bonds that do not trade). In order to replicate the return of such indices, practitioners either need to stratify the benchmark into "buckets" and own liquid investments representative of each bucket; or they need to devolve the benchmark into its return driving factors and create portfolios exhibiting an identical factor profile. In each case practitioners are at least implicitly stating that they know something very fundamental about each security's, and hence the total market's, future return distribution. They may not be able to predict which specific return we will get, but they need to be able to specify the set of possible return paths. Otherwise they couldn't construct replicating portfolios. This requires the very same skills that indexers say active managers do not have. As a practical matter, some investments will have superior return distributions to others. If indexers really do know something about future return distributions of all investments, why not select those securities whose distributions are more favorable than the average?

In fact, they must, because benchmarks bear no transaction costs while index portfolios do. Indexers need to trade at the very least to accommodate fund flows. In order to deliver benchmark matching performance, indexers must deploy various strategies that add returns at the margin in order to make up for the resulting frictional trading losses. In matching benchmark returns, indexers are therefore proving that generating some excess return consistently <u>is possible</u> even as they declare active managers unable to do so.

Index rebalancing reflects another transaction cost that must be overcome. Indexers also need to trade to react to changes in the benchmark's composition. Index publishers declare such changes in advance. Originally, indexers used to transact near to the close of trading on the day of the change in order to approximate the closing prices of the securities being exchanged and thus deliver the index return. Plenty of profit hungry traders used to front run them such that the rebalancing occurred at distorted prices. Over time, indexers have become very clever in masking their rebalancing activities, yet again consistently deploying active management skills they say do not exist.

Liquidity has become an issue. It used to be, for instance, that Vanguard (a major index provider) owned more than 5% of outstanding shares in fewer than 30 companies. Today they own more than 5% of outstandings in hundreds of equities. Collectively, the major indexers have become so large that it is increasingly difficult for them to transact without significantly affecting underlying prices. The advent of Exchange Traded Funds (ETFs) has compounded that issue. This problem exists even when indexers and ETFs are not trading for their own portfolios. Less available float for everyone else means prices can move excessively even on smaller trades by others. Yes, the passive vehicles are still delivering the index return, but that return reflects increasingly less efficient pricing. Paradoxically, the more people index, the greater the opportunity for active managers to exploit inefficient prices.

Relatedly, if everyone indexed, free markets cease to exist. The whole concept of a free market relies on having vibrant competition between profit seeking participants "debating" prices in their transactions, in order for an efficient clearing price to be established. Thus we all need some active market participants to exist. Markets may be able to function with even a greater proportion of assets indexed (though even at the current 30%, U.S. equity investors do admit feeling illiquidity effects), but is it appropriate to deride the work done by those whose existence you are relying on?

While not a permanent or universal condition, the so called FAANG market in the U.S. introduces concentration risk. Commentators have observed that over the past two or so years, returns on the S&P 500 benchmark have been highly correlated to the movement of just five stocks (Facebook, Apple, Amazon, Netflix and Alphabet-Google). If your active manager offered to manage your money by owning only this handful of investments, you would likely impolitely show them the door. Yet S&P 500 index investors have, in effect, acquiesced to just that level of concentration risk. By any metric, these stocks are far from cheap. New money invested in this benchmark is at peril to future valuation realignment. One need only look back to the "Nifty Fifty" market of the early 70's to understand what could happen.

The foregoing nine problems for indexation exemplify three deceits embedded in common arguments favoring passive investing. First, it is anything but passive. In order to deliver index returns, managers must utilize active skills they claim no one is capable of. Second, even in the context of a carefully constructed multi-asset portfolio, passive exposure to broad market benchmarks can create sub-optimal allocations that ill suit specific end investors. While it is possible to tailor individual portfolios to have far more refined exposure to various desired sub-sector and risk/return attributes, the bulk of indexed money is invested in broad market benchmarks.

Last, but not least, it is a trite tautology to proclaim that everyone cannot beat the market always. Duh! Yet active management is not about achieving this result. Active management should be about trying to engineer a distribution of acceptable outcomes under a broad variety of possible yet unpredictable future market conditions. MPT implicitly assumes that all investors have the same investment objective to an infinite investment horizon. That is a truly zero sum game. Your loss is my gain and vice versa. But as previously stated, investors have a very large set of objectives, tolerances for risk, and investment horizons. Game Theory holds that in such a "market" multiple win nodes can exist. The security you are selling may no longer fit your objective and timeline, yet may be perfect for my needs. In such a market, a transaction between us (directly or through intermediaries) helps us both win. Yet, comparing either of our respective returns to a market benchmark representing the "average" says nothing meaningful about the efficacy of each outcome. In summary, as long as your portfolio delivers an acceptable result relative to your needs after any given market move, your manager will have served you well regardless of how it performed relative to an index during that period.

Jacob Navon
Partner
Westwood Partners LLC
jn@westwood-partners.com

Tel: 212 672 3366
Fax: 212-757-4640
Mobile: 646 331 0426
Website: www.westwood-partners.com

Biography: Jacob has more than thirty years of financial services experience as an investment manager and an executive search professional. Before joining Westwood in 2003 as Partner, Jacob was a Managing Director at Warren International, a boutique search firm exclusively serving the asset management industry. Prior to entering search, Jacob spent ten years in the asset management industry including positions at Paloma Partners, Columbus Circle Investors, and The Boston Company. He began his career in fixed income sales and trading at Salomon Brothers Inc. Jacob holds an MBA with distinction from Harvard Business School and both a BA and MA in Natural Sciences from the University of Cambridge, UK.

Property Notice & Disclaimer

This document was produced and is owned by Macro Allocation Inc and its author. Copying, reproducing, modifying, distributing, displaying, or transmitting any of the contents in this document for any purposes without the express written consent of Macro Allocation Inc is strictly prohibited. Requests for copying, reproducing, modifying, distributing, displaying, or transmitting any of the contents in this document should be sent to pbrodsky@macro-allocation.com.

Unauthorized use of this document may give rise to a claim for civil damages and/or be a criminal offense. Your use of this document and any dispute arising out of such use is subject to the laws of the state of Florida, United States.

The information contained in this document is for general information purposes only. It is provided by Macro Allocation Inc to Subscriber/Members, and, while we endeavor to ensure the information is up-to-date and correct, we make no representations or warranties of any kind, express or implied, about the completeness, accuracy, reliability, suitability or availability with respect to this document or the information, products, services, or related graphics contained in this document for any purpose. Nothing in this document should be taken to constitute professional advice or a formal recommendation, and we exclude all representations and warranties relating to the content and use of this document. Any reliance you place on such information is therefore strictly at your own risk.

In no event will Macro Allocation Inc, its affiliates, and employees be liable for any loss or damage including, without limitation, indirect or consequential loss or damage, or any loss or damage whatsoever arising from loss of data or profits arising out of, or in connection with, the use of this document.

Through this document you may infer that other sources of information mentioned in it could provide suitable analysis related to issues on which you may act and suffer damages. Any mention or reference herein does not necessarily imply a recommendation or endorse the views expressed or implied by it.

Macro Allocation Inc reserves the right to revise and amend this disclaimer notice from time to time and any revised version will be deemed to be applicable from the first date of publication of this document.