Strategy Thoughts

April 2017

An ‘Existential Crossroads’ as Optimism soars!

Introduction

On the 3rd of April the CFA Institute released a study based upon surveys conducted with more than 1,000 investment industry professionals. It was titled ‘The Future State of the Investment Profession’ and described the industry as being at an ‘existential crossroads’. Two of the pressures on the industry were pinpointed as an expectation of lower profit margins and a continuation of the growth of passive investment, at the obvious expense of higher margin active approaches. These are important trends, however, for the underlying investor the crossroads may be somewhat different. Passive versus active is an important question that all investors should consider but it is far from the most important driver of underlying investor returns. In this month’s Strategy Thoughts I examine just why it is that the majority of investors get far worse long term returns than even the simplest low cost funds would have delivered and describe a solution that would present an even larger ‘existential crossroads’ for the investment industry than contracting margins or the active versus passive debate. I also look at the extremes in sentiment that have become more extreme and revisit, again, the results of looking at Apple from an expectational basis.

An existential crossroads

The CFA survey was refreshing in that it did highlight that all too often the investment industry’s primary focus becomes their own business, rather than the outcome delivered to underlying client. A shortcoming I highlighted at length in ‘Investing: The Expectations Game’. It also forecast a continuation of the current trend of assets moving from expensive active solutions into much lower cost passive solutions. This is certainly an important trend for the industry, however, it is actually of much lesser significance to the underlying individual investor.

For them the **Active versus Passive debate is a little like rearranging the deck chairs on the Titanic!**

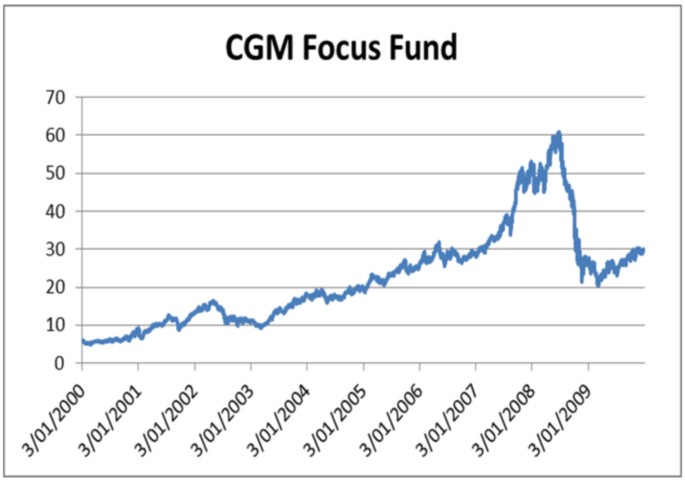
This may sound a highly inflammatory statement; if it does then I am pleased. The media over the last twelve months has been flooded with reports of the ascendancy of passive management and the apparently inevitable demise of active management. Mid last year Morningstar reported that only 12% of active large cap fund managers outperformed their passive peers over the prior decade. Given the attraction of lower fees and on average superior performance it is not surprising that passive funds saw a huge increase in new funds last year while active funds suffered a net withdrawal. The actual numbers across all fund types, according to Morningstar, was that passive funds enjoyed inflows of more than $500 billion while active funds fell by more than $300 billion.

This behaviour on the part of investors and their advisors is understandable and, on one level, rational. The active fund management industry has many shortcomings, including the tendency to charge higher fees for supposed active management when, given the industry's strong tendency to herd, what many actually deliver can easily be described as a passive product, or 'closet indexing'. This is a subject I have discussed at length in the past and is now becoming more easily tracked with measures such as 'Activeshare'.

This increased visibility of how active managers are, and the competition brought about through the dramatic growth in indexed, or passive, funds, has put pressure on average expense ratios for actively managed equity funds. According to the 2016 Investment Company handbook from 2000 to 2015 the average expense ratio of an actively managed equity fund fell from 106 basis points to 84 basis points, a 21% decline. However, over the same period the expense ratios of indexed equity funds fell from just 27 basis point to 11 basis points, a 60% decline.

The attraction, from both a cost and average performance basis, of low cost index funds is understandable, however, it is unfortunately the case that the average investor will still most likely receive disappointing returns over the long term, and this will not be as a result of paying high fees. It will be down to how their portfolio is constructed and managed and the very strong likelihood that they will make just the wrong investment decisions at just the wrong time. I highlighted this in "Investing: The Expectations Game" using numbers released by the US based research group DALBARS. That research showed that over the thirty years to the end of 2014 the average equity mutual fund investor in the US achieved annualised returns of just 3.79% while over the same period the S&P500 delivered annualised returns of 11.6%. Some of this underperformance would have been due to paying too much in fees, but by far and away the largest determinant of average investor returns was the timing of their decisions to get in and out of the market. This tendency for marked underperformance on the part of individual investors continued through 2016. In their most recent release DALBAR showed that the average US mutual fund investor lagged the S&P500's return for the year by almost 5% and again the majority of this underperformance was due to poor timing decisions. It seems, perhaps not surprisingly given the negativity that was pervasive ahead of president Trump's election victory, that the majority of investors missed out on the November and December 'Trump rally'.

The damage wrought through poor timing decisions is most easily illustrated with an example that I included a few months ago in the January 2017 edition of Strategy Thoughts.



At the end of the 2000s the Wall Street journal declared that the single best performing equity mutual fund for the prior decade had been the CGM Focus Fund.

The fund had delivered a remarkable annualised return of 18%, however, as can be seen in the chart above, the journey for investors in the fund throughout that decade was far from smooth. Nonetheless, that annualised return was more than 3% better than its nearest rival. The real question is how did the average investor fare throughout this volatile journey, and the sad answer is not very well at all. In fact, solely due to poor timing decisions, getting in when the fund was hot and panicking when it fell, the average investor in the CGM Focus Fund throughout the decade of the 2000s realised an annualised LOSS of 11%.

The fund, understandably given its performance, has a higher than average expense ratio which according to Yahoo finance is currently 1.2%. But the poor experience of the average investor in this fund was absolutely nothing to do with the fees it charged. It had everything to do with the poor timing decisions of investors. This brings up the very important question of what exactly is risk?

Risk?

Risk can take many forms, unfortunately for investors most fund managers see volatility as being the prime determinate of risk. This largely results from the broad acceptance of the Capital Asset Pricing Model. Investopedia introduces the CAPM as follows;

> The capital asset pricing model (CAPM) is a model that describes the relationship between systematic risk and expected return for assets, particularly stocks. CAPM is widely used throughout finance for the pricing of risky securities, generating expected returns for assets given the risk of those assets and calculating costs of capital. The general idea behind CAPM is that investors need to be compensated in two ways: time value of money and risk. The time value of money is represented by the risk-free rate and compensates the investors for placing money in any investment over a period of time. The risk-free rate is customarily the yield on government bonds like U.S. Treasuries.

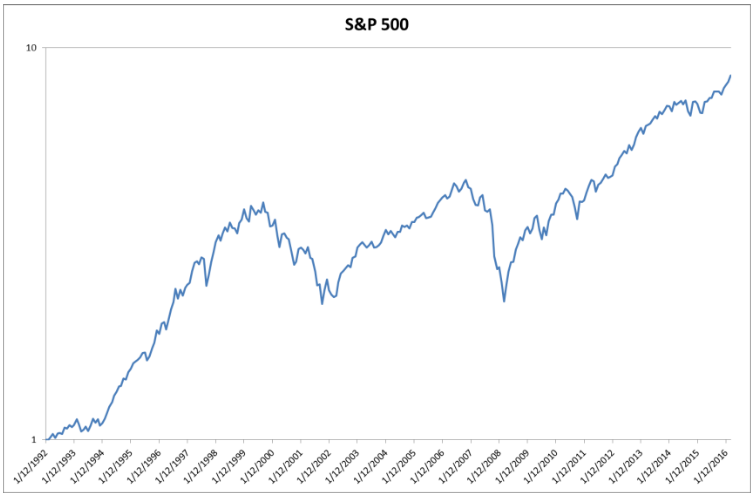
This leads to the conclusion that risk and return are related and that more risky (more volatile) investments should over the long term deliver a higher return. Unfortunately this is not the case. In his excellent paper from 2007, 'CAPM is CRAP (or, The Dead parrot Lives!)' James Montier highlighted the many shortcomings of the CAPM not the least of which is that higher volatility in no way means higher returns, not even over the long term. Quoting a study by Jeremy Grantham of GMO he shows from 1963 through to 2006 (which most investors would consider 'the long term'), that within the 600 largest stocks in the US market the best returns were achieved by the least volatile stocks and the worst, by a long way, were delivered by the most volatile stocks. As Montier puts it; 'the complete inverse of the CAPM predictions'.

Despite its obvious shortcomings the CAPM is still widely taught and the approach to portfolio construction, and optimisation processes that contributed to the development of and are derived from the CAPM, continue to be used, and risk (volatility) and return continue to be seen as inextricably linked.

Ironically, in one way they are linked, but not in the way that the CAPM would forecast. Risk for the individual investor is not volatility, at least not as measured by investment professionals. In my experience most investors love 'good' volatility, i.e. an investment whose price may be extremely volatile, particularly when compared to the market, but that is trending dramatically higher. Conversely they hate 'bad' volatility when an investment trades in a highly volatile, but downward trending manner. This obviously makes assessing any individuals 'risk' tolerance very tricky, and yet this continues to be an integral part of the process of portfolio construction for any investor.

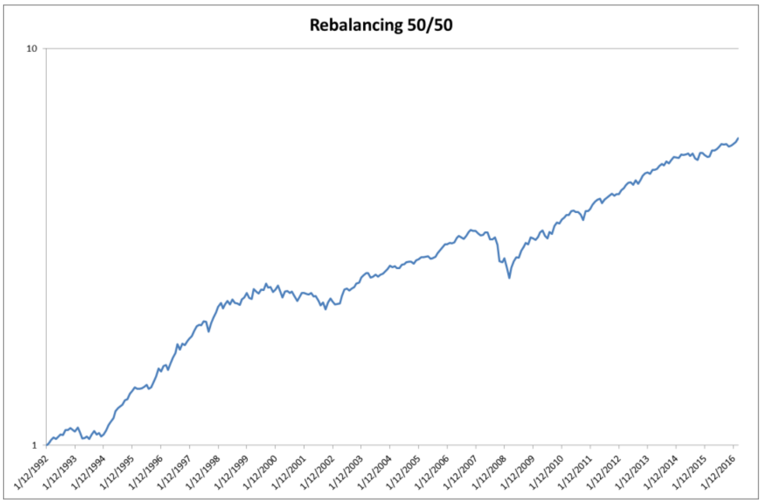
For most investor the single largest risk they face is the permanent loss of capital, this is obviously quite different to volatility. Unfortunately most investors contribute to their own permanent loss of capital through their poor decision making, as was highlighted in the CGM Focus Fund discussion. Investors loved the upward sloping volatility the fund enjoyed in the mid 2000s and flocked into the fund, but the downward severe volatility that followed in 2008 was too much for most to bear and so they panicked out, almost certainly at just the wrong time, and so locked in that permanent loss.

The solution to this dilemma, for individual investors seeking a long term satisfactory return, is not just to rely on passive funds. This may alleviate a small element of any longer term underperformance that they may experience through higher fees, but they are still exposed to the emotional challenge that severe downward volatility presents. A long term investor in the US market, investing in Vanguards very low cost mutual fund (VFINX) would have experienced the total return shown in the chart (left) over the last quarter of a century.



Over the entire period the compound annual growth rate has been a very healthy 9.25%, even with two historically painful bear markets. However, this raises the question as to whether the investor would have stuck with the fund from 2000 to late 2002 as the fund fell month after month and the outlook was supposedly only getting bleaker and bleaker. If they did survive that test, and many didn't (just as most investors did not stick with CGM Focus throughout), they then faced an even more severe test of their resolve five years later. The DALBAR statistics quoted earlier confirm that the majority did not stick with their funds through the trying periods of downward volatility.

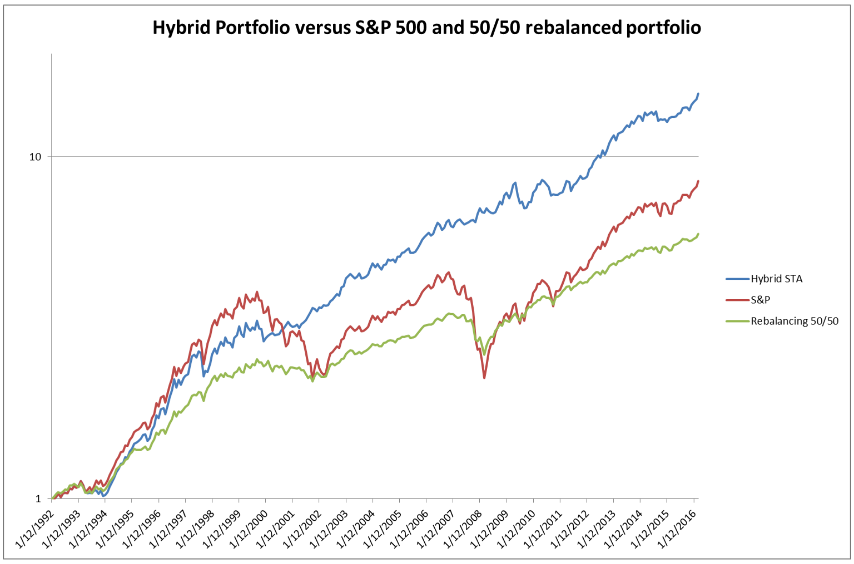
Most investors do not just invest in equities; many would be 'advised' to take a more 'balanced' approach and to split their investment in some way between lower volatility bonds and higher volatility equities. An investor who took this supposedly more prudent approach, and split their funds equally between the two asset classes and regularly rebalanced the funds would have experienced a lesser return but less volatility too, as shown in the chart (left).



In this example, using the low cost Vanguard S&P 500 mutual fund and the Vanguard intermediate treasury fund (VFITX), the return is not as good, a compound annual growth rate of 7.6% but the volatility has also been reduced. However, there would still have been some challenging periods through the deep equity bear markets.

In September of 2002 this rebalancing investor would be down 15% over the prior twenty five months and it would take more than another year before their fund was back to the levels it peaked at in 2000. This would have been a shocking change from the steady growth they had experienced throughout most of the 1990s. Then from late 2007 through to early 2009 this rebalancer would have endured a 25% loss over sixteen months. Not as severe as the losses endured by the pure equity investor but still probably enough to cause them to question holding any equities. This question would have been made even more real to them given the preponderance of 'expert' opinion then highlighting that equities did not actually outperform bonds over the long term and that the risk of Great Depression II was very high. The DALBARS statistics again imply that many investors would unfortunately have locked in those 'permanent losses of capital'.

A far superior outcome would have been achieved by either investor if they had thrown out the CAPM, ignored the risk assessment advice they may have received, and dared to be different in a highly disciplined manner. The chart below shows the results that would have been achieved by both the investors described above and one who invested solely in the S&P500 fund when it was above its 13 month moving average and switched into the intermediate treasury fund if, at the end of a month, it had fallen below its moving average. A simple approach that would have required monitoring only once a month (the same frequency as the rebalancer rebalanced), would have required a trade only once every sixteen months on average, and would have delivered a compound annual growth rate of 11.9%. This outcome is not only clearly superior in term of long term return, it also substantially reduces the risk of making the wrong decision at just the wrong time as even the largest drawdowns experienced were far shallower, and importantly briefer, than in either of the other examples.



The active versus passive debate is an important debate, particularly given as the global funds management business is reportedly the second most profitable business in the world. However, for most investors reducing their fees will be of little consequence if they continue to leave themselves vulnerable to the occasionally overwhelming urge to make just the wrong decision at just the wrong time.

Many readers have already expressed interest in accessing a vehicle that invests in the manner described above, if this approach is of interest to others please contact me on kevin@strategythoughts.com .

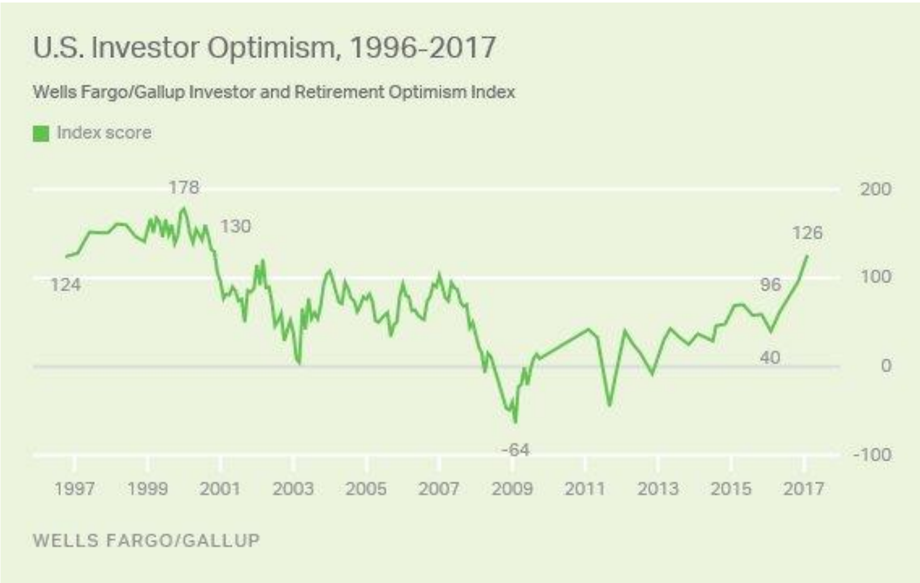
Optimism

Important inflection points in any market can always be seen, with the benefit of hindsight, as having occurred as a result of ever inflating expectations ultimately being disappointed, or of ever deflating expectations ultimately receiving a positive surprise. In real time the disappointment or surprise will not seem to be that bad, in the case of a peak, or that good, in the case of a bottom, but at an extreme of expectations it doesn't take much to actually be a disappointment or a surprise. With that as a back drop it was intriguing to see where expectations currently are in the US equity market. At the end of March the latest survey conducted by Wells Fargo and Gallup on investor and retirement sentiment was released.

Wells Fargo/Gallup Survey: U.S. Investor Optimism Rises to Highest Level in 16 Years

CHARLOTTE - March 23, 2017

The Wells Fargo/Gallup Investor and Retirement Optimism Index is at a 16-year high following a 30-point increase from fourth-quarter 2016 to +126 in the first quarter. Investors are now the most optimistic they have been about the U.S. investment climate since the dotcom boom in November 2000, when the index was +130.



Optimism is now higher than it was at any time in the build up to the GFC, and the only comparable period was, as noted in the article above, the peak of the DotCom boom. Optimism can fuel more optimism, and that is undoubtedly what has been happening over the last four or five years, but this virtuous spiral cannot go on forever as throughout the process expectations understandably grow, but so too does the risk of a disappointment. Given the survey above the risk of disappointment is now higher than it was in 2007, ahead of the worst bear market since the 1930s. Investors should not view such survey results as a source of comfort or a reason for even more optimism. At the same time as the Wells Fargo survey came out the latest Investup sentiment results were published and they too show even more optimism toward equities in the US and their measure continues to sit comfortably in the Greed zone.

Apple update

Over the last two years, ever since it was announced that Apple was going to replace AT&T in the Dow jones Industrial Average, I have been tracking and discussing the relative levels of expectations that surrounded each stock. Over that period there have been some remarkable ebbs and flows between the two company's stock prices. Eleven months ago I wrote;

> Expectations are beginning to change here too. A little over a year ago I highlighted the potential folly of getting too excited after Apple's stock was added to the Dow Jones Industrial Average at the expense of AT&T and have been monitoring the two stocks relative performance ever since. At the time of the switch I highlighted the markedly different performance of the two stock leading up to the switch and the understandably (but not necessarily useful) different expectations that industry analyst had for the two stocks.
>
> *Given this history it is not surprising that analysts hold quite different opinions on the former and new Dow stocks. AT&T is followed by thirty two analysts and twenty four of them (75%) have either a hold, underperform or sell opinion. Apple, on the other hand, is followed by forty nine analysts and only ten of these (20.4%) have a hold or underperform opinion. None have a sell opinion.*
>
> This was all written in the April 2015 edition of Strategy Thoughts in the wake of the Apple / AT&T switch taking place on the 18th March. Since then AT&T has risen about 10%, Apple has plunged more than 25% and the market as a whole has slipped about 3%. As an aside had the switch never been made the Dow would almost certainly be comfortably trading at meaningful new high.
>
> Despite Apple's poor performance the love affair with industry analyst continues, their average rating continues to be between a buy and a strong buy, this may highlight that the risk of disappointment continues. With AT&T however, the picture has changed with a marked improvement in the average analysts opinion to between neutral and a buy, and over the last few months there have been a number of analysts instituting new buy ratings on the stock.

Even though analyst may not be giving up on Apple the media has certainly been having a field day as the following Bloomberg headlines in the wake of the companies poor earnings report in late April highlight;

There's Something Rotten in the State of Apple

Apple Forecasts Second Sales Drop as iPhone Woes Deepen

Apple Becomes the Dow's Worst Performer

These headlines are a world apart from those being seen little more than a year ago when, with the stock trading at $130, Forbes wrote;

Apple Target Price Raised To $260

At the same time CNN reported glowingly that;

Apple stock is making regular

Americans rich

> And analysts from seemingly every Wall Street firm were playing leap frog with their own targets for the stock.
>
> Given this reversal in expectations, at least on the part of the media, towards the prospects for Apple now may be a sensible time for any trader that instituted the historically justifiable trade of buying the stock leaving the Dow and shorting the incoming stock to take at least some of their gains off the table.

Since then attitudes towards Apple have once again gone through another 180 degree reversal, and not coincidentally this attitudinal shift has coincided with a remarkable reversal in Apple's performance. Since May of last year Apple has risen more than 50% to a new all time high. Over that same period the Dow has risen 15% and AT&T has fallen 6%. I am certainly not suggesting yet another switch but this two year long journey following the ups and downs of AT&T and the downs and ups of Apple has certainly highlighted the importance and value of attempting to pinpoint just where expectations may be and where the extremes may be found. This has been particularly true when compared to following the so called fundamental assessments that go into analysts' earnings forecasts and price objectives, both of which, unfortunately and to some extent understandably, tend to be extrapolations of the recent past

Conclusion

Last month's Strategy Thoughts was titled 'Frustration' and the frustration that I was feeling then has only continued, and in some markets grown. But, as I wrote last month, now is not the time to lose discipline and join the ever increasingly frenetic chase of those assets where expectations are already so high. Opportunities will present themselves in the months and years ahead, but they will not be widely hailed as such and the mood will be substantially bleaker than is currently the case. Further disappointments will be expected and as expectations become increasingly depressed the environment will be far more conducive for positive surprises.

Kevin Armstrong

13th April 2017