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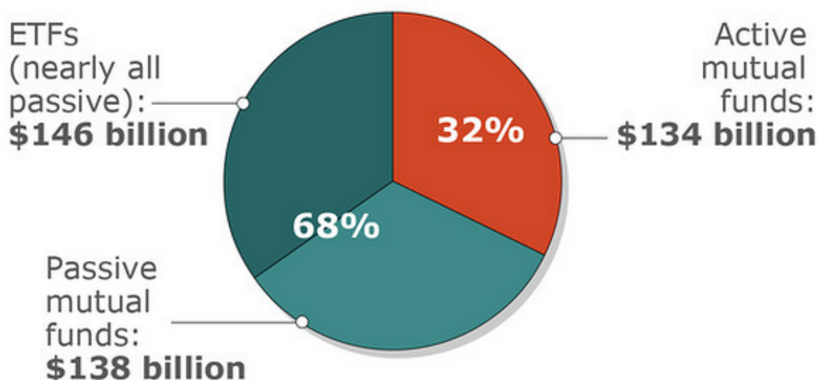
Indexation Creates Opportunity

Of late, the financial press has been filled with headlines about the rise (and commensurate fall) of passive (active) investing. This is one of those topics on which everyone has an opinion, and of course, we are no different, though our opinion takes a variant angle than the conventional conversation. First we will refer you back to our piece from October of last year on "Our 'Actively Passive' Investment Strategy".[1] The fact of the matter is, the true "debate" on active verse passive obfuscates many important points and in the spirit of conventional discourse, requires people actually subscribe to one camp or the other. As is typical with our starting point in such debates, reality is far more nuanced than the conversion.

Conventionally, passive means indexing, while active means any strategy that seeks to outperform the indices. Many practitioners define these terms differently depending on the context, though this definition offers a good starting point. A corollary of this argument has been the assertion that "if one cannot beat the index, then one should not invest actively and instead should simply invest in an index." This assertion has helped fuel the massive rise of passive assets under management:



[1] http://www.rgaia.com/october-2013-investment-commentary-our-actively-passive-investment-strategy/

In defining our own strategy as "Actively Passive" we mainly riffed on the key problems with active management as it is practiced today. We summed up the essence of these problems as "active" coming to be defined by actually being active in the form of forever increasing turnover (transactions) and being more about finding arbitrage opportunities, less about actual investment based on business fundamentals. To that end, a hallmark of our strategy is its aim to turnover no more than one third of the portfolio each year while the average portfolio today (inclusive of passive funds) turns over its portfolio more than 2.5 times each year. We do this because there is a very real opportunity to make good money in the financial markets by taking a longer-term timeframe and focusing intently on the fundamentals of the businesses in which we invest.

The discussion of "Actively Passive" was built on the notion that stocks are an asset class, in which investors essentially earn the yield on the equity (cash flow divided by market cap) plus or minus growth. With bonds, we understand simply how yield translates into return. Pay $100 par for a bond with a 5% yield and assuming default is not on the table, you know with certainty exactly what your return will be. Stocks, on the other hand, are similar and different. You do earn the yield of the equity, and for the sake of simplicity we will call this the free cash flow yield (cash flow from operations minus maintenance capital expenditures divided by market capitalization). But stocks introduce a lot more uncertainty than bonds and this is where the volatility in market prices comes from. Your bond-like yield will include a growth (or contraction portion) and a change in multiple over time (i.e. how much yield an equity owner is willing to capture from a given stock).

Since most active strategies today have such high turnover, the entire notion of equities as an asset class and capturing the yield they offer becomes an after-thought in the construction of a portfolio. Herein lies one of the reasons people like Jack Bogle have pushed most investors to simply index. By and large, the principles behind why passive management works can be deployed in active management, and that is part of what we do.

Let's for a second take a step back and do a little mental exercise. Were everyone in the world simply invested in indices and nothing else, what would happen? One obvious consequence would be how no one would be invested in companies that were not members of an index. Somewhere between such a world and where we are today is the creation of opportunity through the rise of what Murray Stahl calls "indexation."[2] As Howard Marks has taught us, the path to value and turning good investments into

[2] http://www.horizonkinetics.com/docs/Stahl_Report_Compendium_May_2012.pdf

great ones is through identifying a mistake in the market's price of a given asset.[3] The more widely watched a given individual security the more efficient that security's price. Were everyone to focus on indices and no one focus on individual securities, it's easy to see how the efficiency of individual securities would go down in the process.

We think there are three important ways that indexation creates opportunity in and of itself, and one important way that those who do not play the indexation game can further set themselves apart.

Three Sources of Opportunity:

1) ***Inclusion (exclusion) criterion*.** Certain companies get left out of indices altogether and thus become less followed, while others are included in indices though to a lesser extent because of concentrated ownership structures. This is directly related to our point above that were everyone to invest in indices only, then no one would invest in other companies. Since the dot.com bust and the Great Financial Crisis, there has been a whittling down of research desks on Wall Street. Increasingly research and investors alike focus exclusively on the same set of companies, all of which tend to be in one index or another. But there exist an abundance of companies who are in no index at all, with considerable investment merit in their own right. We spend considerable effort familiarizing ourselves with these companies, for even if we do not invest in one such company immediately, building our knowledge-base of off-the-radar companies provides us the necessary information to act if and when an opportunity does present itself.

2) ***The baby out with bathwater phenomenon*.** Indices create buying and selling pressure in its constituent securities that is independent of what these particular company's fundamentals dictate. When there are macro problems, people trim their exposure to indices. They do not ask themselves “does company X out of 500 deserve to be sold.” Rather, they sell the index and in doing so, there is selling pressure that flows through to individual securities. In each and every transaction there is a buyer and a seller. One of the arguments against active investing is “how do you know that the person selling you his shares does not know more about this company than you?” When the selling pressure is the result of index-based declines, then the answer is easy: the person not only does not know, he or she does not care. Such situations are not necessarily available at all times, but when they do exist, those with deep fundamental insight can use it to their advantage. It’s important to point out that the

[3] “It’s All a Big Mistake,” by Howard Marks.
http://www.oaktreecapital.com/MemoTree/It's%20All%20a%20Big%20Mistake_06_20_12.pdf

corollary is true as well; when the indices are simply rising, forced buying can come into stocks that do not deserve upside. This is a good time to be a strategic seller.

3) ***Mislabeled sector-level identification.*** Alongside the rise in indexation has come the proliferation of the "sector-based ETF." This has enabled passive investors to make investments in only those sectors they like and is a means to work around the indexation problem whereby in broadly diversifying, an investor inherently buys "good" areas to invest along with the "bad." As evidenced by biological taxonomy, us humans like things to fit neatly into hierarchies and labels. Reality is not so simple. For example, small cap growth companies are often thought of as young, new companies, but you can also have really old companies that were once large market cap behemoths, whose earnings and then stock price cratered, leaving a small cap company. If this company then finds growth once again, it becomes a "small cap growth" stock by definition despite being inappropriately lumped in with "young" companies. Should a company whose revenues are earned via selling newspapers, but whose value is in its real estate holdings be thought of as a newspaper or real estate company? Well, the way sectors work, this company would most definitely be lumped in with other newspaper companies. Further, does a company who uses the Internet be in a sector called "Internet" when their primary revenues are earned through advertising, or selling household products, or providing software as a service while that same sector excludes an old retailer who makes more money online than in its actual stores? These questions have real investment consequences that open up considerable opportunity, yet no clear answer in practice.

What non-Indexers can do differently:

In an index, an investor is beholden to the direction of the economy. To an extent, all investor are always exposed to this effect; however, it manifests itself differently for the long-term fundamental investor than it does for the indexer. An indexer by definition purchases his or her stake in an index and lets it sit idly by. This is so whether the index is cheap or really expensive, and herein lies the problem: Indexers by definition do not worry about valuation. They operate under the premise that "if you hold long enough you will simply earn the cost of capital." Yet it has been proven in countless different ways that the starting valuation at your point of investment considerably impacts what your long-term return will look like.

While it is generally true that when indices are expensive, so too are most stocks, but it is not uniformly true. There is a degree of rational flexibility available to the non-indexers not afforded to the purely passive investor.

In the most general sense, contrarianism is the way to make really good money in the stock market but contrarianism in and of itself is no panacea. One must be both contrarian and right in order to make do well. A market truism that persists over time is how when everyone does something (aka when something becomes conventional wisdom) it is exactly the time to do the opposite. The corollary is that when everyone ignores something is the time to be doing that very thing. The rise of indexing itself is one of the bigger factors creating opportunity in today's investment landscape. This does not mean that the non-indexer can beat indices in each and every timeframe, whether large or small, but it does mean that over the long-run non-indexers can put themselves in position to both earn the cost of capital of the asset class (essentially the average long-term return of the indices) and gain exposure to factors which with prudent analysis can lead to increased upside.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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