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Looking for Eldorado

Throughout history, humans have sought the mythical city of gold, Eldorado. Explorer, Sir Walter Raleigh essentially spent his life searching for it, but never succeeded. Eldorado represents something much sought after, but something that may not even exist.

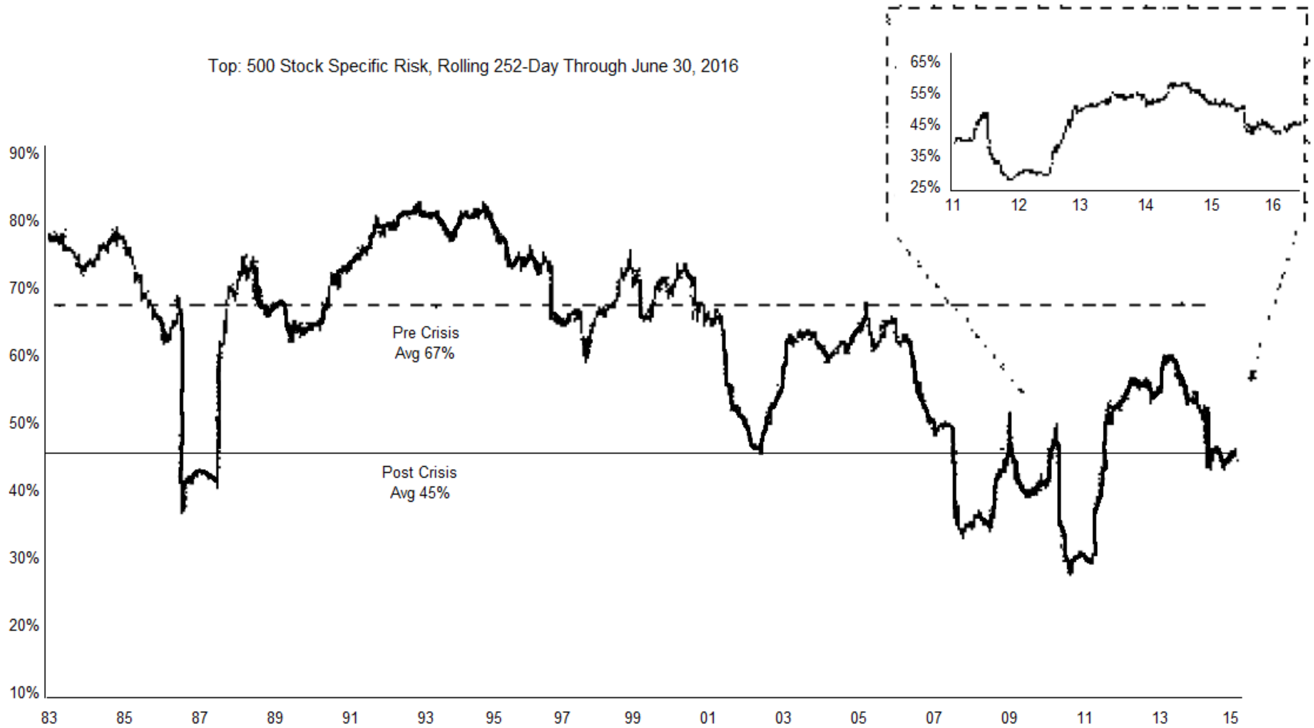
For centuries, humans have also been searching for a perfect investment vehicle. There is a long history of fads and fashionable new strategies that, at the time, offered a seemingly simple, dependable solution. Often these fads have led to overuse (manias) and then disillusionment. Author, Charles Mackay's "Extraordinary Popular Delusions" include vivid descriptions of financial manias such as the Mississippi and South Sea Bubbles and Tulip Mania.

What is extraordinary about the current investment fad, passive strategies or ETFs, is that they are not offering truly extraordinary results. They offer just less than average returns for low fees. But, they are a one-size-fits-all product. The other unique feature of ETFs is the speed and breadth of their acceptance: the sheer size of their growth over the last decade and the breadth of the product categories in which they are used is remarkable.

Yes, there have been tweaks and innovation to the original plain vanilla passive product; for example, the incorporation of low volatility, smart beta, leveraging, sector bets and factor bets into this approach. More innovations will come and more regulation will follow. Humanity tends to overdo a fad until a minor flaw becomes a major one.

A major concern with ETFs is pro-cyclicality. Investors are gathering together in a crowd in a similar constructed product with multiple embedded components. Given the popularity and growth of ETFs over the last decade, they have proven that they can easily be constructed with no constraints on one-sided buy days. But, how do you suppose ETFs might do if another "Black Monday" occurs again, when equity markets fell more than 20 percent in one day, stock trading quotes were halted and delayed, and computer systems crashed? It is likely that if another market crash were to happen, some ETFs would cease trading, shocking those investors who may not have read the prospectus quite thoroughly enough.

The other issue related to pro-cyclicality is the diminishment of stock-specific risk that is typically embedded in security pricing. The chart below demonstrates that pre-crisis, 70 percent of average stock performance was idiosyncratic, but that dropped to approximately 50 percent in 2016. We believe that the growth of passive investors buying indexes significantly contributed to the price movement in index stocks and squeezed out the stock-specific pricing.



Source: Morgan Stanley, Disruption, Asset Management: Disruption Looms; How to Survive the Storm, July 12, 2016.

Further, Israeli, Lee and Sridharan's "Is There a Dark Side to ETFs?" highlights the growing inefficiency of pricing of underlying securities over time. Some of the issues include: higher trading costs, increase in stock return synchronicity, muted price response following earnings announcements and decline in number of analysts covering a company. These factors can lead to less efficient security prices.

Stock prices may become untethered to intrinsic value in the short run, but history teaches us that in the long run true values are realized. The unanswerable question for now is: when is there too much money invested in ETFs relative to active managers, such that the overall market is no longer efficient and the benefits of passive investing become deficits?

Stock markets have 200 years of trading to analyze; they have experienced inflation, deflation, wars, good and bad governments, capital gains taxes and more. We have a pretty good idea of the magnitude of volatility and return. Passive strategies, on the other hand, have only been around since the mid-1970s. ETFs have less than 20 years of history, and never in the current volume. Notably, we don't have detailed historical precedents on how they will behave in the fullness of time.

We are now at a stage in market development where critics of ETFs can be labelled too old fashioned and stuck in the old ways; unwilling to embrace the new. At Sionna, we are students of history and skeptical of new products and approaches until they have been proven through a number of market cycles. That's why we continue to focus on active stock picking, and the historic data that supports this strategy.

Over the long term, we believe that a proven approach, like the one we follow at Sionna, will serve our clients better than searching unsuccessfully for the mythical Eldorado of investing.

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