Epsilon Theory

THEORY IN ACTION BY RUSTY GUINN

I Am Spartacus

The Five Things that Don't Matter: Part I

March 15, 2017

Herald: I bring a message from your master, Marcus Licinius Crassus, commander of Italy. By common of His Most Merciful Excellency, your lives are to be spared! Slaves you were, and slaves you remain. But the terrible penalty of crucifixion has been set aside on the single condition that you identify the body or the living person of the slave called Spartacus.

Antoninus (Tony Curtis): I am Spartacus!

Other Slaves: I'm Spartacus!

—Spartacus (1960)

We are all active managers, friends. The sooner the better that we realize this and start focusing on the when and why it makes sense for investors, instead of wishcasting "good environments for active management" that don't exist. While we may not be obscuring each other's identities, it's probably time for more of us to stand up and say, "I am an active manager!" Although, I suppose it is worth mentioning that shortly after this scene, Spartacus is forced to kill his best friend before being crucified.

"Active management is a zero-sum game before cost, and the winners have to win at the expense of the losers."

—Eugene Fama, Ph.D., *Investment News*, October 7, 2013

Walter Sobchak: Am I wrong?

The Dude: No, you're not wrong

Walter: Am I wrong?

The Dude: You're not wrong, Walter. You're just an asshole.

Walter: All right then.

—"The Big Lebowski" (1998)

"You heard about it? Yeah you had to.
Mm hmm I know you changed your mind,
You ain't the only one with bad news.
I know that it made you feel strange, huh?
You was right in the middle complainin'
and forgot what you was cryin' about."

—Mystikal, "Bouncin' Back" (2001)

Ahchoo: Look, Robin, you don't have to do this. I mean, this ain't exactly the Mississippi. I'm on one side. I'm on the other side. I'm on the east bank, I'm on the west bank. It's not that critical.

Robin: It's the principle of the thing.

—"Robin Hood: Men in Tights" (1993)

It seems like every few years the debate on active vs. passive management comes back in full force—not that any of this is new, of course. DFA, Vanguard, and brilliant investors and writers like Charlie Ellis have been shouting from the mountaintop about what a waste of time active management is for decades now. So why the breathless excitement from the financial press on the topic this time?

Mostly because they haven't the faintest idea what they're talking about.

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Don't mistake me: Charlie Ellis isn't wrong. Jack Bogle isn't wrong. Gene Fama isn't wrong. But the basis for the broader active vs. passive debate is misleading at best, and outright fraud at worst. Let's get a few objective, unequivocal facts out of the way about active management:

1. There is no such thing as a "good" or "bad" environment for active management.
2. Everyone—including you, dear reader—is an active investor.
3. Costs matter. The rest of this debate is a waste of time.

This is why the debate over active vs. passive is #1 on my list of Things That Don't Matter.

The myth of the good or bad environment for active management

Most investors have at least a passing familiarity with the notion of the zero-sum game. It is an academic and logically sound construct which says that if one investor is overweight or long a particular security relative to its market capitalization weighted share of that market, it stands to reason that another investor must necessarily be underweight or short.

This is true to the point of tautology, and there's no disputing it. It's true, and it's used as the fundamental, deterministic argument for why active management can *never* work. If every winner is offset with a loser and everyone is paying fees, over time the house is going to win. It's also why Dr. Fama has famously and accurately said that if the data shows that active management is working, then the data is wrong.

But if this is the case, how it is possible that there are "good" or "bad" environments for active managers or stock pickers? Wouldn't every environment just be equally bad to the tune of the drag from fees and expenses? If so, why are we talking about this historically bad period for fund managers?

The reason we are talking about it is that practically every study, allocator, advisor, researcher and article covering this topic considers passive management in context of a particular benchmark or index. However, not every pool of assets benchmarked against an index is necessarily seeking to outperform that index on an absolute basis. Even more to the point, these pools certainly don't confine their investments to constituents of that index.

If you weighted each of the benchmarks used by investors, funds and institutions by the value of each of those pools of capital, you would end up with something that looked very different from the market capitalization of the world's financial assets. By way of the most obvious example, I suspect that the total value of pools of capital that benchmark themselves formally against the S&P 500 Index ("S&P 500") vastly exceeds the market capitalization of the S&P 500 itself. The value that does so informally is probably many multiples of that.

The way that this plays out in practice is surprisingly consistent. Consider a U.S. large-cap strategy. There are four biases that are ubiquitous—uniform might be nearer the mark—among both actively managed mutual funds and institutional separate accounts:

- investments in small- and mid-cap stocks
- investments in higher volatility / higher beta stocks
- investments in international stocks
- cash holdings

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In other words, there is no good or bad environment for active management. There are good or bad environments for the relatively static biases that are almost universal among the pools of capital that benchmark themselves to various indices.

If you are an allocator, financial advisor or individual investor, you heard from your large-cap fund managers during the first half of 2016 how bad an environment it was for active management. Maybe they said that the market is ignoring fundamentals or that everything is moving together or that the market is adopting a short-term view.

That's about 50% story-telling and 50% confirmation bias. It's also 0% useful.

In an overwhelming majority of cases, that environment is simply one in which either small-caps underperformed or high beta / high-risk stocks did.

From the same investor vantage point, the second half of 2016 probably looked different. We often say that we don't have crystal balls, but I have a very reliable prediction about your annual reviews with your U.S. large-cap managers. They will inform you that "fundamentals started mattering again" in the second half of the year. The market started paying attention to earnings quality and management decisions and [insert generalization that will fill up the allotted time for the meeting here].

No they didn't.

Small-cap and high-beta or high volatility stocks bounced back really hard. When you do your review with your active small-cap managers, you may be surprised when they, on the other hand, are doing so poorly relative to their benchmarks. Why? Because small-cap managers manage portfolios that are practically always above the market cap of the Russell 2000 Index ("Russell 2000") and nearly uniformly underperform when small-cap is trouncing large-cap.

Let's take a look at how and why this is. The chart below splits up every month from January 2001 through January 2017 by the spread between the return of the Russell 2000 Index and the S&P 500. The chart plots the average excess return of each of the funds in the Morningstar Large Blend category against the S&P 500 by how pronounced the difference between small and large caps was for the period. In other words, what we're looking at is whether large cap funds have done better or worse vs. the S&P when large caps are outperforming small caps in general.

The results are stark. In the bottom decile of months for the large vs. small spread (i.e. the 10% of months where small caps do the BEST), large cap blend managers outperform the S&P by an annualized rate of just over 4%. By contrast, in the top decile for large cap vs. small cap, they underperform by an annualized rate of nearly 5%!

Those bad environments for stock picking your fund managers are so fond of telling you about? They're only bad because almost all of your active managers are picking riskier stocks and putting small- and mid-caps in your large-cap fund.

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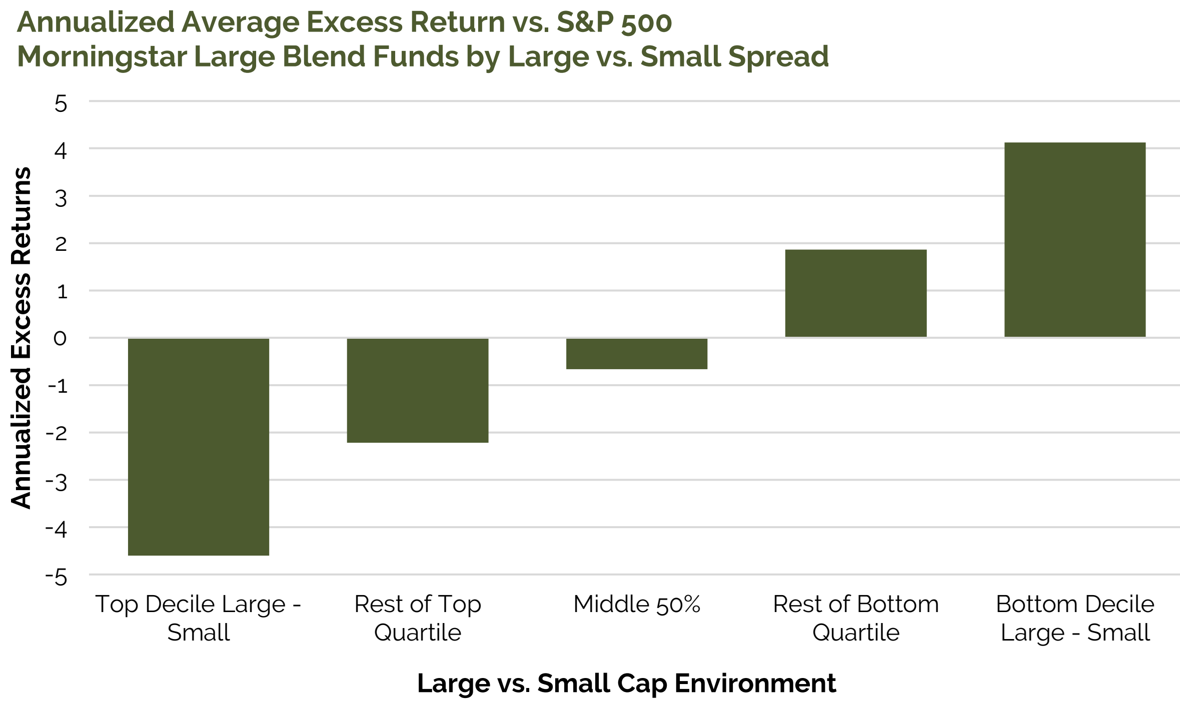

Sources: Bloomberg, Ken French U.S. Research Returns, Morningstar as of 01/31/17. For illustrative purposes only.

Unfortunately for those of you who breathed a sigh of relief in August and September of 2016 because your active managers were 'working' again, this doesn't mean your fund manager had a flash of brilliance from the patio of his Southampton rental. Low beta just spat up all the excess returns it generated in the first half of the year.

These kinds of biases are not confined to large cap US equity managers, of course. As mentioned, your small cap managers are usually going to get smoked when small caps are roaring. Your international equity managers are all buying emerging markets stocks around the edges of their portfolios (that's why they were geniuses until the last 3 years or so, and now you think they're stupid). Your fixed income guys are just about all doing "core plus" even if they don't say so on the wrapper. Your long/short equity and event funds have persistent sectoral biases.

Every category of active management its own peculiar but fairly persistent bias against its benchmark.

OK, so active managers have consistent biases. So what? It still rolls up to the same zero sum game, right? Yes, but it's useful to think about and understand what's going on underneath the hood. Namely, since we know that actively managed large-cap mutual funds and institutional separate accounts are usually *underweight* mega caps, large-caps and lower risk stocks relative to the passive universe, we must fill in the gap: who is *overweight* these stocks to offset?

The answer is, well, strategies other than large-cap strategies, or ones that are not benchmarked to the S&P 500 or Russell 1000 Index ("Russell 1000"). That can include a wide variety of vehicles, but at the margin it includes (1) hedge funds, (2) individual or corporate holders of 'un-benchmarked' securities portfolios and (3) portfolios that are targeting a sub-set or variant of the large-cap universe. Clearly it also includes all sorts of strategies benchmarked to other markets entirely, one of the most

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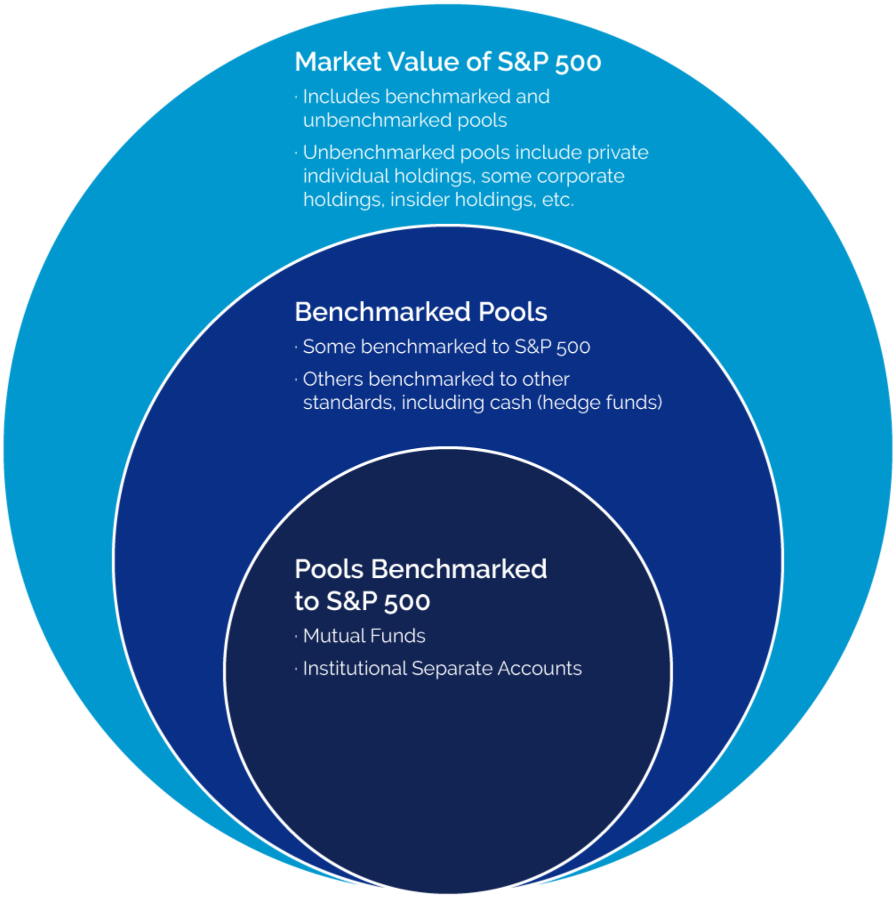
common examples being multi-asset portfolios. As illustrated in the exhibit below, the S&P 500 is very obviously not completely owned by pools of capital that are benchmarked to the S&P 500.



Hedge funds provide us with the most exaggerated example of one of the ways this happens. Let's presume that large-cap mutual funds are underweight low volatility mega cap stocks to the tune of $50 billion.

Now let's examine two cases—in the first case, $25 billion in hedge fund capital is deployed to buy all $50 billion of that on a levered long basis. In the second case, $100 billion of hedge fund capital is used, meaning that the funds chose to hold 50% cash and spent the remaining 50% on the mega cap stocks.

If the S&P 500 is up and a particular publication wants to talk about hedge fund returns, they're going to talk about the first scenario as a heroic period of returns for hedge funds. In the second scenario, hedge funds are a scam run to prop up the richest 1%. Neither is true, of course—well, not on this basis alone, at least—because the benchmark isn't capturing the risk posture that an investor is using as part of its asset allocation scheme to select that investment—in this case a long/short hedge fund.

Consider as well that many of the strategies that are 'filling in' for active large-cap managers' underweights to Johnson & Johnson and ExxonMobil do so in tactical or multi-asset portfolios, many of which are going to be compared against different benchmarks entirely. Still, others may be executed under minimum volatility or income equity mandates. When you consider that the utility

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functions of investors in these strategies may be different, and that one investor may reasonably emphasize risk-adjusted returns rather than total returns, or that two investors might have meaningfully different needs for income in context of their overall financial situation, the argument starts to get very cloudy indeed.

There is no such thing as a passive investor

So when faced with an income objective like the example above, the response of many in the passive management camp is typically some form of, "Well, just buy more of a passive income equity fund, or move more money to bonds."

It is this kind of argument that exemplifies why this active vs. passive debate feels so phony, so contrived. As it is too often applied, the mantra of passive management emphasizes avoiding funds that make decisions that many those allocators/advisors/investors will then make themselves and charge/pay for under the guise of asset allocation.

If a fund manager rotates between diversified portfolios of stocks, bonds, credit and other assets based on changing risks or income characteristics, he gets a Scarlet A for the vile, dastardly active manager he is. If an investor or allocator does the same thing by allocating between passively managed funds in each of those categories, he posts about it on Reddit and gets 200 up-votes.

If a fund manager invests in a portfolio of futures (cheaper passive exposure than ETFs, by the way) to reach a target level of risk and diversification without trying to pick individual securities at all, just go ahead and tattoo the "A" on their deserving forehead in permanent ink. If an investor or allocator does the same thing to build a portfolio that is equally or more distinct from a global cap-weighted benchmark using more expensive ETFs, we can only celebrate them and hope they pen a scathing white paper on the systemic risks embedded in risk-targeted investment strategies.

Everyone is doing the same things—and usually paying for it—in different ways. To paraphrase Achoo (bless you), some of you are on the east bank and some of you are on the west bank. But this ain't exactly the Mississippi. It's not. That. Critical.

What IS critical is understanding why this debate occupies such an august (notorious?) spot on this list of Things that Don't Matter. And here it is: I am fully confident that not a single passive investor owns a portfolio of global financial assets in the respective weights of their total value or market capitalization. Instead, they allocate away from the cap-weighted global financial assets standard based on (1) their risk appetite, (2) in order to better diversify and (3) to satisfy certain personal goals around income and taxes.

Let's put some figures on this. Using a simple methodology from public sources (while acknowledging without having access to his letters that Paul Singer has adopted a similar approach) as of the end of 2015 or 2016—we're talking big numbers here, so the timeliness isn't that important—global investable assets look something like the pie chart below.

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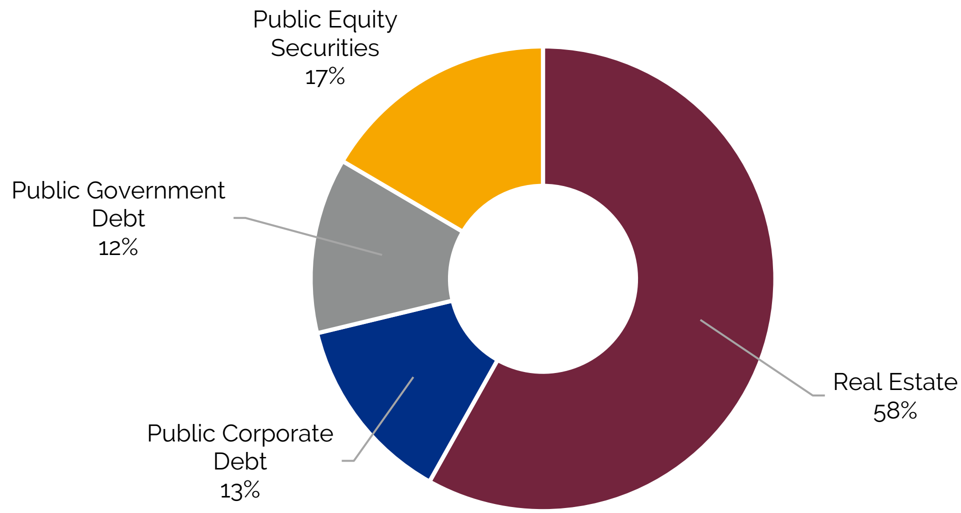
Estimated Share of Global Market Cap



Sources: BIS, Savillis, World Bank. For illustrative purposes only.

Yes, there's overlap here. Yes, if you added in capital raised to invest in private companies it would add another 1.2% to equities, and including insider holdings in private companies would expand this more (although debatably). It also doesn't include a range of commodities or commodities reserves because of the (generally) transitive nature of the former and indeterminate nature of the latter. But it's good enough for our purposes. So does your portfolio look like this? If not, let me be the first to initiate you into the club of active managers.

Every investor is an active investor when it comes down to the major dimensions of asset allocation: risk, diversification, income and liquidity. Eliminating strategies as "Active" because they take seek to manage risk, improve diversification, increase income or take advantage of greater (or lesser) liquidity is wrong-headed at best and hypocritical at worst. Most of all, it harms investors.

The S&P 500 example is not universally applicable, of course. Public large capitalization stocks are well-covered by indices, and so index funds that track the S&P 500 or Russell 1000 are generally sound examples of vehicles seeking to avoid the pitfalls of the zero sum game. That is not always the case, however.

One example of this I like to use is the Alerian MLP Index. It is a perfectly acceptable representation of the energy MLP market, and deserves credit for being the first to track this growing asset class. It tracks 50 key constituents with around $300 billion in total market cap. The overall universe of listed midstream energy companies, however, is closer to 140-150 and sports a market cap of nearly $750 billion. There are several index funds and ETFs that track the index, and dozens of so-called actively managed funds that include a higher number of securities that look rather more like the cap-weighted market for energy infrastructure!

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A more mainstream example of this might be the Dow Jones Industrial Index, famous for being used by CNBC every day and by a professional investor for the last time in the mid-1950s. This index of 30 stocks covers only a fraction of the breadth of listed stocks in the United States with meaningfully different characteristics on a dozen dimensions, and is tracked by a "passive" ETF with roughly $12 Billion in assets. Meanwhile, cheap large-cap mutual funds and accounts with 120 holdings built to deliver higher than typical income at a lower volatility than the market are "actively managed." To make matters more complicated, many asset classes that are a meaningful—*and diversifying*—part of the cap-weighted global market simply do not have passive alternatives.

There is a wonderful local convenience store chain called Wawa where I went to college. I had a…uh…friend whose laziness was so well-developed that his diet was entirely driven by what was available at Wawa. If they didn't have it, he didn't eat it. Now, there are all sorts of delightful things to be had there, so don't get me wrong. But if you've got something other than hot dogs, ham sandwiches or Tastykake Krimpets on your mind, you're out of luck.

I'm sorry to say that the Index Fund Wawa is fresh out of vehicles owning securities issued by private companies, listed securities in certain niches of the markets (e.g., preferred securities in real estate) with meaningful diversification and income benefits, less liquid instruments and others unable to be held in daily or continuous liquidity vehicles. Many of these strategies have significant diversification potential and roles within portfolios. Many are highly effective tools for adding income, efficient risk mitigation or other characteristics to portfolios. Many may even have higher expected returns or risk-adjusted returns. But you'll have to leave the Wawa to get them.

None of this even begins to venture into hedge funds and other alternative strategies, and how they ought to be considered in context of the overall debate. To be sure, the answer is probably to observe that the same criticisms and defenses that can be brought to bear against (or on behalf of) active management apply to strategies like this as well.

But to a great extent for hedge funds (and to a lesser one for traditional strategies), there are sources of return that can be consistently exploited that have nearly the same empirical and fundamental underpinnings of market exposure as a source of return. At their core—and consistent with how we discuss them in Epsilon Theory—they are almost universally an expression of human behavior. Whether expressed through premia to value, momentum or carry premia, or else biases investors have toward quality, lottery payoffs, liquidity and the like, the great irony is that the most successful actively managed strategies are those that exploit the fact that investors are drawn to the appeal of active management under the guise of 'beating the market.'

For this reason, it is somewhat baffling to see the disdain with which passionate passive investors treat many alternative strategies. **If we believe that active management can persistently lead investors to predictable bad outcomes driven by understandable behavioral biases and responses to information, why would we be averse to approaches that seek to exploit this?** Most investors can, however, see the forest for the trees on this issue. That is the reason why, despite the

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contraction in actively managed strategies more broadly, most projections for the market for liquid alternatives posit a doubling of assets in the space between 2015 and 2020[1].

Costs matter (and the rest of this debate is a waste of time)

Now admittedly, I have waited quite a long time to talk about one of the principal concerns around many actively managed strategies: cost.

In coming around to this critical consideration, it is worth circling back to the indisputable fact that Bogle, Fama and Ellis are *right*. Trying to beat the market in most markets by being overweight the right stocks and underweight the right stocks is a loser's game. Doing that and paying fees for it makes it an *expensive* loser's game. The reality is that investors need to put the pitchforks away and ask themselves a set of simple questions when considering actively managed funds:

- **Portfolio Outcomes**: For a fund that is making active decisions that I would be responsible for in my asset allocation, like risk targeting, biasing toward income and yield or improving portfolio diversification, do the benefits justify the cost?
- **Incomplete or Non-Existent Indexes:** When an active fund provides better diversification or coverage of an opportunity set, or covers an investment universe that is not investable through passive solutions, do the benefits justify the cost?
- **Exploiting Bad Behaviors:** When investing to exploit the behaviors of other investors who are trying to beat the market to increase returns or improve risk-adjusted returns of my portfolio, do the benefits justify the cost?

It shouldn't be any surprise that this will often lead you to the same conclusion as a passive management zealot, because adding value that justifies the cost on the above dimensions is still really hard. But because it won't always be the case, the process matters, and the code you follow to draw your investment conclusions matters. Active management should be evaluated with the same critical eye and cost/benefit analysis every one of us use when we make active decisions in our portfolio design and asset allocation.

[1] Both PWC and McKinsey's work on this topic comes highly recommended.

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