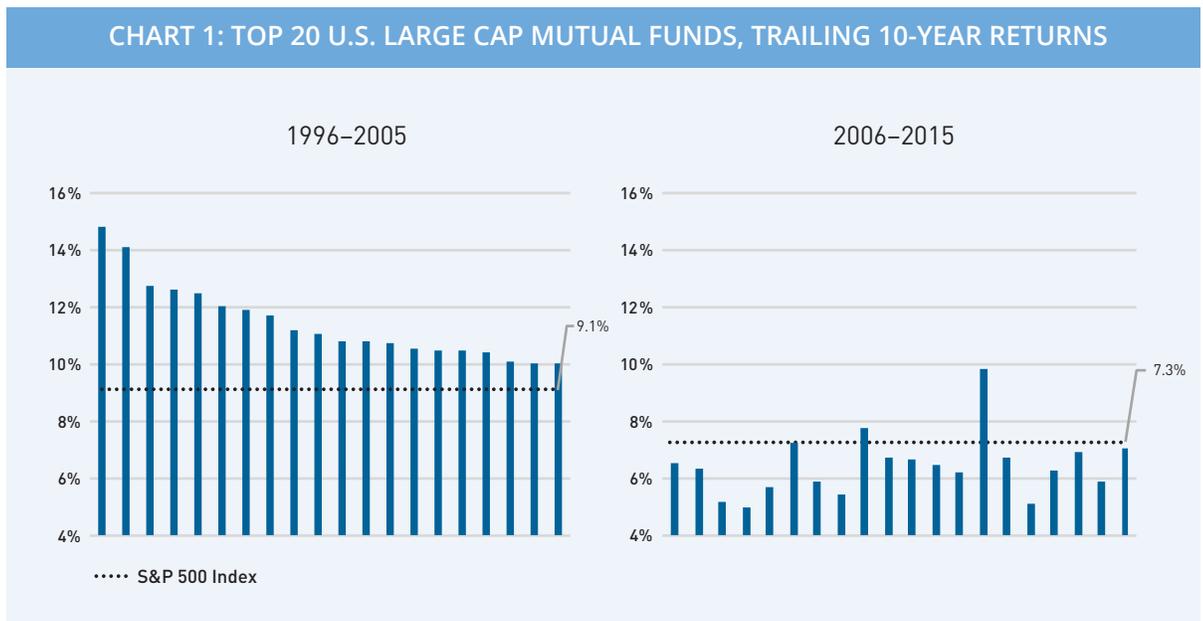


Thoughts on the Active-Passive Debate

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SBH ALL CAP EQUITY OCCASIONAL PAPER

A front page article in the Wall Street Journal on Oct. 17, 2016, entitled “The Dying Business of Picking Stocks,” was one more example of a steady flow of stories about the supposed demise of active management. The article pointed out that the top-performing domestic equity mutual funds from the period of 1996 through 2005 had not performed nearly as strongly in the following 10-year period. Please see below for a chart displaying this phenomenon.

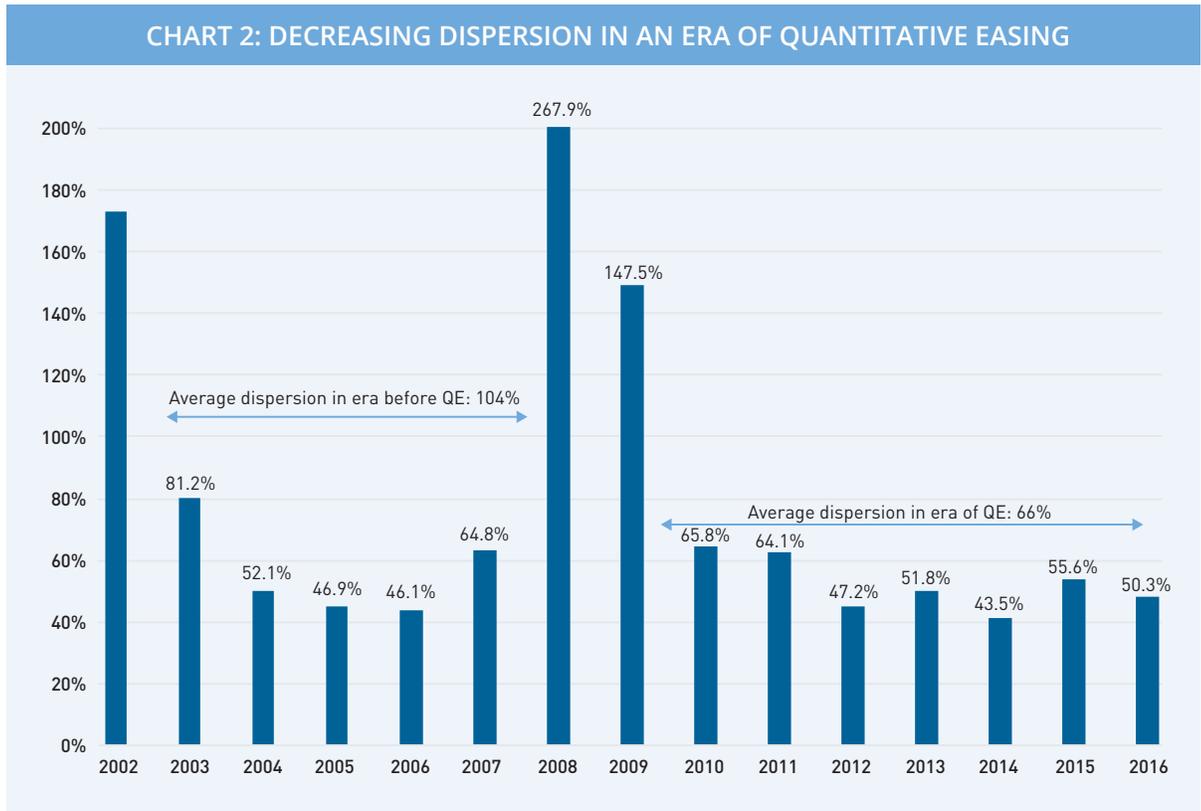


Note: Data reflects the performance of the top-performing 20 large cap core mutual funds (excluding exchange-traded funds) for the period of January 1, 1996 to December 31, 2005 and their subsequent performance from January 1, 2006 to December 31, 2015. Only mutual funds with a track record fully covering both periods were considered.

Source: Lipper, FactSet, SBH

What the chart shows is the experience of the 20 top-performing mutual funds for the 10 years ending in 2005 and their subsequent experience in the 10 years ending in 2015. Drawn across each of the columns is a dotted black line showing the results of the benchmark S&P 500 Index over these time periods. In the column covering the earlier decade, the line (index) sits roughly in the middle of the column. In the latter decade, the index is virtually at the top. In other words, actively managed funds had the potential to outperform “back then,” but had almost no chance to do so of late. As my geometry teacher in high school would put it: “Q.E.D.” (a Latin abbreviation meaning “which is what was to be shown”).

I had an entirely different response. What else can one notice about the two columns? For one, the second column is considerably shorter, indicating that the range of outcomes in the second 10-year period was considerably more constrained. This heightened correlation of stocks to each other, or, put slightly differently, this lower dispersion of returns, is somewhat aberrational. It is, we believe, one of the pernicious byproducts of the unconventional monetary policies implemented by all of the central banks around the globe in the last seven years. Consider the chart below.

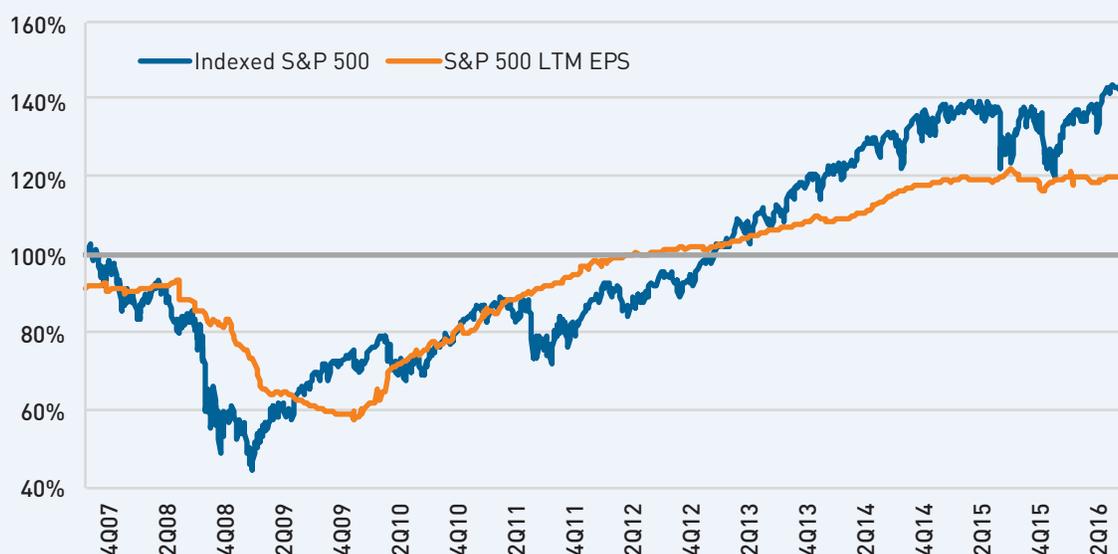


Note: Data reflects the average of percentage difference between the intra-year high and low for S&P 500 Index constituents, as a percentage of the low for each year.

Source: SBH, Strategas Research Partners, S&P, FactSet

The chart shows the degree of dispersion exhibited by the S&P 500 Index in the six years before QE was implemented and the seven years in which it has been used. The data shows that the degree of price change in the average S&P holding over the course of a year was roughly twice as great in the period before QE than in the period thereafter. As Ben Bernanke, Chairman of the U.S. Federal Reserve (Fed) explained in 2010, one of the Fed's avowed goals was to boost asset prices in order to kick-start the economy. Indeed, in the fixed income markets, there has been a strong relationship between higher credit risk and return in this period. Equities, at the very bottom of the capital structure (i.e., the riskiest part), top the list. The Fed has achieved one goal (raising asset prices) but not the other (kick-starting the economy.) Note the disconnect between the growth in stock prices and the growth in corporate profits of late. The stock market continues to rise even as earnings have plateaued and fallen. Investors have continued to push valuations higher even though earnings advances have not warranted such enthusiasm. Chart 3 shows this growing disconnect. It is no stretch of the

CHART 3: U.S. EQUITY RETURNS ARE SEPARATING FROM FUNDAMENTALS



Source: FactSet, Bloomberg, S&P

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imagination to see that the rise in stock prices has been the result of monetary policy engineering by the central banks, which currently involves buying bonds and stocks (the latter being done by foreign central banks, but not the Fed) in exchange for new debt. It is not unreasonable to assume that such policies cannot be sustained indefinitely. After all, at some point — when the relationship of debt to GDP exceeds traditional bounds — investors will no longer buy additional debt. When and as these buying programs are ended by the central banks, either because they destabilize financial markets or simply because they have lost their efficacy, asset prices will no longer be subject to the almost gravitational pull of these policies, which have so neatly aligned with returns. In short, dispersion will return. And when it does, we should all recall a famous saying attributed to Napoleon: “Ability is nothing without opportunity.” We believe that active management has not worked as well in the last decade primarily because it has been suppressed by the overwhelming power of central banks and their printing presses. Turn those presses off and manager skill will be allowed to express itself. It should come as no surprise that indexing has achieved almost cult-like status. Over the years, many strategies that have had periods of success over multi-year periods have been heralded as the “Solution” – i.e., the approach to investing that will produce superior rates of return. A great deal of research will be written, demonstrating (Q.E.D.!) the virtues of the strategy. Wall Street excels at taking reasonable ideas and driving them to their absurd conclusion.

A short walk down the memory lane of my career calls many examples to mind. In the early 1970s, the “Nifty Fifty” (a group of consumer product and drug companies, many still around, some not) were known as the “one-decision” stocks. Investors merely needed to pick the time to buy because these stocks would never need be to sold. Their earnings were projected to grow in almost straight-line fashion because the businesses were so dependable. Their valuations peaked around 70x earnings. In due course, many of those valuations fell to the mid-teens. This was followed by a boom in energy stocks following the second oil embargo in the late 1970s. The mantra was to buy energy stocks

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because the world was running out of crude oil, and as oil became more scarce, it would only get increasingly more valuable. After peaking above \$30 per barrel, oil prices bottomed at around \$10.50 per barrel¹, bringing down the shares of energy companies with them. The late 1980s brought the innovation of “portfolio insurance,” a way of hedging a portfolio with put and call options that would guarantee returns. It worked until the Fallacy of Composition — which states that people infer that something is true of the whole because it is true of some part of the whole — kicked in. When “everyone” tried to insure their portfolios using the same approach, it stopped working, which was brought home vividly in the Black Monday Crash of 1987. More recently, the late 1990s brought the Tech bubble and subsequent crash, which was followed by the popping of the residential real estate bubble in 2008.

Now indexing is the strategy of the hour. It will work ... until it doesn't. (These bursts of enthusiasm seem to repeat in some variant over seven to 10 years, usually towards the end of a decade. I have no good idea why.) Once the unprecedented monetary policy of recent years inevitably ends (as it indeed has to), we expect dispersion to return to more normalized levels. This should greatly expand the opportunity set for active managers. At the same time, investors in passive strategies will merely be able to ride the overall performance of the market. Fees on indexed strategies will almost definitely remain lower than those of active strategies, but investors will be getting only what they pay for — no more, no less. While indexing with low fees may seem like a great deal during an unprecedented bull market — driven by extraordinary support from central banks — investors may end up disillusioned as they are forced to settle for mediocre returns once that support goes away. After mediocre returns no longer appear satisfactory for many investors, we believe that paying a bit more for skill will resume being seen as a rational decision. Consider the legal profession. Fees overall for lawyers are generally under pressure these days, but the fees for top-notch lawyers stay high. And law, at least the courtroom part of it, is truly a zero-sum game. If the plaintiff wins, the defendant loses, and vice versa. Yet no one ever suggests going to trial with just an average lawyer because it saves on fees. The only successful approach to investing requires adherence to a well-thought philosophy applied through a consistent process with skill. A large dollop of luck doesn't hurt. Anything else is just a fad.

¹ Source: U.S. Energy Information Administration



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