Greenwich
Roundtable Quarterly*
2018
EXPLORING NEW FRONTIERS OF INVESTING

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The Next Big Thing

As an old-school investor I believe that the principles of investing haven't really changed and I've managed to resist most if not all of the fashion trends that have come and gone. Running the Roundtable for the past 23 years I've had a front row seat. The risks have been incredible but the new ideas and exotic strategies have been equally breathtaking. In 1993 I remember being very skeptical of the internet. Two years later after meeting with a former colleague from Bloomberg I came away with an overwhelming sense that this offspring of DARPA would revolutionize everything. And it did.

After our Board meeting in October, longtime trustee and venture capital connoisseur Peter Lawrence pulled me aside to say that he was working on a big subject. I was thrilled for two reasons. Peter has always been ahead of the curve and his GR sessions are reliable leading indicators. Later when I heard the subject was Crypto Assets it struck me as another short lived fashion. On the night before the session Peter organized a private dinner with Brad Burnham and the speakers. I walked into the dinner with more than healthy dose of skepticism although I was looking forward to listening to Brad who two years earlier alerted us to this new block chain technology. The conversation was compelling. These young people were working on the next big thing. I came away from that dinner with same overwhelming sense that I had felt in 1995 about the internet.

Crypto Assets are still in the first inning of their game. They've got a steep curve to climb and the risks are high. But this phenomena has all the signs we look for in exotic strategies…scarcity of capital, creative destruction, asymmetric information, inefficient pricing, pent-up demand, innovative technology, scalability, unsavory operators, outsized payoffs, and wild volatility. Would I invest in this strategy today? No. But the clues for future investments in this space are clear. Take a look at Peter's introduction and the speakers comments. After that, get this strategy on your radar screen. Steve@greenwichroundtable.org

Blockchains and Crypto Assets: Value vs. Vertigo

November 16, 2017

Introduction

"Crypto" was the surprise of the 2017 investment year. Understanding why was the purpose of the GR session entitled "Blockchains & Crypto-Assets: Value vs. Vertigo". The public debate raged last year regarding the inherent value of Bitcoin, with such leading financial figures as Jamie Dimon, Warren Buffett and Howard Marks decrying its recent bubble-like price behavior and lack of apparent utility. Even the most informed blockchain experts acknowledged that speculation is key to the evolution of token-based applications in fulfilling the critical role of blockchain's distributed ledger architecture in championing a fully-decentralized Internet.

So, questions of true "reason-for-being" and rational price discovery were central to the discussion led by three of the central figures in the evolving blockchain-based protocols ecosystem: Peter Van Valkenburgh of Coin Center, the Washington DC based non-profit research and advocacy center focused on the public policy issues facing cryptocurrency and decentralized computing technologies; Ari Paul, formerly of the University of Chicago's endowment management office and founder of BlockTower Capital, a leading cryptocurrency investment firm employing professional trading strategies in a hedge-fund structure; and Chris Burniske, formerly of ARK Investment Management, co-author of *Cryptoassets; The Innovative Investor's Guide to Bitcoin and Beyond* and co-founder of Placeholder, a venture capital fund investing in digital token-based technologies. Their presentations built upon one another in a spellbinding discourse of the potential for token-based applications to disrupt classical business practices, thereby creating real value and, in the process, ushering in the next iteration of the Internet.
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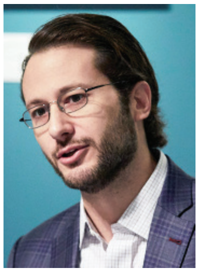
Greetings from the Greenwich Roundtable® symposia. Our topic Blockchains and Crypto Assets: Value vs. Vertigo is our first look into what seems to be a phenomenon as important as the internet. Is it a pyramid scheme or a revolution? Very few people know what's going on and there's a lot of noise. There are also some clear signals. Top tier venture capitals have historically benefitted from the network effect and asymmetric information among other things. That doesn't seem to be true anymore with crypto assets. It's a wild frontier with a new set of disconnected players. Peter Lawrence has done it again. Operating on the road less travelled he persuaded three of the central actors to bring us up to speed.

Peter Van Valkenburgh

Peter Van Valkenburgh, Coin Center

Coin Center is an independent non-profit research and advocacy organization based in Washington DC. We're focused on the public policy implications arising from crypto currencies. We've been educating legislators since 2014 because we believe most bad policy is born from ignorance not malice. New blockchain technologies like bitcoin and ethereum are new public goods just like the internet that are shared public or unowned resource that no private interest or company controls. Public goods are important and deserve independent advocates. Bitcoin isn't innovative because it's a digital currency. Money's been digital on bank balance sheets for decades. It's not innovative because it has a blockchain. Signature algorithms have been around for decades too. Instead bitcoin is innovative because it's a network of free and independent people around the world providing a service that, before, could only be provided by a corporation or another centrally planned organization. That service is electronic money transmission. It's not sexy. Before bitcoin you needed a bank or a company like PayPal to manage the transfer. Bitcoin allows a network of unaffiliated individuals to provide the same money transmission without relying on any one individual in that network, without any central coordinating player. No government, no company, nor any third party guides the transfer. Now the network opens accounts, checks passwords, keeps a ledger, and provides oversight. Every computer connected to the network can verify a signature at a trivial cost. Every computer keeps its own copy of the ledger. They call it a blockchain or a distributed ledger technology. Default rules in the software resolve discrepancies to make sure every computer stays in consensus with the current set of transactions. Who provides the oversight? Bitcoin has no oversight committee just an algorithm. The transfers are mathematically pure and self-verified across the network. Now it's a digital commodity with no intrinsic value and a market with low transaction costs. Everything relies on the rules of the software. The bitcoin is the service actually commoditized. If the service is in demand then the commodity will trade well against others. If demand falters so does the value of the commodity. Bitcoin is just the beginning. (editor's note- The Coin Center is non-profit trying to raise the bar and maintain the independence of the crypto asset class.) peter@coincenter.org



Ari Paul

Ari Paul, BlockTower Capital

It's incredible to be part of a new industry…the birth of something new. We're all learning as we go along. In 2011 bitcoin was trading at $3 and I told an investor friend…'electronic currency will never have value. Value comes from a historic appreciation of value like gold or a fiat backed by governments.' It took me 3 years to really understand the phenomena. The learning curve is a graduate study in cryptography, game theory, computer science, and economics. Skepticism is reasonable. We're not wild-eyed optimists about the space. There are crypto assets that are overvalued and there are elements of a bubble. Your skepticism is healthy. What should we be looking for? Excess returns are driven out of markets by competition. Nowadays every asset class is incredibly competitive. I started trading crypto currencies and the arbitrages were bigger than I'd read about in the 1970's or the 1800's. Why is this market so inefficient? There are huge barriers to entry. Some investors seek rewards for taking beta, liquidity or duration risk. However excess returns come from complexity or reputational risks that might not be rational for an agency investor. Crypto currencies pose a regulatory or reputational risk for institutional investors. Crypto currencies contain complexity risk as so few people possess knowledge of engineering, computer science, trading and portfolio management. The number of those people is increasing but it's still a barrier to entry. Some hedge funds have been studying it for 2 years and they're still not confident. The comfort of a cash flow analysis or a dividend discount model is a long way off. Crypto currency analytical frameworks are all new, all complex and all scary. These are the kinds of risks that deliver compensation. My conclusion as an allocator at University of Chicago was 'this is fantastic; there are the kinds of risk that we want'. We can get compensated for taking complexity risk, reputation risk, or unusual volatility and manager risk. These are the risks that are diversifying the portfolio and delivering higher expected returns. As a trader how do you buy an asset that rose from a dollar to $100? It's useful to frame the value proposition with the question; what service does bitcoin provide? It offers a censorship service or a judgement-resistant store of value. The primary value proposition of bitcoin is competing with the offshore banking system. Offshore banks are collecting tremendous fees off the $20 trillion in their system because billionaires and companies like Apple can't afford to have all of their assets in one legal jurisdiction where one judge can shut down their entire global enterprise. Offshore banks are complex judgement-resistant trusts. Crypto currencies provide a way to protect your wealth against censorship or seizure. The addressable demand is $20 trillion. The real demand is much higher. If bitcoin is a Swiss bank on your iPhone how many people in the world will have some percentage of their wealth on it? The middle class will easily download an app to get offshore banking services without the fee friction or the hassle. The potential is huge. There is massive fundamental demand as well as humanitarian implications. What if Syrian refugees could've taken all their wealth with them? Crypto currency governance is messy. Crypto currencies are open source code running on hundreds of thousands of computers. Software updates require everyone to upgrade simultaneously. If someone doesn't upgrade the network it creates a fork. Hopefully the fork dies quickly. If it doesn't and it grows in economic value I will own two bitcoins. This can be confusing and potentially damaging. Today crypto currencies have no governance mechanism. Governance by exit, leaving bitcoin and creating your own, is the only mechanism so far. That can change with voting mechanisms. It's a complex landscape. ari@blocktower.com

Christopher Burniske

Christopher Burniske, Placeholder Capital

In 2014 I was an equity analyst looking to invest in the next generation of internet technologies like cloud computing, machine learning and crypto assets. There were no publicly traded instruments like bitcoin yet. Then an ETF of private placements called the Bitcoin Investment Trust (GBTC) was created and equity analysis was possible. A new investable asset class was born. At first liquidity was thin. Then we focused on the political-economic issues like governance, supply schedules and use cases. Governance wasn't like a public equity. It was different. Bitcoin was on a deflationary supply schedule. Every 4 years the rate of supply increase was cut in half with no human subjectivity to the process. In 2016 bitcoin's supply increase was cut from 8 percent to 4 percent annually. We had almost perfect visibility and were able to position ourselves. Incredibly 80 percent of all bitcoin ever to be minted is already outstanding. In 2020 that rate of supply inflation will be 2 percent. In 2024 it'll be 1 percent. And in 2030 it'll be quarter percent down to zero. Then we analyzed its use cases. We needed reassurance that bitcoin was actually going to be used for real things in the real world. We looked at bitcoin transaction volumes embedded in the blockchain. It was doubling and tripling year over year. Currently a billion dollars are transacted every day. Real value is being transported using bitcoin. Then we analyzed the risk reward profile. Potential rewards were rich. $100 invested in the first trust would be worth $200 million today. On the other hand the risks are huge and we need proper compensation. Volatility was big but it was overplayed by the media. Today it's tolerable on par with oil. Then we analyzed correlations. It was clear that bitcoin had zero correlation to every other asset class. The capital markets don't overlap with crypto assets. My feeling is that they will become negatively correlated with the capital markets over time like we saw with Brexit and the Trump surprise. Bitcoin will become a hedge. In its short history if you added 1 percent bitcoin it's increased your portfolios' return and lowered its volatility. Our initial investigation led me to write a book called Cryptoassets because it's a new asset class beyond a currency. Currencies are a vertical dimension. They serve as a universal medium of exchange, a store of value, and a unit of account. Initially bitcoin served that vertical and the name crypto currency stuck. Now there are crypto commodities like Ethereum that serve a different vertical and provide a specific price for its service. Crypto commodities will become financial instruments. At some point we'll have a cloud storage ETF that you can sell short. Crypto tokens are consumer facing crypto assets. They provide things like prediction markets or decentralized Uber but there's more work to be done. Crypto assets from a venture capital perspective have been a movement towards being open. Linux and the web started the open-standard era. Today we're in the open-standard data era. Facebook, Amazon, Google and Netflix are aggregators earning fees for proprietary data. Block chains are open data layers where that data is free and shared on a global basis. Governance frontiers will be the next era. The way these communities will be held together will be by properly governing the constituents of its network. That network provides a digital good or service like crypto currencies, crypto commodities or crypto tokens. What are they worth? Nation-states provide governance around an economy. Crypto asset governance will be a way to coalesce around a mini-economy that specializes in a single good or service. Then we can approach valuation from traditional methods of monetarism. Digital currencies have almost no friction so their velocity must be discounted. Crypto asset valuation is important because we don't want to get caught in a bubble. Decentralized information networks aren't priced on cash flows. User and provider and everyone in the network shares in the value creation together. Today global network value is about $200 billion. It won't be long before we break through $4 trillion. People calling a top won't be wrong they'll just be early. We're very early in the explosion of a new asset class. chris@placeholder.vc

Building Returns in Infrastructure

October 19, 2017

Greetings from the Greenwich Roundtable® symposia. Our topic Building Returns in Infrastructure is a continuation of Rian Dartnell's excellent series on the strategy. His last session in 2009 alerted us to the big structural changes emanating from Obama's appetite for shovel ready projects. This session was initially motivated by Trump's announcement of a trillion dollar infrastructure program. Ultimately it was inspired by a need for tangible defensive investments with recurring cash flows to get us through the next cycle. Rian assembled a top-tier panel of deeply experienced veterans in the space. Rdartnell@paxiskey.com

Peter Taylor

Peter Taylor, Carlyle Group

What's the status of the US infrastructure program? Let me offer three observations. First, returns are available in value-added infrastructure, not core. It's not about clipping coupons. It's about improving a business and improving the outcomes. Airports are rethinking their infrastructure. In the US airport terminals are just conduits to feed people into airplanes. Outside the US airport terminals are focused on a positive customer experience. It's less troublesome, you're treated better, and a much happier experience. In that environment you have a propensity to spend money. US airports only outperform Africa on the amount we spend in the terminal. Spending in European and Asian terminals is double the US. Secondly, outside of the Asian emerging markets, the US represents the largest opportunity for infrastructure investments. US operations are the most inefficient, on par with emerging markets. Operational improvements can help airlines increase their margins. Airport infrastructure should be focused on better customer outcomes. Unfortunately airport operators fall back on the minimum requirements as dictated by their regulators, not the customer experience. Jeremy Corbin wants their infrastructure to improve the customer experience because it'll increase your returns. Rather than replacing expensive infrastructure, value added technologies can be applied to deliver lower cost outcomes. The emerging markets have scores of opportunities to improve their infrastructure. City and county executives are driving the push towards better infrastructure. They're not waiting for a master plan from Washington DC. Funding does need to come from the federal government. Local governments are looking for better technology to deliver better outcomes and politics don't matter. Third, infrastructure started as a financing strategy to privatize public projects. Today it's a service or outcome strategy that justifies the returns and the role that private capital has in public infrastructure. Providing private capital or municipal finance isn't the endgame anymore. You need operational improvements that engage a broad array of operations. For example, Munich uses big data technologies to improve boarding times and security. Better customer experiences at the airport translate into better returns for the investors. peter.taylor@carlyle.com

Mark Florian

Mark Florian, BlackRock Real Assets

We specialize in energy infrastructure and our focus is on power. Our returns are low to mid-teens with a lot of cash yield. We try to provide stable income producing investments with the potential for growth. First we build a portfolio with a moat around it with stable contractible revenue streams. Then we move to control expenses. Then we try to reduce debt over time, pay dividends, make some operational enhancements and then try to build some growth. How do we generate alpha? We try to use our capital and our knowhow to help our partners to run better, grow faster, or cut their infrastructure costs. We try to help our partners strategically which we think will generate better returns for our investors. Most energy infrastructure is privately owned and financed. You really need deep expertise and focus in the sector because there's a huge amount of relentless change. There are changes in regulations, technologies, and there are massive capital costs. The myth of peak oil is gone in people's psyches. The US is no longer thought to be a declining producer. That changed in 2008 when new technologies turned the US into one of the largest energy exporters. Natural gas is no longer thought to be a local commodity because you can't put it into a pipeline. Now we can freeze it and put it onto a tanker. The natural gas value chain is creating huge infrastructure needs around the globe. Renewables required huge government subsidies at one time. Now the cost curve for renewables has dropped in a massive way. They're competitive in many markets. Solar and wind are becoming a bigger part of our power supply. Finally, prepare for the worst, plan for repairs and constantly reevaluate what can go wrong in your businesses as well as the broader energy market. When you're holding a business for 12 years you've got be on top of your operations constantly. You've got to look for opportunistic exits when they arrive. mark.florian@blackrock.com

Michael Korengold

Michael Korengold, Enhanced Capital Group

Tax credits can play a role in infrastructure financing and public policy. They're one of several incentives to bridge funding gaps for projects. Large scale public projects often need subsidies. Subsidies can include low cost leverage, government guarantee programs, and tax credits. Tax credits are not just federal. States are quite competitive in offering credits to incentivize investment. Small projects that are otherwise uneconomic are getting their states to subsidize them with credits. Enhanced Capital got its start in underserved states. There's been a proliferation of tax credits in the last twenty years. There's solar, affordable housing, and historic building renovation as the primary federal tax credits. Affordable housing is the most well-known program for an otherwise uneconomic project for a builder. Solar costs are coming down. The government is weaning the market off the 30 percent subsidy over time. It's a successful program. The government primes the pump and the project becomes economically viable. Historic restoration kicks-in a 20 percent subsidy for a building that's fallen on hard times and it rejuvenates the entire community. We play in the less efficient down markets where subsidies are imperative. In general, tax credits are a way for private investors to participate in an asset class with a different risk-reward profile in a different part of the capital structure. It's a dollar for dollar offset of your tax obligation. It's tax-equity for the builder and it's a powerful incentive. Builders use Enhanced Capital to bring investors into a project to acquire those tax credits for 85 cents on the dollar. The risks are builders who don't comply with the rules of the tax credit issuer or project risks in general. MKorengold@enhancedcapital.com

Asset Allocation for 2018

September 21, 2017

Greetings from the Greenwich Roundtable® symposia. Our topic Asset Allocation for 2018 is our annual symposium for the chief investment officer. We always held this session in the third quarter because we had to give 90 day notice to get our money back by the end of December. Nowadays lockups have lengthened but we keep meeting at this time to figure out which strategies to buy and sell in the year ahead. Ray Gustin chairs our Programming Committee, our equivalent of the investment committee. Mr. Gustin serves as the intellectual architect for our curricula striking a balance between short term themes and timeless investment principles. Ray organizes and moderate the Asset Allocation session every year. rgustin@drakeadvisors.com

Charles Van Vleet

Charles Van Vleet, Textron Inc.

Textron has 8 pension plans around the world with $7 billion in assets and $7 billion in liabilities in the US. We're nearly fully funded. Our portfolios are focused on growing the assets. There are other pension funds that are driven by their liabilities. These portfolios are driven by their chief financial officer, not their chief investment officer. Ultimately it's the CFO's decision to either grow the assets or manage the liabilities. Corporate accounting rules require pension expenses to be offset by earnings. I've got 15,000 participants still accruing. Every year I have an expense that must be met with either a contribution from the company or growth from the market. My CFO wants the market to make the contribution. Any excess from the market flows through to earnings per share. My job is to deliver a 7.75 percent return. So I invest at the bottom of the capitalization structure in growth assets like venture, credit, public and privates. There are other pension managers who try to capture the upside and limit their downside with expensive hedges. We don't hedge because we've got an 80 year horizon for our portfolio. We believe stocks will outperform bonds over the long run. If they don't then we've all got big problems. In the hunt for 15 percent investments I'd rather stand in the front of the line in US bankruptcy court with first lien loans rather than standing with a Venezuelan bond. At the bottom of the cap structure I like private credits and the CLO equity. We're looking at buying BDCs, 400 middle market loans that trade with daily liquidity, on the dips. BDC is an acronym for be damn careful and we hire a manger to build that portfolio. We've got several small investments that we'll increase when the time is right. Broadly speaking we're 50 percent in equity, 20 percent alternatives, and 30 percent bonds which are less than investment grade. 80 percent of our real estate is direct with retail strips and value-added multifamily. It's taken us a long time to build-up this mix. cvanvleet@textron.com

Philip Zecher

Philip Zecher, Michigan State University

Our endowment has $2.7 billion and our investment committee recently decided to build an investment staff. Today I'm the first CIO at MSU with full discretion. Our target is 5 percent growth which matches our spending policy. Built-up over 25 years our portfolio is entirely active with 225 fund managers. First we're getting a handle on what we own, what we should watch more closely and what we need to change. We measure ourselves against the benchmarks to gauge our added value. Benchmarks also give us a sense of the relative volatility that our trustees are willing to tolerate. Once we know our comfort level I won't pay extra to lower that volatility or to get lower correlations. Indexing and the new styles of active management are more interesting than the traditional styles. Hedge funds have failed to set expectations properly. Originally hedge funds promised to deliver excess returns. As inefficiencies were arbitraged away they sold themselves as uncorrelated diversifiers with low volatility. Hedge funds are not an asset class, not a bucket that needs to be filled. They're opportunistic and should be employed when an anomaly erupts. They're not a fixed income replacement either. Private equity seems to offer the same return characteristics as our public portfolio. Buyout strategies may be crowded as too much money is chasing the same deals. So we're lowering our exposure and getting more critical with managers who survive the cut. We look at their persistence of persistence. We're too small to co-invest. But making direct investments and removing the GP is an attractive way to accumulate companies with good cash flows. Especially when one of our buyout managers announces that they have sold one of their companies to one of other buyout managers. That's churn and my pocket feels a little lighter. Regarding risk, many events that produced growth and fat returns in the global economy over the last 30 years are not repeatable. We still don't know the full impact of technology on the economy. I'm afraid we're in a low return environment for a long period of time. Historically our portfolio delivered 8 percent and that's what we expected. However we shouldn't expect that cushion going forward. We need to pay attention to risk because if we're wrong we could wipe out that cushion and be forced to cut our spending. zecher@msu.edu

Louis-Vincent Gave

Louis-Vincent Gave, Gavekal Research

I manage our global equity portfolio. I've got a growth bias and try to separate the secular from the cyclical growth stories. Most of the structural growth stories start in the US. Medical breakthroughs, consumption patterns, and technology starts in America. Most cyclical growth starts in China. China is the catalyst for shifts in the global cycle. The biggest surprise of 2016 was China reaccelerating. It didn't fall apart. This is the reason emerging markets are outperforming and we're experiencing a cyclical upswing. Everyone thought it was the end of the world when China devalued the RMB. Last month the RMB was the best performing currency and commodities were up across the board. Surprise! Everyone is focused on the structural deflationary forces like technology or high debt levels. However the cycle still exists and it's pointing towards global synchronized recovery. Global growth is strong, metal prices are rising, oil prices are inching up, and you're seeing currency revaluations across Asia. These are deeply reflationary. Why is everyone comfortable with low bond yields? Global recoveries have historically impacted the bond markets. We need to position our portfolios for higher interest rates. The risk is not a deflationary bust. The risk is rising interest rates that will impact your (barbell) portfolio. Stocks may sell off as rates rise. China has its 19th Party Congress where new leaders are appointed and 5 year plans are installed. Xi Jinping is in conflict with the Communist Party. Jinping is trying to monopolize political power. The Party is not happy because since Mao one-man-rule has been a disaster. They believe in management by committee which has served them well. Xi Jinping initially drained the swamp with an anticorruption drive. Then he integrated the outlying areas into China's economy. Xi Jinping will likely crank up environmental protections. The RMB will accelerate into a strong currency. However I think he will lose. If the Party prevails it will be bullish for commodities and bearish on global fixed income. Prepare your portfolio for higher interest rates. louis@gavekal.com

The Challenges of Long Term Investing in a Short Term World

June 15, 2017

Greetings from the Greenwich Roundtable® symposia. Our topic The Challenges of Long Term Investing in a Short Term World is our most recent look into the effect of behavioral biases onto investment decision making and good governance. Today we all struggle with the concept of patience and long term investing. John Griswold is the Roundtable's chairman. He organized today's session as he continues to probe the frontier of emotions and intellect on the investment process. johngriswold67@gmail.com

Roger Lowenstein

Roger Lowenstein, Journalist

Long term investing is a subject that's fascinated me but it's never been satisfactorily resolved. Why do so many investors call themselves long-term but exhibit short-term behavior? What are the challenges for investors who are actually long-term? Bill Ruane said either you understand the principles of long-term investing, in the first 5 minutes, or you don't. Buffet says that investing well isn't a matter of IQ but a matter of temperament. In 1956 he wouldn't tell prospective investors where he'd be investing because he didn't want them questioning him every 5 minutes. He was acutely aware of temperament. He was confident and his long term record is rare. Today investors have difficulty in ignoring opinions or difficulty in turning CNN off. How often are we tempted to buy a stock because it's rising or sell because it's going down? Some people are professionally rewarded for this behavior or punished because they don't. Portfolio managers say they're long term but they live in fear of deviating from the index. The GE board recently fired Jeff Immelt because his short term fixes didn't satisfy an activist investor. Corporate boards manage analyst expectations for quarterly earnings. Honest boards will tell the Street that the future is unknown. It hasn't happened yet and the company is focused on a long term strategy. It's filled with unexpected events. Businesses get the customers they deserve. Customers-investors are trained to expect quick results. I was fired from an investment committee because I urged the university to ignore short term volatility. I ignored the fact that the president and chief investment officer had short term horizons. Their self-interest was rational but it wasn't congruent with the purpose of the money. The self-interests of these professionals are clear. Why do individuals or institutions, which are free to act in any way they wish, resist the siren of short-termism? Behavioral economists offer a helpful explanation…the impact of recent experience is disproportionately influential. It's really hard to avoid what the crowd is doing. Long-term investing is not for everyone. It's a very lonely game. elrogl@gmail.com

Will Goetzmann

Will Goetzmann, Yale University

My work is inspired by long-term history and the behavior of stock markets. In 1372 a company in Toulouse created a remarkable charter describing the rights and responsibilities of shareholders. Shares could be transferred like real estate. We could track the price of transfers and dividends from the company's annual records. The company lasted until 1946, almost 600 years. This is the definition of long-term. Its rate of return was 5 percent. Its volatility was the same as most stocks today. So its performance was very similar to stocks today. History can be useful in setting our expectations today. We've examined long term markets over centuries. There are many recurring themes that are echoed again and again. They keep echoing the fact that there is an equity premium. You have to

wait to get it. There is volatility which means that over a decade you may get unlucky. Should people panic when the market really moves? We looked at 41 stock markets from 1900 to 2015. When markets rise by 100 percent people were terrified that they were in a bubble. In the next year, in 7 percent of the outcomes the market doubled again. In another 7 percent of the outcomes the market was cut in half. Over 5 years the markets in general were higher. There was little evidence of mean reversion. The message is painfully simple, long term investors are rewarded. Interestingly, people fret about a crash when the market goes up and they fret when the market goes down. When markets are cut in half the probability of a rebound is high, like 13 percent. Shiller and I survey a lot of people every year. What are the chances of a catastrophic crash in the next 6 months? 75 percent of those people believe the chance of that occurring is greater than 10 percent. The real probability is less than 2 percent. People seem to believe the sky is falling. This may explain the equity risk premium. People want a lot of compensation to hold stocks when the sky is falling. They may not understand the probabilities and just focus on the feelings, the pain of the experience. Does negative reporting in newspapers influence their feelings? Yes. There is a feedback loop. The financial press represents a collective memory of the stock market. They refer back to the crashes when they try to put recent events into perspective. Then people selectively use history to focus on the negatives. This can move us away from our long-term strategy. History can be helpful but it's not perfect. We need to keep our eye on our strategy…the long-term. Private equity is an expensive way to keep our hands tied to a long term strategy.
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Arnie Wood

Arnie Wood, Martingale Asset Management

Harry Potter's professor offers this wisdom…it's not your ability that counts in life, it's the choices you make. Many investors have talent and ability. But it's their choices that define success. Fifty six years in the business is driving my view. Nowadays my work is focused on predictions, peer pressure, prospect theory, and principle versus agent. People will believe a prediction if the biases of the crowd confirm it. Confirmation bias has a huge influence on how people handle predictions. Peer pressure is the enemy of independent thinking, especially within investment committees. Understand the pressure you're under and be vigilant when it's not good. Prospect theory is a rich area of psychology to understand. The prospect of losses has a huge effect on how you make decisions. The concept of how you feel in a negative environment is incredibly important. Puggy Pearson was a professional gambler who said, 'know the odds and don't go beyond them'. In gambling the odds are fairly straight forward. In investing, you should know the odds as best as you can and don't overextend yourself. Whose money is it? Principals and agents are ways to understand who is making decisions. When you're the agent it has a perverse effect on your decision making. When you're the principal it's your money. Your self-interests are better aligned with your strategy. It's very difficult for an agent to convince a principal to do something they don't want to do. It's been very hard for an agent to convince people that low volatility matters. There are games to be played from other people's behavior that can be helpful as long-term investors.
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The Future of Healthcare: Risks & Opportunities

March 23, 2017

Greetings from the Greenwich Roundtable® symposia. Our topic The Future of Healthcare: Risks & Opportunities is only second time we looked at life science, the first time we invited Craig Venter after he mapped the human genome in 1999. It's been a while. Today we heard some provocative insights. Healthcare represents 18 percent of the US economy and there's greater spending after people hit 40. It's growing faster than GDP and innovation is flourishing. Because it's highly politicized, wasteful spending is believed to approach 50 percent and valuations seem attractive. Dom Napolitano organized and moderated today's session with some outstanding practitioners. dom@talsonpartners.com

David Chan

David Chan, Jennison Associates

The invasion of politics is the big story in healthcare today. The American Healthcare Act is in front of the House today (it was later withdrawn). The votes are not in sight. In the last 25 years I've spent most of my research time talking to people who influence policy in Washington DC. On reflection it's been a waste of time. The industry is resilient and has survived political attacks. If we bet on the healthcare exchanges and insurance companies we would've lost money. We spend too much time worrying about the impact of legislation. It has little impact on the drug and biotechnology industries. However these politics have scared away investors in drug companies. Valuations are attractive. Legislation that mandates competitive bidding would be helpful. Cancer and infused drugs would benefit from more competition. Passing legislation here would lift the overhang and drug pricing would be done for another 4-5 years. All would be fine. The stage would be reset. dchan@jennison.com

Joon Yun

Joon Yun, Palo Alto Investors

Healthcare innovation is exciting. This is the greatest time in history. Very soon the average lifespan may exceed one hundred years. Today the average age of the population is 40. The heaviest demand for healthcare begins at 40. We're creating more old people that need more healthcare. This is a recursive profit engine. Our industry is creating more customers. The geometric consumption of healthcare is driven by demand and growth. This may require a much larger healthcare system that gobbles-up more than half the GDP. We're playing whack-a-mole. We haven't alleviated the suffering of old age so we're just kicking the can down the road. It may not be investable. At 22 years old you feel nothing. You're healthy. At 40 you start to feel something. At 70 you feel everything. You wobble and it's hard to get back to center. The ability to get centered is nature's greatest endowment. Equilibrium is the state of homeostasis. Our homeostatic capacity is diminishing with age. We treat conditions with drugs but they cause our system to atrophy. We need to rethink the problem we want to solve. The opportunity lies in restoring homeostatic capacity. We need to improve our system dynamics, our coping mechanisms. We need to improve our ability to recover on our own. Doctors monitor our state variables, our heart rate, our blood pressure or our glucose levels. They describe our state but not our system dynamics. Every other scientific field except medicine does resilience testing. The future of diagnostics is measuring everything as a stress test. Push it and see how it responds over time. The future of intervention, of therapy, will be to restore your system capacity. Exercise is a good example. The more we challenge our body the more we restore our capacity. We need to reinvent our diagnostic measures and start measuring over time. Lifestyle recommendations have their limitations insomuch as they're static. We need to expand our range. The best thing to do is to alternate. Inflammation isn't the killer. It's the loss of inflammatory capacity. Venture capitalists and the National Academy of Medicine are buying into the concept of measuring the time dimension. The frontier lies in finding the genes that regulate aging. Then we have an opportunity to recode our body. Cancer cells are doing this already. They can edit-out genes to make themselves immortal. We also need to expand medical education. We need to train one million new doctors a year, not ten thousand. Then the breakthroughs will come much faster. JYun@pa-investors.com


Rod Wong

Rod Wong, RTW Investments

Healthcare innovation, specifically in drug discoveries and cancer, has experienced an amazing transformation. Before this period, innovation was slow. It started with race to sequence the human genome in the late 1990's. Craig Venter proposed a more efficient way to sequence that he accomplished in 2001. Shortly thereafter the genomics bubble burst. The business prospects were too expensive. Sequencing one genome cost over $300 million per. A dark period emerged where nothing was done. Advancements were small and incremental. In the meantime, the cost of sequencing plummeted and today the cost is $1000 per genome. Simultaneously an ecosystem of genetic tools was created. New tools together with cheap genetic information dramatically transformed the way new drugs were discovered. Drug companies have been picking the low hanging fruit. A lot of diseases have single gene causes that are cheap to figure-out. More complex diseases have seen dramatic changes. Cancer is the number two killer in the developed world and the largest single area of development. Cancers are complex and they can mutate. Researchers shifted their focus on the immune system because it's constantly monitoring the body for changes. Dying of cancer can be described as your immune system is losing the fight for control. Immune system pathways were the first to get this attention. Long lasting remissions or cures are within sight. This is dramatic. The single biggest step will be the next wave of discovery in a handful of new drugs. This may lead to over two hundred thousand lives saved. The next ten years may witness cures for a third to half of all cancers. That's just cancer. I could go on and on. Breakthroughs are simultaneous. Value creation is dramatic and it makes my job much harder. But it's an incredible time to interpret these innovations. rw@rtwfunds.com

The Promise of Factor Investing

February 17, 2017

Greetings from the Greenwich Roundtable® symposia. Our topic The Promise of Factor Investing is our second look into the field of passive management. As evidence on the superiority of the index approach emerges, we're struck by the range of possibilities that Factors provide. We're blessed with three preeminent thought leaders on the subject. Always ahead of the curve, in the right kind of way, Brian Feurtado organized today's session and picks-up where he left off with his Big Data symposia. brian.feurtado@blackrock.com


Jim Rowley

Jim Rowley, Vanguard Investment Strategy Group

Factor investing isn't new. The modern era started with Morningstar's nine-box. Equity mutual funds began organizing their portfolios around a size mandate or a style mandate. Then practitioners started looking at fixed-income in that grid with credit and duration factors. Practitioners, not academics, have been defining these factors. There are three challenges. Your factor exposure and your security selection have been bundled over time. The grid doesn't know whether its performance was attributable to security selection or the factor effect. This is the biggest driver of the active-passive debate. When a certain percentage of active managers outperform their benchmark over a certain period we think that active must be smarter than passive. Look at the style purity hypothesis to better understand the influence factors have on active managers. The purity hypothesis states that when an asset class does well, index funds will outperform active managers in that asset class. The reason is that an index fund will tend to have a purer exposure to the asset class, while active managers tend to style-drift. Factors have had a tremendous influence on the active-passive debate. The second challenge is cost. If you want factor exposure there may be a price point you're willing to pay. There may be a higher price point you're willing to pay for security selection. This is the unbundling exercise. The third challenge is control. How strong is the factor? For example a manager may be deep value versus value. Today the playing field has gravitated to indexing. Investors are saying they want to remove security selection from their portfolio construction choices. They just want exposure to factors. There are challenges with this approach. The first is market capitalization weighted indexing as a factor exposure. They're not built for purity. Some call it factor-lite. Second is that index funds don't come in long-short format. The return stream comes from the market factor rather than a specific factor choice. And the third is the definitional aspect where you're competing with everyone's different definition of that factor. Today the sophisticated investor harnesses factors to express their portfolio construction strategy. Thus factor investing is an active form of passive investing. james_j_rowley@vanguard.com

Adam Duncan

Adam Duncan, Cambridge Associates

Mine is a cautionary tale. It makes sense to look at the world from a factor perspective. However the world doesn't present itself in factor form. It presents itself in asset form. So we start with a top-level view of the world in factors. Then we need to boil it down to a portfolio of assets. We get compensated for bearing default risk. Default risk lives in many different securities. How do we harvest default risk? Which securities should I hold? What's the most efficient expression of exposure to default risk? What's happened is the difficult work has been swept under the rug. The hard work of expressing the factor down to an asset is being overlooked. There is broad disagreement on what the factor-set is. MSCI has identified 2000 factors. Cam Harvey identifies 316 lucky factors in equities alone. Mark Carhart identifies 29 exotic factors that form the basis for his beta product. There seems to be from one to two thousands factors to harvest. There's no clear guidance on what we should do. Why is the topic popular now? Anecdotally people are disappointed with security returns. And there's this shiny object called factor investing that can save us. People are bummed out. They're not being compensated for taking risk. Rebundling your risks into factors won't change the shape of your efficient frontier. Let's settle on a set of factors. How do we think about which factors to be exposed to now? What's the order of the most attractive factors I should be exposed to? How about the least attractive? Some argue that this is another form of timing. Is that a sensible way to think about it? It would be nice to have a valuation framework to structure our decisions. How expensive or cheap is this factor now? Not many vendors provide a valuation framework. This fact should inspire caution. Has quantitative easing caused some factors to be too rich? There's evidence to show that factor investing has not been influenced by QE manipulation. Let's say we've agreed on the factors, we've created a valuation framework and we're taking a stand on timing. Now putting these factors to work in a portfolio is very difficult because there's tremendous estimation and mapping error. Taking a factor based view of the world is absolutely the right way. However more hard work needs to be done in expressing them into a portfolio. Delivering factors effectively should be considered a skill. aduncan@cambridgeassociates.com

Andrew Ang

Andrew Ang, BlackRock

Why invest with factors now? We're living in a difficult investment environment. Even more difficult now that uncertainty has increased worldwide. Yields are still negative but rising. It's difficult. Factors are popular because they're tried and true. If we can take factors in a low cost way, we should because we need to extract as much blood from the stone as possible. Secondly we've seen the benefits of looking through labels and packaging. Take the food in front of you for example. We need to look through the flavor, the presentation and the color to the nutrients within. Our job is to express a healthy combination of nutrients in the foods of asset classes and funds. Third, factors are popular because investors are demanding more alpha. They need it. Factors are empowering investors to get more alpha for less. If we can save money with broad, persistent, well-known, intuitive sources done in efficient ways like ETFs then it saves our alpha budgets for where it's truly value-added. Why is it new? First, let's take the smart phone and our unhealthy attachment to it. Factor investing is the smart phone. It democratizes access. It industrializes it, refines it, purifies it and it democratizes those access points. Secondly, unbundling is allowing investors to pay separate prices for alpha, beta and factors. Third, factors are building blocks that allow us to create solutions. Finally, we need both factors and active managers. They're not mutually exclusive. We really need to look through to the factors that drive returns. This is the essence and the challenge of factor investing. andrew.ang@blackrock.com

Investing for Inflation

January 19, 2017

Greetings from the Greenwich Roundtable® symposia. Our topic Investing for Inflation is our first look at the seismic events that we suspect may lead to higher prices. The recent elections in the United States are anticipating new socioeconomic policies and the possibility of regime change in the markets. Mickey Levy's active conversations with policymakers give him an insider's insight. Poring over thousands of balance sheets, Simon Peters and John Reilly alerted us to a new set of opportunities emerging as a result. Leading his fourth tour of duty, Ray Gustin, chairman of the Programming Committee, assembled another outstanding array of talent. rgustin@drakeadvisors.com

Mickey Levy

Mickey Levy, Berenberg Capital Markets

We're 8 years into a slow economic expansion. We've got full employment and wages are tilting up. The Fed achieved its dual mandate. That's the starting point. Caution! It's exceedingly important for you to disentangle your personal feelings about Donald Trump with what's likely to be enacted and the impact on the economy, profits and markets. Some of the biggest institutional asset managers hate Trump, they've underperformed and they can't accept reality. Others are more comfortable with reality. You've got to be dispassionate. 2017 will be the year of economic regime shift. Every president leads with tax reform. It's the first item enacted by Congress. Ways and Means Committee is leading the way. It will pass. The blueprint was developed by a staunch Democrat. It will pass with some regulatory reforms. Higher inflation involves accelerated economic growth. My growth forecast of 3 percent is above consensus. We'll get corporate tax reform, infrastructure spending and defense increases. Hoping Congress eliminates individual tax cuts because at this stage of the expansion you need reform, not stimulus. The weakness in the economy has been capital spending. Fed has lowered the cost of capital. Why haven't businesses invested? Because business hurdles haven't come down. Uncertainty, weak demand, taxes and regulatory policies are inhibiting capital spending. Tax reform and eliminating regulations will remove these hurdles. They'll get enacted by summer. Growth will start slowly. Consumer confidence surveys have already shot-up dramatically. Overheating in 2018 is possible if Congress gives Trump everything he wants. Stronger growth will cause real interest rates to rise. Look for a pop in corporate profits. Markets and the Fed will be hypersensitive to any signs of inflation. Bond yields will rise. Short the bonds rather than play the curve. Going long the bank stocks is another way to short bonds. Banking reform and the Financial Choice ACT will favor the small & regional banks. The dollar should appreciate. It rose 80 percent in Reagan's first term and exports continued to grow. Europe's going nowhere, China's decelerating and Japan's inching up. They're all quietly hoping their currency falls. The US is the only play. Ten year yield may rise to 4 percent. How do you play that? Look at my heat map. I don't like Trump's foreign policy. China & Mexico do not want a trade war. We need to get used to Trump and the crazy things he says. Republicans know regime shift is rare and they're going for it. mickey.levy@berenberg-us.com

John Reilly

John Reilly, ACK Asset Management

We run a long-short fund focused on US consumer & industrial sectors. We've seen fits and starts of inflation. We had rising commodity prices and rising cost of service. But they were fleeting. It's been choppy. Bad inflation is when a commodity price spikes from supply disruptions. We haven't a negative impact on our companies from bad inflation for the past year. Good inflation is when economic activity picks-up and capacity utilization rises. Then you get pricing power and rising wages. Over the past year we've seen this happen. Several areas are benefitting. Labor is the highest beneficiary. Skilled labor started the trend. Baby boomers are retiring and younger workers don't want to work with their hands. That's trickling down to unskilled workers. Fast food workers are getting signing bonuses. Food, oil and metals prices have bottomed. Small price increases have begun. All will be in a slowly rising environment. Consumer goods are still gripped by deflation, especially technology goods. It's the Amazon effect that's not likely to change. How does that impact companies? Truckers will increase their profits by 20 percent. Companies with strong demand like distributors and framers will see their profits rise. Companies with stagnating demand will suffer. They'll get squeezed by labor and raw material costs. This is good for Main Street. Wages are rising. Stock pickers need to be selective. Some stocks have reached peak margins. It's a story of the haves and have nots. Forty percent of small caps are fully valued. Money flows and multiples have expanded. These are all new developments. jreilly@ackasset.com

Simon Peters

Simon Peters, Algebris Investments

We're excited about financials. After 8 lean years we expect 8 fat years ahead. Why buy banks and life insurers? You will make money for 3 years. What are the drivers? How powerful are they? How long will they last? The price of money has been deflationary. Regulatory capital requirements have been hyperinflationary. There's no worse scenario where your top line is collapsing and your capital base needs to rise. Shareholders have suffered. Net interest margins in the US peaked at 4 percent and dropped to 3 percent. Net margins fell 25 percent since the financial crisis. Quantitative easing stopped in the US and Europe. Regional banks were forced to double their capital. European banks were forced to raise their capital ratios 100-500 percent. Ratios have been achieved and regulators are backing off. European banks have suffered. Bondholders benefitted and shareholders suffered. The trend has stopped. Margins will expand without new revenue. In the US, deposits exceed loans by $2.5 trillion. That's never happened before. Deposits have been rising. People haven't borrowed because they're uncertain. Interest rates are rising. That revenue will fall straight to the bottom line. It's a global theme. The US rebound is already underway. Europe's is just beginning. European inflation is just beginning. European banks provide 80 percent of the credit to the economy. They're just beginning to see loan growth again. M&A activity just started. GDPs are rising. All these factors will deliver a positive surprise because these numbers aren't bake into the models. Clearly we're bullish but the risk is that inflation leads to heated lending activity. Banks and life insurers will outperform for the next 3 years. Financials are an inflation hedge with carry. Stick with the large caps in Europe. Italian banks have the biggest upside because no one believes they'll benefit from these changes. simon@algebris.com

PURE PASSIVE: RISKS & REWARDS

October 27, 2016

Greetings from the Greenwich Roundtable® symposia. Our topic Pure Passive: Risks & Rewards is our first act of heresy (in the temple of active management) as we begin to explore the world outside of alternatives. Massive inflows into passive strategies have made this phenomenon impossible to ignore. Today we focus on the techniques and unintended consequences. What can go wrong? Is there a tipping point? Bob Dannhauser moderated today's session. It's his second tour as moderator and he's clearly got the gift. bob.dannhauser@cfainstitute.org

Charley Ellis

Charley Ellis, Partners of '63

There's nothing communist about indexing. The biggest risk of indexing is being called passive. It's a pejorative label. If we switch to the index label, all those negative connotations go away. In 1965 there was no investment courses taught at Harvard. There was a course on trust management called Darkness at Noon because it had a boring professor. Only 5000 people were involved in active management. Individuals accounted for 95 percent of trading on the NY Stock Exchange. On average they bought one stock every 18 months. There was no performance measurement and people paid 40 cents to trade a share. You went into the business because you needed to manage the family fortune. The business did not pay well. Today 99 percent of trading is done by expert professionals. Trading volume has gone from 4 million to 5 billion shares a day. Information is ubiquitous and 1 million Bloomberg users are involved in active management. Markets have changed. Let's look at the rewards of indexing. Other people do all the work. They cover all the costs of keeping the market efficient too. Investing is a long term, continuous process. There's no way you can predict the success of an active strategy from looking at 3 years of data. It takes 50 years. Barr Rosenberg carefully calculated that it takes 74 years. However salesmanship keeps the clients happy by being good, kind, trustworthy, thrifty, cheerful, clean, brave and reverent. However you don't get any of those attributes when you're indexing. Taxes are important for private investors. Indexing allows you to ignore taxes. The most important benefit of indexing is that it allows you to think deeply about what you're trying to accomplish. Who are you as an investor? What makes you different from other people? What are you trying to accomplish…to avoid? There are some other risks. Getting paid from actively managing someone else's portfolio will decline. You will never become famous for beating the market. The psychological or social disadvantage from being known as passive will increase. Nobody has anything positive to say about being passive. Is there a tipping point? At what point does price discovery break down because so many people have withdrawn from active management? It's probably in the single digits (percentage of those actively managing). If we got back to the markets of the late 1950's it's probably in the 80-90 percent range. But that's unlikely. The most profitable business on the planet is active investing. People feel they need to do something. Strategically, be alert to a force(s) of change that could affect you or your portfolio. Then you may want to consider possible action. charley@partners63.org

Colin Kerwin

Colin Kerwin, ExxonMobil Corporation

Today I plan to discuss some of the key principles that drive our embrace of a passive investment style, covering both the theoretical and administrative benefits of such an approach. Before beginning, I'd like to remind everyone that we continue to offer our employees a traditional defined benefit plan, including new hires, and that we believe these plans are well aligned with our business model and long-term career orientation. We also believe they are not inherently difficult to manage and are no more costly than we design them to be. It may be helpful to keep in mind that pension liabilities also represent a small portion of our total market capitalization. From a theoretical perspective, market or beta risk is rewarded by the marketplace because it can't be diversified away. Active or idiosyncratic risk is not rewarded by the marketplace because it can be diversified away. What this means is that active management is at best a zero sum game. Whereas passive investors will by definition earn the market return, active investors will either win or lose relative to the market return. No doubt there are skilled investors who can beat the market but it's a zero sum game across all active investors. One active investor's gain is another active investor's loss. Unfortunately, all active investors aren't from Lake Wobegon. Active investors do play an important role in keeping the markets efficient, but it doesn't take a large share and passive investors can benefit from this efficiency at low cost. In 1975 Charley Ellis argued that active management is actually a Loser's Game, a negative sum game. Higher costs involved in active management mean that active investors (as a whole) will earn less than passive investors. The higher friction costs from management fees, transaction fees, and taxes eat into returns. Add to this the realization that increasing skill and competition from institutions with considerable resources make the game even harder to play. Today it's extremely difficult to consistently outperform the market. Conditions for success have very long odds when playing this loser's game. First you need to identify an inefficient market, a necessary condition for active to work. Then you need to ex-ante identify a skilled manager. Next the manager will need a competitive advantage that's persistent. Finally you need to believe that manager will share that persistent skill with you net of his/her own fees. It's clear that the managers themselves will benefit from the fees you are paying, but will you? Winning at this loser's game is a tall challenge. Empirically it's also clear that very few managers beat the market. The SPIVA scorecard is one example that helps to document this. Beyond the theoretical challenges of active management, at a large pension portfolio such as our own it's difficult to assemble a diverse group of active managers who don't end up effectively replicating the passive market as a whole at higher cost. One's good idea can often be cancelled out by another's. In addition, a large suite of active managers add both manager risk and complexity to the overall portfolio. With a simple commodity product like passive indexing there is essentially no manager risk and no overlapping investment strategies. In 2009 we let go our enhanced and active equity managers and moved to a passive approach with one manager after a competitive bid. We eliminated high management fees and saved millions. We eliminated the ongoing administrative overhead of monitoring a large group of active managers. We also eliminated the need for periodic complex asset allocation studies as we now simply hold the global public market at its market capitalization. A less obvious savings are the avoided transactions costs as securities move between various artificial sub-indices, whether it be between large and small cap, or emerging to developed. It's effectively close to a buy and hold strategy and we gained tremendous efficiencies in the process. I'd like to conclude with a reminder of the purpose of a pension trust. It is to hold a portfolio of assets that protects the plan participants if the sponsor were ever unable to fulfill its obligations. In other words it is a pool of collateral, set aside in advance, with the express purpose of securing the pension promise. It's not a vehicle to bet on financial markets through active management. The purpose is not to subsidize, but rather to protect pension obligations. From this perspective it makes more sense to conserve risk taking for areas outside the pension plan, not in the pension portfolio itself. colin.j.kerwin@exxonmobil.com

Jim Rowley

Jim Rowley, Vanguard Group

Exchange Traded Funds (ETFs) make great tools for managing active portfolios. Let's define indexing. The dollar that gets invested doesn't get spread across the total market. It's invested in a piece of that index that represents a beta exposure. Individuals then decide which pieces get aggregated up into an index strategy. We refer to this as active indexing. I can put together pieces of index funds in an effort to add value by beating the total market with separate betas rather than beating the market through security selection. The advantage to that is style purity. The market factors you wish to express are done more efficiently with control and style purity that cannot be achieved through security selection. You can do this (for 1 bps) with small versus large-cap, corporate bond versus government bond, or with developed versus emerging. These combinations are done with great cost effectiveness. I can capture the entire market, with extremely low costs, and apply a tilt that may allow me to beat the market. This is a very attractive value proposition. It's not about security selection. Rather it's about picking systematic exposures to beat the market. With a handful of ETFs I can get broad market exposure with stocks and bonds and then pick my tilts. These smart beta products are active products. They are not cap weighted, which in itself is an active decision. So money flows into passive strategies are not altogether passive. What are the risks? There are perceived risks that should be viewed in the proper perspective. Are flows into passive distorting the market? It's not distorting volatility or dispersion because they're randomly fluctuating. The real risk is…that's what the market does, it goes up and down. Are the structures of ETFs flawed? 90 percent of ETF assets are structured as mutual funds. The difference is that ETFs are traded on an exchange (paying commissions). The due diligence is the same. Does ETF liquidity dry-up during periods of market stress? ETFs react to the rules and behaviors of the exchanges. The perceived risk is that they're causing upheaval. The actual risk is that you're responsible for your own execution as a result of intraday trading. Use marketable limit orders. Use a block desk for liquidity. Today about 30 percent of all US market assets are passively managed. And 15 percent of US stock market assets are passive. The tipping point is a much bigger concept than measuring the assets solely in actively and passively managed funds. Index rebalancing is not a risk in the sense that passive managers are skillful in avoiding market impact. James_J_Rowley@vanguard.com

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