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Quarterly Commentary

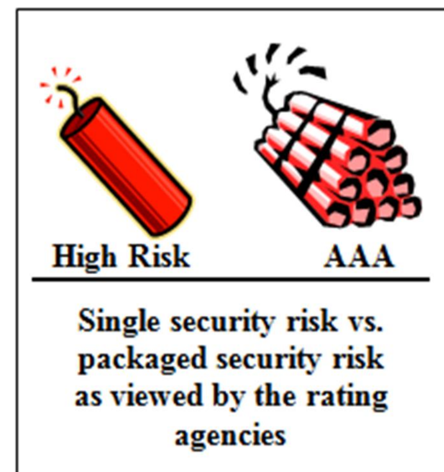
2nd Quarter 2017

The Package Store

Many state laws decree that alcoholic beverages must be contained in a brown paper bag or similar package prior to the purchaser leaving the premises from where the beverages were obtained. Thus the term "package store" came to be synonymous with "liquor store". Such laws were meant to cover the true identity of the contents. Presumably, these laws were developed after Prohibition ended in 1933 in order to assuage the sensitivities of those folks who looked down on the sale, purchase and consumption of spirits.

In much the same way, the current investment cycle has seen a rush to investment products that hide the true identity of their contents. In the Fed's liquidity driven market of the last several years, it is exposure that counts to the general public, not what is inside the package. Much like the too frequent visitor to the package store, most market participants are not discerning about what is inside the package, they just want to know that they have obtained the active ingredient.

It was exactly 10 years ago that we cautioned in this Commentary about the use of packaged products designed by the sell side (a.k.a. Wall Street) for the purpose of trying to create the image of quality and liquidity where it did not exist. Structured securities called collateralized debt obligations (CDOs) were constructed with tranches (think security within a security) whereby the buyer was exposed to less or more default potential, depending on the investor's appetite for credit risk. To our amazement, the major credit rating agencies continuously rated some of these securities AAA, which prompted us to include the nearby illustration which described our thoughts on that logic.

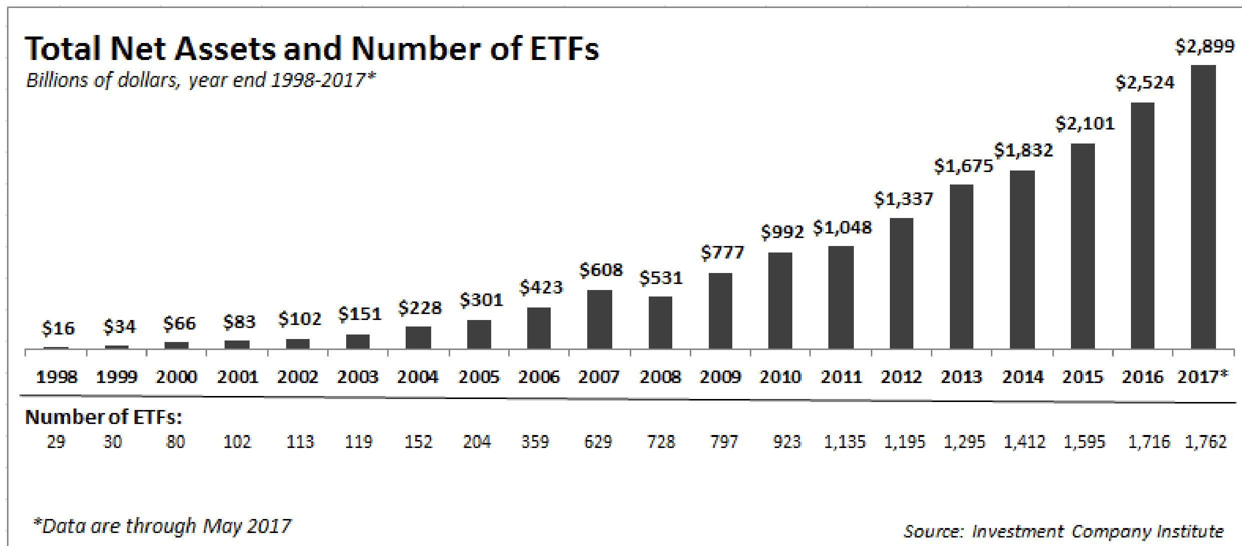


Single security risk vs. packaged security risk as viewed by the rating agencies

The explosion in the growth of CDOs at that time helped facilitate the housing boom by providing a source of funds for the sub-prime portion of the housing market. As we now know, that did not end well. Memories can be very short.

As we explained in last quarter's commentary, we are in a period almost exactly like the late '90s, as about 95% of active managers have under-performed the broad stock market over the last five years. The resulting investor frustration has caused a large exodus of assets from true investment management to passive investing. Packaged investments are all the rage. **In today's bull market environment for stocks and bonds, participation is what matters, not security analysis**, so investors are rushing to index funds and exchange traded funds of all makes and models. We thank the folks at ***Grant's Interest Rate Observer*** for bringing to our attention that you can now "invest" in products that ostensibly track trends in such things as obesity, gender diversity and millennials.

According to a recent article from the ***Wall Street Journal***, passive index funds and exchange traded funds (ETFs) are growing rapidly at the expense of managed funds, and this year, exchange traded funds are on track to take in more money than they did in 2015 and 2016 combined! According to Moody's Investor Service, in 2016 passive funds attracted $506 billion while managed funds saw withdrawals of $341 billion. Passive vehicles now control about 30% of the $26 trillion dollar U.S. stock market.



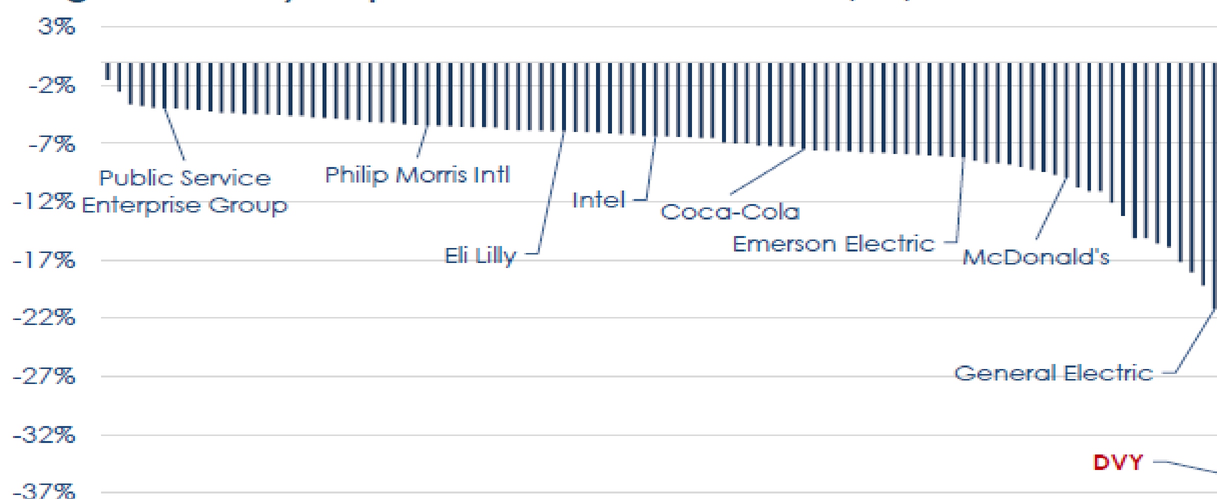
While the unwinding of the indexing hysteria of the late '90s is well-documented by the bear market of 2000-2002, the renewed growth of indexing along with the even more rapid growth of ETFs in the last few years has added, we believe, more of a "hair trigger" element to the securities markets than ever before. **This hair trigger environment derives from the emphasis put on momentum-driven demand for exposure to asset classes while totally discounting security analysis.** It also results from what has been referred to as the "mirage of

liquidity" in exchange traded funds, whereby many market participants believe that ETFs are always highly liquid and therefore they will always be able to exit their position rapidly and with negligible market impact.

It is not our intention to go into a highly technical description of how ETFs are constructed and operate, but a couple of main axioms are key at this point of the discussion, and both work in tandem with each other.

Regardless of what their owners might believe, ETF shares can be no more liquid than the underlying securities that are represented by them (axiom #1). That fact arises from the second axiom: the authorized participants (read big brokerage firms) in the ETF market are **allowed** to form new ETF shares or redeem existing shares **but are not required** to make a market in the shares or the underlying securities as is a specialist on an organized exchange. Each individual underlying security varies in its degree of liquidity, which could lead to the potential for a small number of less-liquid securities providing the catalyst for the authorized participants to remove themselves from the arbitrage process supporting the market.

This is exactly what was determined to have occurred during the "flash crash" of August 24, 2015. One of the most dramatic dislocations occurred in Black Rock's iShares Select Dividend ETF **(DVY)** that day. The nearby chart reflects that panicked selling of the ETF shares had driven down the price by 35% at the low, despite the fact that the underlying stocks had not declined anywhere near that much. While most of the differential between the ETF price and the underlying securities had been reduced by the end of the trading day, it was only because the authorized participants and other institutional investors eventually **chose** to arbitrage the difference away by buying the ETF shares. The authorized participants may have done so for possible redemption at the net asset value (determined by the value of the underlying securities at the end of the trading day). Other institutional investors may have done so by making a bet that the difference between the ETF price and the value of the underlying securities would eventually narrow, and they would be able to flip their ETF shares at a profit.



Source: Morningstar, iShares, Bloomberg, Horizon Kinetics

It is not at all clear to us that in a period of prolonged market downturn that the approved participants or other institutional investors would or perhaps even could react in this same fashion depending on market influences on their balance sheets at the time. What is clear is that there are tremendous amounts of trading activity in many ETFs relative to the underlying securities. Said another way, the trading in paper claims dwarfs the trading in the actual securities they represent. State Street's S&P 500 ETF (**SPY**), one of many on the market to track the performance of the S&P 500 Index, currently has an annual turnover rate of over 1900%, while even the most actively traded underlying stocks in the index had annual turnover rates around 100%. Remember, this comparison pertains to only one of many ETFs tracking this particular index.

While bond ETFs are a smaller portion of the ETF universe than their equity brethren, they are growing rapidly. It is our belief that the underlying bonds traded over the counter in many of these ETFs have significantly less liquidity than even small cap stocks. Part of the rapid growth in these ETFs is derived from institutional portfolio managers trying to immediately match a benchmark as cash floods into their funds from investors desperate for yield. This strikes us as a sure sign that many investors see bond ETFs as having higher liquidity than the underlying securities.

The purveyors of passive investment products are coming up with new indices and new ETFs all of the time. Examples include products to track many areas of hedge fund activity and real estate. The newest offer participants products that track various volatility measures as well as the inverse of every asset class and sub-class imaginable. Finally, if those products don't offer enough bang for the buck, there are now currently 190 different ETFs offering leveraged exposure to a myriad of sectors and sub-sectors to those in the fast lane!

You may ask, as one client did in a recent meeting, "What does any of this have to do with me?" In the face of investment manias and fads throughout the last 30 years, we have chosen to continue to perform direct security analysis and portfolio management. We see this as the only prudent way to invest our clients' assets. At the present time, our work shows that artificially low interest rates are supporting well above average valuations in most stocks and bonds. These high valuations hold the promise of very low future returns for the overall market, not to mention the lack of a margin for safety. We believe that the risk associated with these high valuation levels is not appreciated by the consumers of today's modern investment products. The psyche present in the current market cycle is that one only needs exposure to the overall market, the right sectors of the market or the right sub-sectors of the market, and any effort beyond that is wasted expense. This relegates investing to a top-down, macro approach, one in which we humbly see ourselves as incapable, but one that produces a siren call of easy implementation, low fees and participation with the crowd. When the crowd heads for the exits, we doubt that the door will be wide enough. For our clients' money as well as our own, we won't be shopping at the package store.

Wait For It.......

The Federal Reserve has bumped overnight interest rates all of the way up to a whopping 1%-1.25% over the last 18 months. During the second quarter, the Fed signaled that they were ready to begin reducing the size of their balance sheet, one that expanded by more than a factor of five during the financial crisis and the effort to calm financial markets that followed. This had the very significant impact of supporting bond prices (and lower interest rates) to the tune of about $3.5 trillion.

The Fed plans to eventually begin reducing their assets by the miniscule sum (relatively) of $50 billion per month. Of course this has to be phased in, starting with an even less impressive $10 billion per month and bravely working their way up. They are not disclosing when they will garner the gumption to make this bold move (read that tongue in cheek if you wish), only that it will be by the end of the year. From the schedule that they have laid out, we calculate that the balance sheet will finally be back to pre-crisis levels sometime in 2024!