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RATIONAL VS IRRATIONAL INVESTING

It is estimated that 90% of the US equity trading is irrational, having nothing to do with the fundamentals of companies or investor's judgement.

On any given day, about 50% of trading is computerized high frequency trading, conducted so fast that by necessity it is done from computer to computer without human hands, much less rational forethought. Another 40% is executed by index traders, where baskets of securities are traded based solely as a bet on the overall direction of the market. That leaves a mere 10% of trading that is the result of active investors attempting to rationally value securities. Little wonder that what happens to the price of a stock on any given day appears to be inexplicable.

Fortunately, most of the time high frequency trading is just so much noise. They are in and out of a trade in a blink of an eye. Their computers only effect the real world when their circuits get crossed and they cause a market meltdown. Unless you have a supercomputer and are hardwired to an exchange like the big boys are, high frequency trading will have very little effect on your portfolio.

Index trading has a bigger influence on the market. It accounts for less of the trading than high frequency shops but because they hold their positions longer, their effect on stock prices is longer lasting . Index funds, ETFs and other passive products represent about 30% all stock holdings, but 40% share of trading.

On top of that, many portfolios that are labeled as being managed by active managers are really involved in what is called "closet indexing". These portfolio managers match their holdings to the index with few exceptions guaranteeing that their performance will not be significantly below the averages. Mediocrity might not sound like a achievement, but it beats what can be several quarters of underachievement when the market is going up solely on the backs of a few big cap stocks. Ask an active manager why they own most of the FANG stocks and if they are honest, the answer is they have to.

Index investing is growing much faster than the market. There are currently over 5,000 ETFs globally and about 2000 just in the US. Moody's estimate is that by 2024 passive index investing will represent over 50% of the market at which point their trading activity will be over five times the trading of active investors. Rational, active investing will have an even smaller impact on the market.

The questions then are: What does this mean for the market? Are active managers more or less likely to beat the market? How will this all end?

How Has Indexing Changed The Market?

First, let's admit that widespread use of equity indexes has had several beneficial effects. Institutions who manage large portfolios now have the ability to enter and exit the market with much less expense and more rapidly than ever before. At the other end of the spectrum, small investors now have a very low cost way to own the entire market that previously was only available to big institutions.

Indexing is a perfectly reasonable alternative to individual stock selection or mutual fund picking. It costs much less than active management. The average cost of active management is estimated to be approximately 1.4% for mutual funds and 1% for institutions. The cost of indexing is generally less than 0.25%. If the annual expected return of the market is 8 or 9%, the difference in long term returns between active and passive management due to cost is significant. It would be less significant if active management had historically significantly beat active management, but hasn't. Part of the reason is that the cost differential is just too big of burden to overcome.

Leave it to Wall Street to ruin a good thing. First by adding on fees for actively trading what was meant to be a passive investment and then by selling special ETF products that have much higher fees and commissions. These are all ways to put their hands in investor's pockets.

The negative effects of indexing are just beginning to be understood. The first is the misallocation of resources that indexing may create. The S&P 500 does not represent each stock equally because it is market cap weighted, as are most indexes. The top 50 companies in the S&P 500 represent better than 50% of the value of the index. They have 10 times the weight of the average company.

That means these companies have disproportionate access to capital, not because they have a higher return on capital or have more exciting prospects than their smaller competition, they are just bigger. That's not the way capitalism is supposed to work.

So in rising markets the rich get richer, but we all know there is another side to that story. In falling markets the easiest thing to sell is the big cap index. The flip side of liquidity is volatility. All the recent short term crashes in the market were triggered by or exasperated by index selling. 99% of the time the indexers do their thing in relative obscurity, but when the swings of the market turn violent, they are almost always to blame.

More troubling may be the effect of index investors on the way individuals view the stock market. An index is several steps removed from a real company. Can you fall in love with an index? Is an index something you can believe in the way you can become attached to a great company? When things get tough can you see it through because you believe in management and know their business can endure?

Without a firm commitment to owning great companies through thick and thin the index becomes a trade instead of an investment. It's just too easy to hit the sell key once and let the pain of a market correction just go away. Of course what usually happens is that traders end up selling low and buying back at much higher prices. There is nothing new about that. It is what traders have been doing for centuries, but now they can do it so much easier. There is no law against stupidity.

ARE ACTIVE INVESTORS MORE OR LESS LIKELY TO BEAT THE MARKET?

Indexing is changing the behavior of the market and it is expected to have an even greater effect in the future as active management declines and passive indexing becomes even more popular. One of the most obvious effects has been a greater degree of uniformity in the market. Large cap stocks now trade within a few percentages of each other on a daily and minute by minute basis because they are being bought and sold by computers to match the index instead of being valued on an individual basis. That is true of the 50 or so top stocks in the S&P and true of major stocks in the industry sub-indexes. When one transportation or financial stock declines because of a surprise, the whole group gets hit, largely because the industry specific index is being sold.

The rise of irrational investing can be frustrating, at least in the short run. We own a great company that just announced a blowout quarter and it goes down because they are selling the S&P index and then it gets hit again because another stock in its sector announced bad earnings. Sometimes it makes you wonder if this is a game worth playing.

It is though! In fact, in the long run irrational traders make it easier for rational investors to make money. Let's say there is company you have always wanted to own but like many great companies, it always seemed too expensive to buy. One day the market goes down for no good reason other than the indexers were having a party. You can now buy that dream stock at fraction of what it's worth. Will it turn around tomorrow? Probably not, but you know that for what you paid for it the company only has to grow at its historic average and trade near its low valuation to make a great investment. Will an irrational sell-off happen again? Sure, but you won't sell if it does. You'll just take some spare cash and add to what has been a great investment.

Nobody likes to see their favorite stocks sink like a rock, but it's worth the upset stomach if it makes you money…more money than you would have made if the market had nothing but rational participants.

But as indexing dominates the market, will there come a time when fundamentals don't count at all? When cheap great companies trade at the same price as expensive poorly run firms, not just on a temporary basis, but permanently? Probably not, at least in a capitalist society.

As value investors we know that markets can be irrational in the short run, but in the long run there are a lot ways a company can be rationally valued besides the market coming to its senses. We have owned dozens of companies that have never gotten any respect but finally became appropriately valued in other ways. In the eighties Michael Milken was funding the likes of Boon Pickens with junk bonds some investors thought it was a travesty. We thought it was capitalism. If a company can be bought cheaply enough to pay off debt at 13 to 16%, it should be put out of its misery.

Corporate raiders are now called activist investors but their goal is the same. Take an undervalued company and get the valuation up by fixing it or selling it. Waiting to buy what needs to be sold is today's multibillion dollar private equity funds. They may be sharks picking off the weakest fish, but they make the whole school swim faster.

Then there are mergers and acquisitions within industries. It used to be considered bad form by the gentlemen that ran companies to pursue an undervalued rival. No more. In today's cheap money environment bankers are willing make huge loans at low rates to any company that thinks it can pick off a weak competitor. That process might be accelerated by the indexers giving better multiples to bigger companies. All the more reason to be a rational investor.

So while the market is increasingly becoming dominated by irrational indexers, there is another part of the market ready to step in when valuations become extreme. We try to do work in the middle of these two very different forces. Buying what is cheap, assuming it will get fairly valued but if not, pretty sure that somebody with deeper pockets will step in.

Irrational indexing will improve the chances of rational investors finding undervalued securities, and so long as there is a free market, those securities will provide superior returns.

HOW WILL IT ALL END?

We have been at this game long enough to know that every fad, every sure thing and every feeding frenzy ends someday…usually badly. How will irrational investing end? It may have already started?

While money is still pouring out of active management and into broad index funds thousands of sub-indexes are being brought out that tweak the index based on higher yield, better value, higher sales ratio, cleaner balance sheets or some other formula in an attempt to find a magic bullet to reduce volatility and improve performance. Success attracts money and while we would argue that there is no one magic bullet that beats the market in the long run, at least there is some thinking going on here.

Gradually, the market will reward good portfolio management over indexing and money will follow as it always does. How fast this process will play out is anybody's guess.

The part of the indexing market that was sold on the false promise that market timing as a substitute for sound stock selection will be disillusioned as volatility increases and trading algorisms implode. If it's bad enough, we may even see some regulation of the market to discourage mindless destruction of wealth, but that's not really necessary. Traders will bring about their own demise if given enough time.

One thing we know for certain is that there will always be a new mania, a new sure thing and a new system that despite being irrational, is wildly popular. We'll stick to rational investing.

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