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Investment or Investment Product

& The Truth About Active Versus Passive

We are stock and bond investors. We do not use investment products that promise better returns, but ultimately only guarantee higher costs. It's not that we are against progress. We just have seen too many new products fail to be better investments than the stocks and bonds they were created to replace.

Today, most investment advisors manage assets using products rather than in the traditional approach we employ. There is no mystery as to why products have a lot of appeal - their added fees can be a source of revenue to both the sponsor and the advisor. A product portfolio is also easy to manage. They don't require the time and effort needed to pick stocks or analyze credit risk. You can just put some products together and move the portfolios in and out of the market with a few key strokes.

Does it work? It always works, because when one product fails there is always another one with a better past record to replace it. The products have performance reports, however brief. Unfortunately, client's actual performance, subject to management by remote control, is seldom reported.

The promise of a better way to buy stocks and bonds (or whatever else can be sold) isn't new. It's been going on for decades. *Today's iteration comes through the halo of "index" or "passive" investing.* However, there is a problem this time around. Wall Street cannot make money selling plain vanilla index funds because price wars have degraded fees on these funds to next to nothing!

While "index" investing should be a boon for investors by making markets accessible at virtually no cost, *somehow these benefits are being perverted by the never ending chase for assets and fees.* This isn't a new phenomenon. Since the first mutual fund was created almost 100 years ago, investors have had to fight the high fees and poor performance of investment products. ***What today can be qualified as "passive" investing through ETFs is the latest iteration of Wall Street's game.*** *History demonstrates that no matter how great a product sounds on paper, our core buy and hold philosophy has withstood decades of product innovation, only to come out looking even better on the other side. Will this time be the same?* A quick reminder of how we got here in the first place tells us it likely will.

The First Investment Products: Mutual Funds & Annuities

During the boom of the 1920s, there was a need for professional investment advice for the millions introduced to stocks. The Massachusetts Investor Trust seized on this opportunity in 1924 with the first open-end mutual fund, allowing individuals to pool their money to be managed by professionals.

After World War II, mutual fund growth exploded alongside the American economy. Insurance companies wanted in on the fun, so in 1952, Teachers Insurance & Annuity Association (TIAA), created the first variable annuity: the College Retirement Equities Fund (CREF). These two products laid the foundation for the retail facing Wall Street we know today. Neither was designed to harm individual investors, but over time, both warped into fee-chasing vehicles that padded the pockets of Wall Street.

Wall Street Perfects Product Placement

For most of the 20th century, investment options were simple. There were stocks, bonds, mutual funds and annuities. Your broker was happy to sell you any of them for a sizable commission. After the turbulent market of the 1970's, financial regulation changed the direction of Wall Street with Rule 434d and 12b-1 allowing companies to advertise and pay for distribution for the first time in 40 years.

Combine aggressive legislation with the bull market of the 1980s and Wall Street's machine took off. The financial media exploded. CNBC and *Morningstar* were born. Superstar fund managers like Peter Lynch became household names. To put some context around this growth, in 1980 Americans had $100bn in 500 mutual funds. By 2001, there were 8,200 funds with $6.6trn in assets. This growth came despite the overall fund market providing inferior after fee performance for the average investor.

During the late 1990's, improved technology and the Web made markets more transparent. The legacy model shifted to the "discount broker". Schwab and E*TRADE hijacked traditional brokers by lowering costs, and promising "do it yourself" fortunes. Brokers could no longer exist on high commissions.

So what does Wall Street do? It invents product. Specialized product. Structured product. Exotics. These products promised the world to unsuspecting investors. They did things like "protect" on the downside, while providing "the upside". They also convinced the public to pay extra for their research and hedge funds. In most industries high prices mean we get something better; Ritz vs. Motel 6. It is usually the opposite with financial product. By 2008 we all felt the result of "downside protection" and fancy product when the financial crisis exposed these fallacies, leaving many in financial ruin.

Wall Street Survival Guide the Sequel: Create More Product

Wells Fargo established the first indexed portfolio in 1971. Five years later, Jack Bogle and Vanguard created the first index mutual fund. Index funds were slow to take off because they aren't sexy. They simply track the benchmark. But it wasn't until after the financial crisis and the growth of low cost ETFs that assets herded towards indices.

The idea behind an index fund is that you earn a market return while keeping costs low. That sounds great, because it's the whole idea behind long term investing! But with investors shifting from expensive actively managed mutual funds towards low cost index ETFs, the investors gain is Wall Street's loss.

So Wall Street shifts the story and develops a barrage of new ETF products. **There are currently over 5,000 ETFs globally and nearly 2,000 in the US alone.** You can purchase anything from a triple leveraged S&P 500 fund to a specific sector fund to a fund based on Millennials. The funds have highly marketable tickers (FAN – wind fund, CLIX – e-commerce, etc.), and successful commercials that extol the virtues of being able to invest without having single stock exposure.

The Myth of Passive Investing

The first ETF began as a relatively cheap, tax-efficient way to gain market exposure. The ETF category has since turned into an irrational trading party. *Market commentators refer to the act of buying an index, generally in ETF form, as making a "passive investment". They don't care what that index is, or how often you trade it. So long as the investment is not with an active stock investor, they call it passive.*

But very few of these "passive" managers are actually passive. If they were, their clients' money would be invested in a few very low cost, diversified index ETFs such as the S&P 500 or the Russell 2000. But how can you sell that? Instead, you get a portfolio of multiple ETFs and an assortment of different investment strategies. **The end result is anything but passive**. **It is simply using ETFs to make active investment decisions instead of individual stocks or bonds.**

If an advisor wasn't good at picking stocks, what qualifies them to guess the best investment asset classes? Instead of picking Pepsi and Coke, or Fidelity Magellan and Franklin Growth, they are playing a similar game with index funds. There are now so many indices and ETFs to represent them that the exercise of selection is overwhelming. That's why the debate around "active" versus "passive" is misleading. *People are really arguing about active stock pickers versus active index allocators.*

The Free ETF Lunch

Fidelity recently launched two well publicized ZERO cost ETFs. Market returns for free! Obviously, that's not a sustainable business model, but it was an inevitable outcome of the ETF fee battle as companies chase assets. But if the funds are free and it doesn't cost anything to trade them, how can Fidelity make money? The simple answer is that they have to sell you other products.

The big money is in specialty funds. These funds carry significantly larger fees than their vanilla index fund cousins. They are highly marketable and capitalize on hot marketplace trends. For example, according to Bank of America, Environmental, Social, and Governance (ESG) funds grew 50% last year. Blackrock's "socially responsible" ETF, DSI, owns 400 US firms, excluding "bad actors" like alcohol, guns, and tobacco. Stock selection is done by a computer, yet somehow Blackrock charges 5-10x more than the basic index fund. Why should "doing good" cost more? (Yes, Facebook is the third largest holding).

Even more frightening are the products that make familiar failed promises. Innovator Capital Management recently introduced an ETF called "Defined Outcome" that "seek to generate returns that match the S&P 500 Price Index…while limiting downside losses." The same money losing schemes from past cycles have returned, only now they have the ETF halo.

Algorithms to the Rescue (Or Not!?)

Beyond the funds themselves, the "Robo-advisor" was supposed to disrupt Wall Street. Instead it's been embraced. Nearly all trading is automated, and rebalancing happens in the cloud. Many claim they've developed esoteric algorithms designed to do all of the things people could never seem to figure out. Two of the new terms developed for this product cycle are **"Smart Beta"** and **"Target Date Funds"**.

Smart Beta, which is often associated with factor based investing, claims to offer the advantages of both active and passive investing. It operates under the guise that past factors help determine future returns (except markets are dynamic, and we can promise that the next crisis won't look like the last one).

Even scarier is the mass distribution of Target Date Funds, which are available in nearly every 401k. It sounds simple. You select when you plan to retire and the investments are taken care of! Just don't look under the hood. They are essentially an expensive (often 5x more) fund of funds, investing in dozens of other funds, diversifying you to the point that it's impossible to earn a market rate of return. They are also shortsighted in their asset allocation, and forget that your retirement profile is not the same as your investment horizon (usually longer). As you approach retirement, a majority of your money goes into bond funds, blindly ignoring the fact that you may need that money to grow over the next 30 years.

ETFs: Into the Abyss

ETFs and index investing are important investments if used correctly. An investor that acts passively and keeps costs low will do well over the long-run. However, as we've established, the end game for advisors is to sell product. Significant fee generation and misallocation of assets are a given. The consequences of a majority of trading concentrated in these products gives us even further pause.

The ETF itself works because of a system of daily redemption and creation to keep the value of shares equal to the value of the fund assets. Each fund has a set of Authorized Participants (AP), who maintain this equation. The problem is that they have no contractual obligation to do so. If the market implodes, they can just watch. ETF distributors claim that the arbitrage opportunities available in turbulent times will incentivize the APs to act. *Maybe they are right, but we've witnessed too many liquidity events where the system was supposed to work a certain way, but failed to do so under duress.* ***In the event that systematic ETF trading creates buying opportunities, we will be ready to take advantage of them.***

We also worry about how a trading product like the ETF can be so liquid when the assets it represents can be much less liquid. This is more relevant in the bond market where trading volumes in ETFs significantly outweigh liquidity of actual bonds. When it comes time to sell those bonds because investors are selling their ETFs in droves, how will the market function? ***That's why we buy our client's laddered bond portfolios, with every intention of holding bonds until maturity.*** Day to day fluctuations in price are less relevant so long as the company is able to pay us back our principal. The same cannot be said for bond ETFs or mutual funds when the fund has no true maturity date.

Lastly, much like technology companies have economies of scale and monopoly like moats, *Blackrock, Vanguard, and State Street control over 80% of all ETF assets.* Imagine the power they will wield over companies and investors as ETFs continue to grow. Will they always act in our best interest?

These issues aside, the gap between passive investing (owning a well-diversified index) and what today is being pawned as passive investing, grows daily. In the same way that the usefulness of mutual funds morphed over time, many ETF's no longer help investors achieve market returns. **While the Wall Street machine keeps chugging along, we will continue with a strategy that has worked for generations, through every product cycle: Buying a well-diversified set of good companies at fair prices, keeping costs low, and aligning our clients' portfolios with their financial goals.**

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