CONSUELO MACK | WEALTHTRACK

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Global value investor DAVID WINTERS takes on index funds, saying they are more expensive, less diversified and higher risk than commonly believed.

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CONSUELO MACK: This week on WEALTHTRACK: Index funds are more expensive, higher risk and less diversified than you have been led to believe? So says global value manager David Winters. He presents his evidence next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
I am trying to get my head around the monumental flow of funds going into passive index funds and out of actively managed funds. Indexing is being presented as a no brainer, a slam dunk.

Even Warren Buffet, one of the greatest active investors of all time has been recommending it for his family, friends and just about everyone else. His now famous advice from his 2013 annual shareholder letter bears repeating. It is the instructions he has left in his will for his wife's bequest: "*My advice to the trustee could not be more simple: put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.) I believe the trust's long-term results from this policy will be superior to those attained by most investors – whether pension funds, institutions or individuals – who employ high-fee managers."*

In Buffett's view, practically anyone who doesn't buy and hold, "Invest in stocks as you would in a farm" as he once put it, is a high-fee manager.

It seems just about everyone is now following his advice. According to *The Wall Street Journal* "In 2016, 82% of new retail investments coming through financial advisers (more than $400 billion) went into index funds and ETFs.."

And it appears the lion's share has gone to Vanguard. Over the last 3 calendar years vanguard has received 8.5 times as much money as the rest of the mutual fund industry's 4,000 plus other firms. $823 billion for Vanguard vs. $97 billion for its competitors.

By one estimate Vanguard traders put as much as $2 billion dollars a day into stocks in their index funds, a huge portion of which goes into the five stocks with the largest market value, or capitalization. Five tech stocks, Apple, Alphabet, which is Google, Microsoft, Amazon.Com And Facebook have dominated recently and at one point accounted for 53% of the S&P 500's year to date gain.

This kind of concentration is just one of the major reasons this week's guest is critical of index funds. He is an active manager so they also threaten his business. He is David Winters, Founder and Portfolio Manager of the global value oriented Wintergreen Fund which he launched in 2005. Wintergreen is known for its long term investments in high quality global companies. That focus delivered outstanding performance before the financial crisis, but has caused the fund to badly lagged the S&P 500 since, however it has outperformed a global index.

Winters is an independent thinker who does meticulous research. He and his team have analyzed the financials of all of the S&P 500 companies and have discovered what they call "look through" expenses, hidden costs which make index investing much more expensive than advertised. I asked him to explain.

DAVID WINTERS: Well, the idea of index funds originally was a good idea, Consuelo, and what's happened over time is that the fee looks low, and that's what people concentrate on. But they don't look at the total costs, and the costs are that there's dilution from executive compensation plans that in 2015 are about two and a half percent. You can go through the filings and find it, but it's not easy to find, and that would be on average for the S&P 500. Then the other big expense is that stock buybacks, which most people believe are good for shareholders, have become increasingly used to offset these executive compensation plans. So another 1.6 percent of the expense of the S&P 500 that's not apparent is in these buyback costs. So we call it look-through expenses, because you've got to look through, and if you're a shareholder in an index fund, you own a piece of every company in the S&P 500.

CONSUELO MACK: So that adds up to 4.1 percent in these look-through expenses, these indirect expenses that you've identified at Wintergreen, and you've gone through, I don't know, annual reports, proxy materials, whatever. I mean you've done a lot of research to find out that there are these expenses. You did it because you were doing some work on Coke. You were a major shareholder of Coke in Wintergreen Fund. So how did you get into this I mean where you found all these indirect expenses?

DAVID WINTERS: Well, there are a couple of things that happens, is we noticed that things were different in the market in the way that securities were trading and the relationship of value to stock prices, and so we started doing research, and then with Coca-Cola there was a plan that would have effectively diluted the shareholders substantially.

CONSUELO MACK: An executive compensation plan that you at Wintergreen fought successfully.

DAVID WINTERS: Yes, and it was that plan that then gave us the idea that, well, maybe if it's at Coca-Cola, it's elsewhere. So we started this process, and we tried to find a computer program that was out there. It didn't exist. So we had to go by hand through every company of the S&P 500, 10-Ks, proxies, all their filings, the plans themselves, and we didn't know what we were going to find, and ultimately what we found was that there's 4.1 percent, effectively dilution, look-through expenses in the S&P 500.

CONSUELO MACK: Right.

DAVID WINTERS: So this whole idea that people have that index funds and ETFs are cheap, they're actually very expensive, and the expenses are ballooning over time.

CONSUELO MACK: Why are they ballooning?

DAVID WINTERS: Well, what happens is the executive compensation goes up, and the buybacks have gone up to offset it. So it doesn't hurt the reported earnings quite as much, and we're all for management getting paid, but we believe this should be totally transparent, and it's created this distortion in the markets that people basically are all flocking to index funds, and they don't understand that they're expensive, and then we believe they're quite risky because the way the market weight works of index funds, what goes up has to be purchased in greater and greater size.

CONSUELO MACK: We've talked a lot about the market cap weighted indexes and how they get distorted. I mean for instance in 1999 for instance, if you own the S&P 500, 30 percent of the S&P 500 was in tech stocks, and so this is your point. The high risk is that there's a huge concentration which you call them "FANG and friends," and so we've done the Facebook and the Amazon and the Netflix, but you're saying that with the friends there are ten stocks essentially that dominate the market cap of the index funds of the S&P 500 and that you're owning many more of those percentage-wise than you really want to.

DAVID WINTERS: Well, really what's happened is those securities, these fabulous growth stocks which have changed the world, all developed by brilliant people, have dominated the returns in the markets, and so the index funds have to just keep buying more and more of them, so they become more and more of the index. So instead of this diversification, you end up with concentration. So you end up with high fees and concentration in hyper growth stocks and the history of hyper growth stocks. At some point they may not grow quite as fast.

CONSUELO MACK: There are alternatives now to market cap weighted indexes for instance which do eliminate the concentration that you get in those FANG stocks and their friends. What about those? Is that a better alternative? Is that a better mousetrap?

DAVID WINTERS: I think it probably is a better mousetrap, but the problem is then there's this other issue about the opaqueness of the voting. The big index funds vote in 2015, 95 percent of the time for whatever management wants, the rubber stampers. Often times management is right, but what it does is it creates this spiral of expenses, and so if you have no one doing fundamental analysis or very few people, and you have the index funds essentially endorsing these higher hidden fees, it's money coming out of investors' pockets, and over time it becomes ... even now if you take 4.1 percent times the market cap of the S&P 500, it's over $800 billion a year.

CONSUELO MACK: Now Jack Bogle who created the index mutual fund, has been critical of institutional investors for a couple of decades now because he's saying that they're not taking their corporate governance seriously and that, in fact, they do rubberstamp most of what management wants. So that's really not different. Right? You're just saying it's going to perpetuate itself? It's more dangerous now? Or what?

DAVID WINTERS: Well, you know Jack Bogle is a brilliant guy, and he came up with this idea, and it dominates the market, and it was one thing when it was just one segment, but now that it's, whatever, 30 or 35 percent or whatever the exact number is, it's created this enormous distortion. With the active managers ... and historically active managers could choose to own high-dilution securities or not, but now that everybody's getting pushed into the same securities, you have fewer and fewer investors who are basically standing up for their investors.

CONSUELO MACK: I see.

DAVID WINTERS: Their shareholders, their fiduciary duty.

CONSUELO MACK: Wintergreen has expenses of 1.95 percent, and you and I have talked about this before, Morningstar says that's a high fee. So what's the justification? How do you compare your 1.95 percent public versus what you're paying that you don't know about in an index fund?

DAVID WINTERS: Well, part of this voyage of discovery that Wintergreen's been on with all this is, as we went through this, and we have an institutional class that's 1.7 percent, and then we looked to see, well, what were the hidden costs, the look-through expenses of our companies? Because we own companies that generally have lower dilution, and our look-through expenses, the whole expense cost is 3.17 percent in 2015. An index fund is 4.2 percent. So we're 25 percent. Our costs to the investors, not only what you see, but what actually is costing you is a big discount, and we can own securities that trade at a fraction of what they're worth as opposed to owning securities that everybody owns for the momentum. So we think that when you look at it we believe the proper way, Wintergreen's a bargain and that the index funds are expensive, risky, and potentially at some point this bubble is going to pop.

CONSUELO MACK: One of your other major criticisms of index funds as well is that they've created this kind of momentum monster you call it. Why are you calling index funds momentum monsters?

DAVID WINTERS: Well, because they have convinced everybody through all this extensive advertising that we don't believe entirely shows the true cost of this that massive money flows in every day, and it has to be put to weight in the market weight. So what do they buy? They buy these ten securities, and full disclosure, we own Alphabet for years.

CONSUELO MACK: Which is Google.

DAVID WINTERS: Which is Google. So these securities just keep going up and up and up. We talked to some students yesterday at Appalachian State University," and one of them said to us, "We look at Apple, but it goes up every day, and the reason is not only expectation of their next product but because so much money goes in that these are momentum stocks. Every time in my experience as an investor that something becomes a momentum investment and people forget about the underlying fundamentals or they put it aside, here fundamentals are less and less even considered because part of the mantra of the index funds is don't think about fundamentals. Just buy the index.

CONSUELO MACK: The fans of index funds also stress the fact that the performance of index funds has been better than most active managers. So 95 percent of active managers underperform their benchmark indexes over the last 15 years. What's the defense for active managers given that record, that track record?

DAVID WINTERS: Well, there are a couple of elements of this, is that everybody's looking at it today, and since 2010 after the financial crisis and basically zero interest rates, this phenomenon of index funds became the dominant force on Wall Street, and it's become this magnet for capital all over the world. So people are looking. If you look at it, of course it looks the active managers don't look as good because for the last six and a half, seven years that's what's worked. The second element is that active managers have been pushed away from really being active, and that if you look at this statistic called R-squared, so many active managers are really index fund light, and so you have ...

CONSUELO MACK: They're mimicking the index funds because they've got to in order to keep up with the performance that they're under pressure to perform.

DAVID WINTERS: We're not trying to do that, so at times we underperform which is part of life, and this year so far we're outperforming. But if you look at anybody who's really rich, they did it by owning a business or a series of businesses. They didn't do it by being average, and because of these fees, the expenses, these costs that are not well-disclosed, we don't think that the returns of the index funds going forward are going to be nearly as good.
I can't prove it, but I think that active management ... the other element that people don't talk about is, because everybody's in the ten stocks, they're not looking at all these other stocks, and they're not looking at fundamental values anymore. Some people are. We can find securities, Consuelo, that trade at 35 cents on the dollar and there's nothing wrong with them, and it's because people aren't focused. Also, no one's holding management to task.

CONSUELO MACK: So how important a part of active management for you at Wintergreen is holding management to task?

DAVID WINTERS: Well, you know most companies we want to invest in like BAT, they're great. You don't have to worry about them. But then there are other companies that aren't doing exactly what's right, and we have shares of a company called CTO, and we're the largest shareholder, and we are in a proxy contest with them. We're just trying to push them to do the right thing for all shareholders.

CONSUELO MACK: Why would you get involved with a company like CTO? And I'm not familiar with CTO. What is CTO?

DAVID WINTERS: It's a land company in Florida with a 1031 portfolio. We invested in the company because we just thought it was ridiculously undervalued, and we invested over ten years ago, and just we're concerned about certain things with them. There aren't that many people today who are willing to take a stance, but we think the shares are very undervalued, and if we are able to convince management to do the right things for all shareholders, everyone benefits. So part of this is not only that the active managers have to be active, but that there is we believe so much to do today as a global value investor because there aren't that many people looking because they're all convinced through all these studies based on a backward-looking lens, not on a fundamental value lens, that there's a lot to do today.

CONSUELO MACK: Also, overseas for instance. Of course indexing has taken hold overseas, but is it to the extent that it has here with the S&P 500 for instance?

DAVID WINTERS: It's starting.

CONSUELO MACK: It's starting.

DAVID WINTERS: It's starting because you know it's an opportunity for the marketers of the index funds, and it's happening but, that said, there's still a lot of companies overseas that are mispriced. I mean we own a lot of companies that are basically kind of off the radar screen, and one that's well known is Heineken, and the company's doing really well, and it's run for the shareholders. The family is super high quality and they make a great product.

CONSUELO MACK: That was I remember another quality that you look for. Who were the shareholders? You liked owner operated companies. You wanted management that had skin in the game...

DAVID WINTERS: You really want the people who run these companies to have their own money side by side; that they bought stock or they own stock and they think and act like owners. I think where a lot of this disconnect and the disconnect with the index funds is you don't have this thinking like owners. So we like companies that are run for the benefit of everyone in the long term.

CONSUELO MACK: There's another company that is actually not on anybody's radar screen that you're invested in at Wintergreen. Tell us about Elbit.

DAVID WINTERS: Elbit Systems is an Israeli company that we came across because we were looking at the defense companies, and we kept looking and I had a friend of mine who said, "You got to look at drones," a couple years ago. He said, "People do not want their children dying behind enemy lines, and so this is a big change. You got to focus on it. So I looked and I looked and I looked, and we came across an Israeli company, and we went to to visit this company, and they are one of the biggest producers of drones in the world. They're big in cyber security which is now huge. The company basically is barely followed, certainly not in the States. In Israel they follow it, and it's well run. There's a family there. And we think it's cheap. In an uncertain world Elbit makes a lot of products that help make people safer, and so what we try to do at the Wintergreen Fund is figure out ways to participate in how the world is changing as well. If we can do it in an undervalued way and in a way with good governance, we think that Elbit Systems has those characteristics.

CONSUELO MACK: So I remember you were a big shareholder in Nestlé at one point.

DAVID WINTERS: We own Nestlé.

CONSUELO MACK: ... major holding?

DAVID WINTERS: We like Nestlé very much. Consumer products have slowed down to a large extent, but it's a very high-quality company that makes products that people love, and they've moved up the healthy spectrum. It's a wonderful company, and we own other companies. We love Switzerland. We own a company called Sika, which is a specialty building products company that's got an interesting shareholder battle going on between the family and the company, and it's just a great business.

CONSUELO MACK: Again looking with this move to indexing and this concentration in these mostly tech stocks actually, where are you finding the most undervalued securities?

DAVID WINTERS: Well, I'll give you one that's just ridiculous, I mean that we've owned forever. So we own a little company. It's not so little anymore called Birchcliff in Canada, and it's a natural gas company, and we believe it trades at about 35 cents on the dollar, and the thing that's neat about it is the man who runs it, Mr. Tonken, he has all his own money up. He's built the company. He's an honest, hardworking fellow, smart, and then the largest shareholder is a guy named Seymour Schulich who's also a brilliant guy who's bootstrapped himself. So you're aligned with people who have all their own money up who own something that's very undervalued who've built it, and they get it. So we think there's a number of securities around the world that they're just so mispriced.

CONSUELO MACK: It's so interesting because you talk to many other investors, and they're saying the market is really expensive. It's very hard to find good value propositions, and you're saying not so, that there are a lot of them.

DAVID WINTERS: Look. It's sort of the best of times, the worst of times because of this whole index bubble. People now no longer believe in fundamental analysis and value investing and all this, and there are all these studies out there. Yet, because of what's happened, there's all these neglected, unloved, and at some point it's got to change. So you know we have all our own money up at Wintergreen. It's my money alongside my business partner, Liz Cohernour's money, all my colleagues, the Graff brothers. We believe, and we have a great shareholder base. There's room for more to join the party because I think that what most people are doing is financially dangerous, and what we're doing again in my opinion we don't take a lot of risk. We own assets that are cheap, and in general we have managements that wake up every morning and jump out of bed about how they're going to make money for everybody.

CONSUELO MACK: One investment for a long-term diversified portfolio. What would you have us own some of?

DAVID WINTERS: I always feel sort of intimidated when you ask me this question, but we really like BAT. It's our largest position. It's consistent with what the Wintergreen Fund owns. They're doing this transaction to hopefully take complete control of the Reynolds American Tobacco Company. BAT is the most global tobacco company. It's very, very well run. Nicandro Durante who's the CEO is first rate. The team there is first rate. The company generates lots of cash. It generates money all over the world, so you have that sort of hedge, and you get paid to wait and they grow the business.

CONSUELO MACK: David, do you think that the indexing movement that we've seen which is so enormous, I mean how do you think it's going to end?

DAVID WINTERS: Consuelo, I don't know. I don't know. I mean some days I wake up and I think this is just going to go on forever, and there's so much momentum and they've convinced everybody that it's low fee and that it's just fabulous.

CONSUELO MACK: You're well diversified and ...

DAVID WINTERS: But we also think one of these fabulous companies someday is going to have a problem. It's always happened, and at some point the growth will stop. The music will stop, and I think that this is a bit of a game of musical chairs, and because everyone is so concentrated in effectively this one trade, and that is not what indexation was about when John Bogle created his wonderful insight of the index fund. So sometimes too much of a good thing isn't so good.

CONSUELO MACK: Perfect way to end it. David Winters, thanks so much for joining us

DAVID WINTERS: Great to see you.

CONSUELO MACK: Great to see you too. Thanks.

At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's Action Point Is: Be aware of the risks in the most popular index funds right now. As we mentioned earlier just five tech stocks, Apple, Alphabet, Microsoft, Amazon.com and Facebook dominate the market capitalization weighted S&P 500 index and are responsible for the lion's share of its outstanding performance in recent years.   That means the index fund portfolios are heavily concentrated and being run up by momentum as more and more money pours in.

What runs up will eventually run down. Are you prepared to ride it out, or should you lighten up?

Next week successful stock picker, Tom Gardner, CEO and Co-Founder of The Motley Fool explains why index funds are the better choice for most investors, but for the hardy fools he and his brother David have been building portfolios to last.

To see this program again and hear more of David Winter's critique of index funds and defense of independent investment thinking go to our website WEALTHTRACK.com.
And keep reaching out to us on Facebook and Twitter.

Thank you for watching. Have a great weekend and make the week ahead a profitable and a productive one.