CONSUELO MACK | WEALTHTRACK

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Top performing money managers respond to the popularity of passive index investing

CONSUELO MACK: This week on WEALTHTRACK, the evidence is in. In recent years passive index funds have been consistently beating the vast majority of actively managed mutual funds, but what about the few who buck the trend? Top performing money managers respond, next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
The first index mutual fund was introduced to the world by Jack Bogle, Founder of Vanguard in 1976. What was a trickle of interest then has turned into a tidal wave since. Exchange-traded funds, popularly known as ETFs weren't launched until 1993. Interest in them has been explosive. Professional and individual investors are voting overwhelmingly in favor of passive index strategies with their portfolios.

For the first time ever, ETFs, more than 90% of which are passive index funds have one trillion dollars more money than hedge funds globally. According to *The Wall Street Journal*, exchange-traded funds surpassed hedge fund assets two years ago but the trend has accelerated.

It's hard to beat the ETF fee discount. The asset weighted average annual cost for ETF's globally is a quarter of a percent, according to consulting firm ETFGI, compared to the traditional charges of 2% on assets and 20% on profits taken by hedge funds, which by the way, have dramatically underperformed the S&P 500 every year since the 2009 market bottom.

Performance is the other key advantage index funds have possessed in recent years. As we have reported here before, the recent SPIVA report, the bi-annual "S&P Indices Versus Active" scorecard tracked 15 years of performance of actively managed mutual funds versus the appropriate market indexes. Overwhelming: more than 92% of large-cap, 95% of mid-cap, and 93% of small-cap managers trailed their respective benchmarks.

Active's underperformance showed up in international stock markets and surprisingly in many fixed income categories as well.

Of course there are always exceptions and we try to find them on WEALTHTRACK.
Over the last few months we have asked a number of our portfolio manager guests, most with exceptional long term track records to give us their views on the active versus passive debate. We began with Brian Rogers, until recently the Chairman and Chief Investment Officer of T. Rowe Price. Over the past 20 years, during his tenure, 85% of the firm's funds outperformed their benchmarks over multiple rolling 5&10 year periods. And the T. Rowe Price Equity Income Fund which he ran for 30 years, matched the market's performance with much less volatility.

CONSUELO MACK: Active versus passive debate. It seems like we've reached a critical turning point where passive has really taken off, and in a low return environment people are looking very closely at fees. Has passive won that debate?

BRIAN ROGERS: Well, I think passive has won the fee debate. It hasn't necessarily won the performance debate. I think when I think back to 1982 when I joined T. Rowe Price, the share of passive in total U.S. mutual fund assets was probably single-digit percent. Now it's probably a third.

CONSUELO MACK: And growing rapidly.

BRIAN ROGERS: So huge growth, growing very rapidly over the last couple of years. The more money that's invested passively, the better skilled active investors can do because as correlations rise and the same money pours into an index, specifically the S&P 500, the opportunities to cherry pick and excel will increase over time, and probably one of the most fertile areas would be S&P companies 501 to 1,000, arguing if all of the money is flowing into the S&P 500, from plain old passive funds, passive mutual funds, passive ETFs, arguably that sector or that part of the marketplace which is very large will be valued much more highly than it might otherwise be, and there might be arbitrage opportunities to invest elsewhere.

CONSUELO MACK: The major argument for the advocates of passive investing is that, number one, they're very tax efficient because you're investing in an index which isn't being actively managed, and also that the fees are so low that it is such a high bar for active investors to surpass that. What's your response to that?

BRIAN ROGERS: Well, our response is look at our company and look at our data, and again there are no guarantees prospectively, but the opportunity to earn a higher return than an index if realized can have a really positive effect on the investors' fortunes, and even if it's 50 basis points or a percent a year over a long period of time, that can really be a great benefit to the investor.

CONSUELO MACK: But you think there can be a role for passive investing for investors.

BRIAN ROGERS: Consuelo, absolutely.

CONSUELO MACK: So what is it? Where would you assign that role?

BRIAN ROGERS: We have a passive fund business at T. Rowe Price. It's a small part of our business relative to our active business, but we offer index fund products for defined contribution investors and others, and so it's really a matter of the individual investor's preference, and what does he or she want? Is he or she content with an index return, and that's fine. There are many other investors who want to do better, and we really cater to that marketplace.

DAVID WALLACK: First I can't talk about indexing without a defensive active management which I believe very much in and which I think T. Rowe Price as a firm has demonstrated one can do well for years.

CONSUELO MACK: You in defense of or a defensive active management or both? (Laughs)

DAVID WALLACK: Both really. I think one most go back and look at history. I think you need to go back a bit before that, and I think you need to look at the other periods in time when indexing has been popular. The biggest one probably in recent memory would be the tech bubble. You recall in the tech bubble that 30 percent of the S&P 500 was invested in tech stocks. Well, lo and behold, if you measure the return of the S&P 500 from the top in February of '00 to three years later it was minus 45 percent. That interval was a wonderful period for active management. If you go back prior to that, a decade before that, in Japan the Japanese stock market had a tremendous move. And most people who wanted exposure to international markets, professionals I should say, would choose to put a portion of their portfolio and index the EAFE index, the Europe, Australasia, Far East index. At that time, 60 percent of that benchmark was in Japanese stocks. If you had bought that benchmark, unfortunately the Japanese stock market fell 85 percent over the next 20 years. That's the equivalent of a 60 percent loss in that part of the index.

CONSUELO MACK: And it's never really recovered.

DAVID WALLACK: It's not recovered. So in my view it's a cyclical thing. Usually when something becomes very popular on Wall Street, one should be very careful, and passive indexing is really all the rage these days. Many stocks in my view have more or less taken flight from their underlying value, and that can happen for a period of time. It certainly happened back in the '80s in Japan and in tech stocks in the '90s.

CONSUELO MACK: Good reminders for us.

DAVID WALLACK: If you believe as I do that over time if markets work and capitalism is effective, that companies will be valued fairly, the market will be efficient. I would submit that indexing will likely be less popular a few years from now.

THOMAS RUSSO: It's a consensus move, and I can only think back to 1989, and in 1989 you would have had a period of time when the Nikkei Dow went up with the smoothest position of any recorded market in history, and it went up every quarter smoothly. It was never volatile, and it at the top hit 32,500; subsequently, collapsed 75 percent. Now all along the way it was beating all of the active managers. So, there's no reason to think that indexation just because to date it has generated outstanding returns without stumbling... it would be as if you were saying in 1992 after the three years after 1989 and the Nikkei Dow continued to advance. You could have said there, "Look. It's been now 40 months worth of steady advance. It's outperformed anything else, but it was getting ever more expensive."

JOHN ROGERS: One of the things I would start with is say that over the 34 years that I've been running Ariel, I've seen ups and downs when it comes to active management versus passive management where there's all of a sudden everyone becomes convinced that passive is the end all and be all. Eventually that shifts and changes. These things do go in cycles. Now I have to say that this has been the worst I've ever seen with the amount of energy around passive management. It's like I've just never seen before. To have Warren Buffett introduce John Bogle at the annual meeting and write about him in his annual report, it was quite unprecedented, but I do think that once everyone becomes convinced that one way is the easy way to make money, like you said, over 90 percent of active managers underperforming, once everyone agrees then the opposite is going to happen, and it happens because as all that money flows into active, a couple things happen. Those assets get relatively very expensive. People are buying companies that run those funds for reasons that have nothing to do with underlying fundamentals, but they're going to be buying the biggest market caps within those indexes.

CONSUELO MACK: The most expensive. Something like 50 percent of the S&P 500's performance this year at one point was because of the top five companies, the Apples and the Googles and…, right.

JOHN ROGERS: Exactly. Those top companies or the biggest companies drive all the performance, and I found in my career whenever people are buying companies for reasons having to do with momentum and not fundamentals, it always ends in a bad way, and I think as you have more assets move toward passive, there will be fewer people doing the work in the active space, and those of us that are still working there will be able to find some terrific bargains of neglected names, and all of a sudden that's what will create the opportunity for us to outperform again, and people will start to believe and money will start to flow back.
I do think it is something that maybe it'll take a down market for it to really become clear, and people will start to realize, jeez, these things don't always go up. They go down too, and there's no one there sort of manning the steering wheel to make sure that you're protecting assets on the down side. I think that's where active managers will really shine.

ROBERT KLEINSCHMIDT: So one way to defend yourself is to cite studies which show that even index investors underperform the S&P 500. Why do they underperform the S&P 500? Because they can't stick with the game. They get more enthusiastic at the wrong time, and so they put more money in. They get less enthusiastic at the wrong time, and they take money out at the wrong time. So being a passive investor doesn't actually make you a better investor than the index. I think that the best argument for an active manager and particularly in the wealth management business is that you have somebody standing between your emotions and your money, and that is sort of minor importance most of the time, but it can be of major importance when you need it to be. So I think there's an argument for wealth management and the professional investor. So should the professional investor be an index investor or not? I don't know. I think not, and I'll tell you why. You mentioned the decline in volatility recently. There have been some studies that relate the decline of volatility to the prevalence of ETFs because an ETF doesn't sell a stock when it has a bad quarter. An ETF doesn't sell a stock when there's an implication of wrongdoing or fraud. It doesn't sell a stock when it makes a bad acquisition. An ETF holds that stock because that's a part of the ... so I think if you get to

the point where enough of the market is dominated as it increasingly has been by ETFs and by indices, when the worm turns it will turn very badly for these kinds of companies.
So you'd much rather be in a position where you can make a decision about a company, I think, than have it be on rote. I mean why would you want to continue to hold a company that is either way overvalued in your opinion or where there is a possibility of malfeasance or where there's any number of reasons that you might want to sell the stock? But it's tough and it's not for everybody. If you are a sophisticated enough investor and have enough of a distance between you and your emotions, I think ...

CONSUELO MACK: Easier said than done.

ROBERT KLEINSCHMIDT: Easier said than done. It's easier done the great bulk of the time. You don't need these disciplines until you need them, and then when you need them, you need them very badly.

JOHN BELLOWS: Well, especially in fixed income if you think of what the passive index is, if you issue more debt then you're a bigger weight in the index, and an index investor owns more of that. But if you issued more debt, that might make you a less credit-worthy company or country. So, it doesn't quite make the same amount of sense in fixed income that it does in equities. I would say more broadly I'd make two points. One is I do think there's value from doing the credit work. There are a variety of stories, and it's important for investors to know what's in their portfolios and to do the due diligence behind that just so you don't own whatever's out there but you do that. The second is that in an actively managed setting, you can have diversification. So, you can have what I've been describing where you own risky assets and safe assets together and get the power of that diversification. Investors are doing that in their own portfolios. Why wouldn't want you want your bond portfolio to have the same type of diversification? So, I think that last point is probably the most important. The same commonsense thing that you're doing in your own portfolios, have diversification, active management allows you to do that same thing.

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. 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. 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: 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, 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: As The Motley Fool's mission is to help us become better investors, why

would you, why would the first piece of advice be “to buy an index fund?”
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TOM GARDNER: Well, because I think it’s the greatest financial offering that’s ever been created. I mean I believe that Jack Bogle has probably had the biggest impact on investors of any person in human history, far greater than Warren Buffett’s impact, and I’m a huge Warren Buffett fan obviously, but the size and scope of what Vanguard has created and other indexing alternatives that have come after is awesome and transformative, and it’s the cheapest way, the most tax-efficient way to get exposure and diversification in your portfolio. So it’s a great place to start, and even though it could stop you from doing business with The Motley Fool, we’re the first ones to say if you want to end there, if you just want to index, that’s great, and we have fulfilled our purpose of helping the world invest better by getting you into that great solution first.

CONSUELO MACK: So for many people, again quoting you, “active investing is not worth trying even.” Why isn’t it even worth trying for many people?

TOM GARDNER: Well, many people aren’t interested in the subject, so that would be the first reason. Many people just this is like dental work to them more than a great adventure in learning and understanding business and capitalism and how to allocate capital and manage risk and learn about your temperament. For many people this is something they’re not actually doing. So a number of people are going into retirement with far less money than they’re going to need, given medical technology and how long they could live. So I’d say if active investing requires that you spend time and think about things, for many people that’s not a good approach.

CONSUELO MACK: So what is better about buying an index fund, especially considering that everyone else is doing it now too? One of things, that great investors are usually contrarian thinkers, they’re independent, so here you are saying do what the herd’s doing.

TOM GARDNER: It’s pathetic really.

CONSUELO MACK: It is pathetic.

TOM GARDNER: There’s no intellectual curiosity to it at all. I’d say that the number one reason is because the fees are so low. So when you’re going to actively manage funds, you’re paying 50 basis points, 100. You’re paying one percent per year let’s say on that fund. Those funds are trading well more than 100 percent of their assets each year. So you’re getting tax hits that are not published and should be. Mutual funds should be required to publish their after-tax returns for people so that we could see what’s really happening there. So the index fund, I mean it’s essentially like what Amazon is doing to the retail industry. That’s what’s happening. Sure, you can have some more colorful experiences by getting in your car and driving out to a store and all the rest, but you get a broader selection. You get better convenience. You get lower prices. You get home delivery from Amazon, and that sort of convenience is what Vanguard is doing to the financial industry.

CONSUELO MACK: One more question as far as what's happening with the indexing. If you look at this year for instance, 53 percent of the gains in the S&P 500 were driven by five stocks, and the stocks, they're all tech stocks, and they're Apple, Alphabet, Microsoft, Amazon and Facebook. So they accounted for 53 percent of the S&P 500 gains this year. That is concentration. Does that concern you?

TOM GARDNER: Well, I mean at first it feels good, not to hug myself, but at The Motley Fool we've owned a lot of those stocks for a very long period of time, and you know that our orientation is to buy stocks and hold them for five to ten years. So they have been great investments. Do I think that those are the great investments of the future? The next five and ten-baggers that somebody can put in their portfolio and sit back and enjoy? I don't. Do I think that they're going to be poor performers over the next five to ten years? I don't think so, but I don't think these are the great investments of the future now because of the size of those businesses. So it is concerning.

CONSUELO MACK: 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 picks up on what Tom Gardner said. It is: Use passive and active to your comfort levels. If you have no interest in investing go with index mutual funds or ETFs. Just make sure you are broadly diversified globally and by asset class. That means including some safe haven, non-correlated- investments like treasury bonds and gold in the mix. If you are like most of us, combine mix the two with a core position in a broad global stock index fund and satellite positions in actively managed mutual funds in specialties such as small cap value, high growth tech, global bonds, or real estate. The third way is the traditional actively managed mutual fund approach, again combining broad global and asset class diversification.

Whatever you decide recognize that we have far more investment choices than we have ever had which is a blessing and a curse. Maybe a robo investment plan is worth considering after all!

To see this program again and other WEALTHTRACK interviews please go to our website WEALTHTRACK.com. Also feel free to reach out to us on Facebook and Twitter.

Thanks for watching. Have a lovely labor day weekend and make the week ahead a profitable and a productive one.