CONSUELO MACK | WEALTHTRACK

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On this week's show: What the huge, fundamental changes in the stock market's structure mean for investors, with seasoned market observers, Jason Trennert and Jason Zweig.

Jason Trennert
Co-Founder, Managing Partner
Strategas Research Partners

Jason Zweig
Columnist, "The Intelligent Investor"
The Wall Street Journal

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CONSUELO MACK: This week on WEALTHTRACK, surging index funds, fewer publicly traded stocks, computer- dominated trading, what do these dramatic market changes mean for investors? Find out next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.

This is not your grandmother's or mother's market. And if you are a baby boomer, as I am, it's not even the market of your youth. The very structure of the stock market has changed in some fundamental ways.

Among the major differences:
The number of publicly traded stocks available to buy has shrunk dramatically in the U.S.,..
As you can see from this chart, twenty years ago there were nearly 9,000 publicly traded companies on U.S. stock exchanges. That number has declined more than 40% to just over 5,000 today.

And where those stocks are trading has changed dramatically. A decade ago the New York Stock Exchange , with its specialists overseeing orders for each stock, accounted for 80% of the trading of New York Stock Exchange listed stocks, transactions for all to see.
Now only 20% of the trades occur on the big board. The vast majority are disbursed electronically among multiple trading platforms, out of direct human control and the public eye.

Where are new companies getting the financing to develop and grow? Largely from private investors through private equity firms. There are now more than 4,000 PE firms globally, up from a mere 100 a couple of decades ago. 95% of them are in the U.S. they are overseeing an estimated $2.5 trillion worth of assets.

The supply of stocks is shrinking, but the number of indexes is exploding.
As this chart illustrates there are now more benchmark indexes than there are stocks, over 5,000 of them. Many of them are being created to meet the swelling demand for passive index investments, especially exchange traded funds, or ETFs.

The number of ETFs has also soared in recent years to over 2,000 in the U.S. with about $3 trillion in assets. Four of the five most actively traded securities last year were ETFs.

The one exception? Bank of America.

What do all of these changes mean for investors? Joining us are two Financial Thought Leaders, one from Wall Street and one covering it. Jason Trennert is Co-Founder, Managing Partner and Chief Investment Strategist At Strategas Research Partners, an independent investment strategy and macroeconomic research firm followed by institutional investors because of its original and proprietary analysis of the markets, economy and fiscal and monetary policies.

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Jason Zweig is a highly respected financial journalist, who writes a column for *The Wall Street Journal*, named after Benjamin Graham's classic, *The Intelligent Investor.* Zweig is the editor of the latest revised edition. He is also the author of several books including *Your Money & Your Brain*, and the satirical, funny and oh so sobering look at Wall Street, *The Devil's Financial Dictionary*.

Our discussion began with why so few companies are going public.

JASON TRENNERT: I think there's really two reasons. The first is Sarbanes-Oxley after the financial crisis in '99, 2000 after the bubble. That made the cost of being a public company significantly higher. Simultaneously you have this growth in the private equity business. It's estimated there were about 100 private equity firms in the year 2000. There are about 4,000 right now.

CONSUELO MACK: Wow.

JASON TRENNERT: So really the need to go public is just not there. There are a lot of other sources of capital that companies can tap into.

CONSUELO MACK: How big a deal is it, Jason, that we have this shrinking universe of publicly traded companies?

JASON ZWEIG: I think it affects the market on two levels. One, it almost compels institutional investors like pension funds and university endowments and the like to invest ever more in private equity which of course drives up prices and ultimately drives down future returns. So we've already seen a lot of the historic advantage of private equity as an asset class shrinking, and I would expect that all of these people are chasing performance they probably won't catch. The second reason I think it matters is somewhat less significant. I think for fund managers who invest in very small stocks, their job is probably getting harder than ever.

CONSUELO MACK: Because their universe is really shrinking, because that's where the PE firms invest.

JASON ZWEIG: We had roughly 7,500 companies 20 years ago; now we've got roughly half that number. So you've got larger and larger amounts of money chasing fewer and fewer companies. It becomes harder and harder to compete in that environment.

CONSUELO MACK: So the other thing that troubles me, though, is what your saying is that private equity is for high-net-worth individuals or its endowments and pension funds and everything else. So that means that I as an individual investor, I'm losing out as far as my ability to invest in young companies. That's my editorial. I don't usually do that, but Jase, you wrote a piece recently that we actually put on our website, WealthTrack.com, saying it's

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almost like private equity is doing a favor to individual investors. So explain that by investing in these small companies.

JASON TRENNERT: Individual investors will probably have some exposure to those companies through their own pension plans or for their own endowments, but by the same token in some ways private equity is saving retail investors or individual investors from themselves because a lot of the most exciting and the most speculative companies are not public companies right now. So if you think of an Uber for instance or an Airbnb or a Spotify, a lot of those companies at this part after an eight-year bull market, people would be bidding those things up to high heaven, and right now that's really not happening.
That's where the risk is probably more in the private equity side than it normally would be on the individual investor side. So it's also part of the reason why I think the euphoria that's normally associated with a bull market doesn't seem to be as apparent as it normally is, certainly if you remember '99 or 2000. It's really no comparison.

CONSUELO MACK: Let me just finish up on the private equity part of this, because for most of our audience it doesn't really matter to them. I mean it's interesting but you said, Jason, that you thought that they were really expensive, and you two agree on that, that private equity ... is it in a bubble? Is it just they're paying a lot of money for companies?

JASON ZWEIG: If you spend time in the San Francisco area or any other part of the country where there's a heavy concentration of venture capital or private equity partners, you will be almost overwhelmed by how much money is sloshing around. These companies are all valued as if they all are going to dominate the market.

CONSUELO MACK: Just like dot company was, the dot com bubble.

JASON ZWEIG: Yes, and it's pretty much the same mental model which is back in 1999 everybody knew and nobody was wrong. Everybody knew that the Internet was going to be the next great thing and it was. It is, but the problem is 90 percent of the companies involved in it don't exist anymore. So if you were fortunate enough to buy Amazon back then and only Amazon, you did pretty well, but if you bought Pets.com, you lost 95, 98 percent of your money. The same thing is probably going to happen again, but now it's going to happen to the smart money, not the so-called dumb money.

CONSUELO MACK: Jase, is this a problem in fact if we see a lot of private equity firms going out of business, or if things don't work out with these longer-term bets? Does that cause a problem in the financial system?

JASON TRENNERT: Eventually it'll cause a problem in my opinion particularly for state pension plans. I think it's one of the places where there's probably the most risk because part of what allows a lot of state pension plans to have what I believe – an editorial comment – are actuarial expectations that are much too high, are much too high allocations to alternative

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investments, particularly private equity. Again, it's worked well. David Swenson at Yale was the first to really popularize this, but it worked very well for Yale because he was the first person to do it. He had noticed that there was a risk, more of premium, a public company premium over private companies, and he exploited it. Now I think it's quite the opposite. I think there's a private company premium over public equities.

CONSUELO MACK: The next phenomenon that we've been covering a lot on WEALTHTRACK is the explosion in ETFs, and what's so interesting is on the one hand you have stocks that are shrinking, the publicly traded stocks, and on the other hand you have these ETFs which are primarily made up of stocks, that are booming. I mean when do those two facts collide? Jason.

JASON ZWEIG: Well, that's an interesting question. I guess what I would say is that there's an underappreciated factor that's been driving this. Much of the money that has been going into ETFs, it's not strictly speaking new money. It's being shifted from stock mutual funds into stock ETFs, and that migration has been driven largely by financial advisors who charge an annual management fee to their clients. Now if I'm charging you one percent a year to manage your money, and I'm putting your money in mutual funds that cost one percent, you're paying me effectively two percent a year, and you're probably going to start to ask me why I'm not cutting my own fee. But if I move that money out of a one percent mutual fund into an ETF that charges a fifth or a tenth as much, the pressure comes off my fee, and I happen to believe that's one of the big motivations that has been pushing that huge migration of money. That's not a bad thing by the way for the client, but I think it's important to realize that there's an underlying economic force here that's going to keep driving that money probably for years to come.

CONSUELO MACK: The economic force being the financial interest of the financial advisor.

JASON ZWEIG: Yes, absolutely.

CONSUELO MACK: But again, too much money chasing too few goods. So in this case when there are too few goods which are fewer and fewer stocks, and you have I think there are now something like 5,000 indexes which is almost ...

JASON TRENNERT: There are more indexes than there are stocks.

CONSUELO MACK: More indexes than there are stocks. It strikes me that that's got to eventually be a problem that has not been tested yet, because we've been in an eight-year bull market.

JASON TRENNERT: Personally, I believe this lies at the very core of the active versus passive debate. So people are moving money from, as Jason said, from actively managed mutual funds to passively managed ETFs, and there's nothing wrong with that per se except

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that if it gets out of hand which I think it is, people are going to be spending more and more not realizing they're going to be paying higher and higher prices for the constituency of those indices, and I think that's particularly true for the S&P 500, particularly true ...

CONSUELO MACK: Which is the most popular of all the ETFs.

JASON TRENNERT: The most popular stock index and particularly when you look at stocks like what we call the FANG stocks, Facebook, Apple, Netflix, Google. Because their market cap-weighted, they get bid up even more. So more expensive companies tend to get more expensive the more money that flows into these passively-managed funds. The good news is that I do think that gives an opportunity for active management to make a comeback, but for now those stocks will get more expensive.

CONSUELO MACK: Jase, in fact you have written a research piece saying that you think that passive has peaked which you just explained a little bit about why, but what are your major arguments?

JASON TRENNERT: Well, it's partly because of the existence of ETFs, the growth of ETFs, but I think it's also largely because of the monetary policy we've had in the United States which has largely suppressed the volatility of both interest rates, the economy, inflation, and you've also really not had a real business cycle. About a third of the companies in the Russell 2000 have failed to make a profit in the last 12 months. That only happens in recessions. It doesn't happen in the eighth year of an expansion. The reason why it's happening is because interest rates are quite low, and so if you're tasked with buying good companies and selling bad companies, your job has become very, very difficult in a period of excessively low interest rates. As interest rates normalize, as they go up and the Fed starts to normalize interest rates, in my opinion, the volatility of the markets will be higher, and the value of active managers should improve. The last several years, though, have not been kind to active versus passive.

CONSUELO MACK: No. The last eight years essentially, and actually there's a SPIVA report which we've reported on WEALTHTRACK that shows over the last 15 years just about like 90 percent or something of active managers have underperformed their benchmarks and in just about every asset class you can look at. So your response to this passivist peak..

JASON ZWEIG: I think it's a lot closer to peaking than it was a few years ago certainly. My hunch is we still have quite a ways to go before passive peaks. I don't know where it will top out, but I think there's still a lot of room in front for passive management to grow. Also, I might push back slightly, Jase, on your point because I've spent a lot of time looking for this, and I have a hard time sort of proving the case that money flows into passive funds in isolation have contributed to overvaluation in the market. If for example you compare the S&P 500 to the Wilshire 5000, a much broader index, yes, the S&P is a very large share of it, but you don't really see the valuation gap between those two getting that much wider than it

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historically has been even though there have been much greater inflows into the S&P 500 index funds than total stock market index funds. So intuitively I think everybody has the same sense that when millions of investors are all doing the same thing, it has to have a significant effect, but it's really hard to come up with kind of conclusive evidence that we're there, that passive has distorted the marketplace in a way that is dangerous. You can see it in little areas like we saw it in Real Estate Investment Trusts a couple years ago. We saw it in like low volatility stocks and maybe high dividend stocks, but for the market as a whole I'm not totally sure we're there yet.

JASON TRENNERT: I would tend to agree. I think when you're really going to see it is during the next recession in times of economic stress as you always do, and Warren Buffett says you don't know who's swimming naked till the tide goes out. Right now the economic growth is actually pretty good, and volatility is quite low, but our expectation is that with the new administration, if it gets some of its policies through, they're quite reflationary and will change the volatility of the economic growth moving forward.

CONSUELO MACK: There's another theory, Jason, that you have which I thought was really interesting. You've written a column about it as well is that one of the reasons that you don't seem to be as concerned about the rising dominance of ETFs is that you wrote a column called "The Market Really Is Different This Time," and you say that we are in a homeostatic market. So explain what's going on in the market.

JASON ZWEIG: So just as the thermostat in your house or maybe in your car will adjust the heating system to stay within a band around the temperature you're choosing to set. So many investors are now automatically rebalancing or selling some of whatever's gone up and buying some of whatever's gone down. I think at the margin that's having a moderating impact on the market, and I think it may be a contributing factor to why volatility has been so low, at least until the past few days.

CONSUELO MACK: Another issue, Jase, that you and I have talked about before is the fact that the exchange ... we used to have the New York Stock Exchange which the vast majority of stocks are traded on ... is that now that only 20 percent of the stocks are now actually traded on the New York Stock Exchange, and so the trading is dispersed among all of these other groups. I call it kind of like the shadow trading system that maybe aren't so well regulated. They really don't know what each other is doing.

JASON TRENNERT: It concerns me. We have an annual conference every year for out institutional investors, and we almost always have someone talking about market structure because as you pointed out, ten years ago 80 percent of the market share of trading in New York Stock Exchange listed stocks happened on the New York Stock Exchange. Now it's only 20 percent. There are over 30 other sources of liquidity or exchanges out there. When you see things like the flash crash, one of the things that was disconcerting was how few people knew what the source of the problem was. In the old days you could go right to the

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exchange and you would have a good idea. Now you don't have that idea as well.

CONSUELO MACK: Are you concerned about that, Jason?

JASON ZWEIG: One of the difficulties I think is that the system has become not just hard to understand but hard to manage. It's not clear that the regulators in Washington fully understand how the system works. I don't want to sound alarmist, but I think there's some legitimate concern about whether it has become too complicated for anybody to manage.

CONSUELO MACK: So more than 90 percent and it might be as high as 99 percent. Charlie Ellis, I talked to him the other day of trading now is machine-driven evidently. We program the machines, but still to me that's a little scary, but maybe I'm old-fashioned.

CONSUELO MACK: So let me ask you the two final questions and, Jason, I'll start with you and that is, with all of these changes, is the stock market a good place for individual investors to be putting their life's retirement investments in?

JASON ZWEIG: Well, yes. I think so but it's not a good place to be like jumping in with both feet. Now more than ever it's important to have a plan and a structure. You don't want to go out and buy the FANG stocks because they're hot. You don't want to put all your money in Apple. You don't want to put all your money in one market sector or even in one fund, and you also don't want to put it in all at once. What you want to do is you want to have a target for how much you want in ...

CONSUELO MACK: In the stock market.

JASON ZWEIG: ... in the stock market, and you should also have a target time period over which you would get to that level, and above all you want to keep your costs as low as possible.

CONSUELO MACK: Jase, I'm going to quote you to yourself. "Index investors will be subject to the entirety of the next market decline." Is this a place we want to be?

JASON TRENNERT: I think you want to be more selective. I agree. I think P/Es, the valuations of the market aren't cheap by any standard. Interest rates are historically low by any standard, and so I very much agree. This again presents maybe some opportunities for active managers. I will say too I want to get in here the idea of bond funds as well because I think that's one place where the individual investor is probably most exposed. A lot of the surveys suggest that a lot of individual investors view bond funds as a proxy for cash, and it's not. There is clear capital at risk there, and I think again if interest rates and inflation move higher as they will at some point in the future, you'll start to see some of that pain.

CONSUELO MACK: One investment for a long-term diversified portfolio. Jason, I'm going

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to ask you for yours first.

JASON ZWEIG: I'm going to put a little twist on it, Consuelo. I think I'm going to recommend not an investment but a pocket. I think all of your viewers or a very large number of them probably have kids. Probably a bunch of them have teenage kids, and if you haven't opened a Roth IRA for your children, you really should because you can take your kids' summer earnings or any other wage income that they have, and you can match it dollar for dollar in a Roth IRA for your kid. There are no tax consequences for you. The money will grow tax-free for your child. It's a great way to set money aside, and it's more or less a risk-free transaction for you as a parent and for your children.

CONSUELO MACK: And you could do it for grandchildren too.

JASON ZWEIG: Absolutely.

CONSUELO MACK: Jase.

JASON TRENNERT: I would say Bank of America.

CONSUELO MACK: A stock.

JASON TRENNERT: A stock. I'm old-fashioned. So I think someone described buying stocks as model railroading now. It's become that uninteresting, but I still love the game. It's not a game. It's an activity, but I like Bank of America quite a bit. It's interesting. The stock has doubled in the past year, but it's still trading below book value, and I feel very strongly that this administration is going to work very hard to deregulate the financial system, and I think Bank of America will be a big beneficiary of that.

CONSUELO MACK: Thank you both so much.

JASON TRENNERT: Thank you.

CONSUELO MACK: Jase, Jason Trennert, and Jason Zweig, thanks for being with us on WEALTHTRACK.

JASON TRENNERT: Thank you.

JASON ZWEIG: Thanks.

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 is: Consider automating some of your investment decisions.

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There are numerous places to do so:
- Automatic deposits to savings or tax deferred accounts, for your self, your children and even grandchildren.
- Setting up a robo-account to automatically invest and rebalance your portfolio.
- Buying a target date fund to prepare for your retirement.
- Automatic Dividend Reinvestment Plans either through a mutual fund, ETF or DRIP, a dividend reinvestment plan offered by companies for their stocks.

Automating your investments takes you and your emotions out of the process and insures a financial plan for the future.

Next week we will turn our attention to socially responsible investing with two leaders in the field. Gabelli Funds' Christina Alfandary and Calvert Funds' John Streur.

In the EXTRA feature on our website we will discuss why Zweig and Trennert are monitoring some emerging antitrust issues surrounding the dominant roles played by Vanguard and Blackrock , as well as Google, Facebook and Amazon.

Speaking of social media, please keep you comments coming 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.

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