DEALING WITH A DECADE OF LOW RETURNS

Op Ed by Dr Rory Knight

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The coming decade is shaping up to be one of low returns. We have lived through a period of the loosest monetary policy ever seen but growth has remained stubbornly slow. We may now see a swing in the opposite direction, starting in the US, away from monetary to fiscal stimulus. The balance sheets of the major central banks have been pumped up to four times their size through quantitative easing. The US Federal Reserve, the Bank of Japan, the Bundesbank, the European Central Bank, the Bank of England and the Swiss National Bank have all disgorged vast amounts of cash leaving them holding a mountain of securities. These balance sheets will inevitably have to be pumped down which will dampen long term growth. Currencies meanwhile remain mainly undervalued with the exception of the US dollar and Swiss franc. (And of course don't mention the pound!)

A pull-back from free trade and globalisation (to whose impact some trace the rise in nationalist protectionism) could also damage economic growth. It could even result in trade wars, as a result of which the lacklustre performance in emerging markets is certain to continue to deteriorate.

Another source of downward pressure on returns is the asymmetry in the distribution of income and wealth. Although globalization has lifted millions, if not billions, out of poverty there is evidence of a widening disparity in income both within and between countries. In this connection the recent book *Capital in the 21st Century* by Thomas Piketty may be worth a glance. He argues that as the rate of return on capital exceeds the rate of economic growth (return on labour) the gap in income is inevitable. There will therefore be pressure to force the rates together. Regrettably, in the process economic growth is likely to suffer. Pressure from labour and regulators can be expected to dampen financial returns further.

> "The active passive dilemma is back"

One shining white hope is technological innovation. But despite all their promise not all technological innovations are economically benign. Beware the allure of the promised sunlit uplands. The benefits to growth need to outweigh the costs of unemployment that are often incurred. For example, driverless vehicles may be a wonderful thing but they jeopardise vast numbers of jobs. This is also true of artificial intelligence which will surely bring in its wake many social issues. This will certainly not halt or even slow innovation, but growth could suffer in the process.

How should one invest in such a context of diminishing returns? Should one be passive and invest in an index or be active and seek out the best performers? The trend is to the former, but super focused investing may make the most sense.

Active versus passive investing

There is an ideological clash developing in the investment industry which is spilling over into the markets and having some real effects. On one side, armed with decades of academic research on portfolio theory and efficient markets, are the passive investors. They offer index funds at minimal fees to track the market. Jack Bogle, founder of Vanguard a leading purveyor of passive funds, is a vocal supporter of the passive approach. They argue it is all about low fees. On the opposite side of the debate are the active investors. They claim to offer superior performance at higher fees. Index funds have no prospect of beating the market because they are the market. The counter argument is that in order to seek superior performance active managers must take non-market risk which is allegedly not rewarded. The passive strategy advocates focus on fees. This is a distraction as investors are not attempting to minimise fees, they aim to maximize investment returns after fees. The passive managers are currently winning in that the flow of funds as discussed below is in their favour. If all managers switched to being passive securities would become mispriced creating arbitrage opportunities for managers to switch back to an active style. There will always be an equilibrium amount of active management – at the moment the pendulum is swinging against the active managers. The issue is of course empirical.

A century of performance

Tracing the performance of stock markets over the last 100 years is instructive. The chart shows the performance of the Dow Jones Index from 1 March 1917 to 1 March 2017. (In order to interpret the data meaningfully they are presented on a logarithmic_{10} scale in constant 2017 dollar terms.)

Note the following features:

1. Although in nominal terms the value of the index has gone from 97 to 20,850; the compound annual growth rate (CAGR) in real terms over the 100 years has been a mere 2.5%.

2. Notice also how long it takes to recover from high water marks. The 1929 crash took thirty years to reach pre-crash levels, as did the 1966 bear market. The dot.com recovery was interrupted by the 2008 crash, and recovery from both has so far gone on only for 14 years.

3. Thus we have spent 82 years of the last 100 in the red! Namely, periods when we were either digging a hole or trying to climb out.

Equities in aggregate over the past one hundred years have simply not provided adequate returns for investors requiring a long-term return above 2.5%. This would include most pension plans, insurance portfolios and foundations. This has profound implications for the long-term investment horizon. The luck of the cycle has a profound impact on wealth generation. Those who worked through the bull market periods of the last two decades of the millennium were contributing to rising prices but will be consuming off reducing prices. Millennials are beginning their careers with flat returns and high volatility.

So what can be done?

So what can be done? There are many instruments and strategies on offer in the investment market place offering to improve on or beat equity market returns. These fall into three main categories as ways to improve stock market returns:

(1) Time the market by going in and out at critical moments (buy low, sell high). (2) Leverage the returns by borrowing (leverage). (3) Sacrifice diversification (stock-picking).

The first is very tricky and much easier with the benefit of hindsight. Peter Lynch, the well-known investor who ran the famous actively managed Magellan Fund for Fidelity which outperformed the market, claimed that the majority of investors in the fund actually lost money due to market timing. Look at the critical day theory: it turns out that much of the market's performance in any given period is delivered by a surprisingly small number of days. Miss those and performance falls significantly. Although good managers deploy timing, it is not to be relied on as a strategy.

Leverage is certainly one way to accelerate returns and, when combined with strategies such as doubling up losses, can be shown to achieve demonstrably higher returns. Two problems arise, however. The first is that debt is not free. It has to be serviced and increases risk proportionately. The second can be summed up in Bernouli's St Petersburg Paradox, whereby doubling up rests on an unattainable infinite value. In other words you run out of money before the casino. Most shorting and hedging strategies are a form of leverage whereby exposure to market risk is dampened or amplified.

That leaves our third option: a strategy of active stock-picking. The best managers are those whose best ideas involve super-focused portfolios. Many investors focus understandably on volatility as a measure of risk, but while it has some relevance long-term risk is better defined as the dollar amount of capital that might be lost. Bear markets lose capital which drags down the long-term rate of growth. However, trouble represents opportunity. The opportunity for bargains is generated at these times of maximum pessimism.

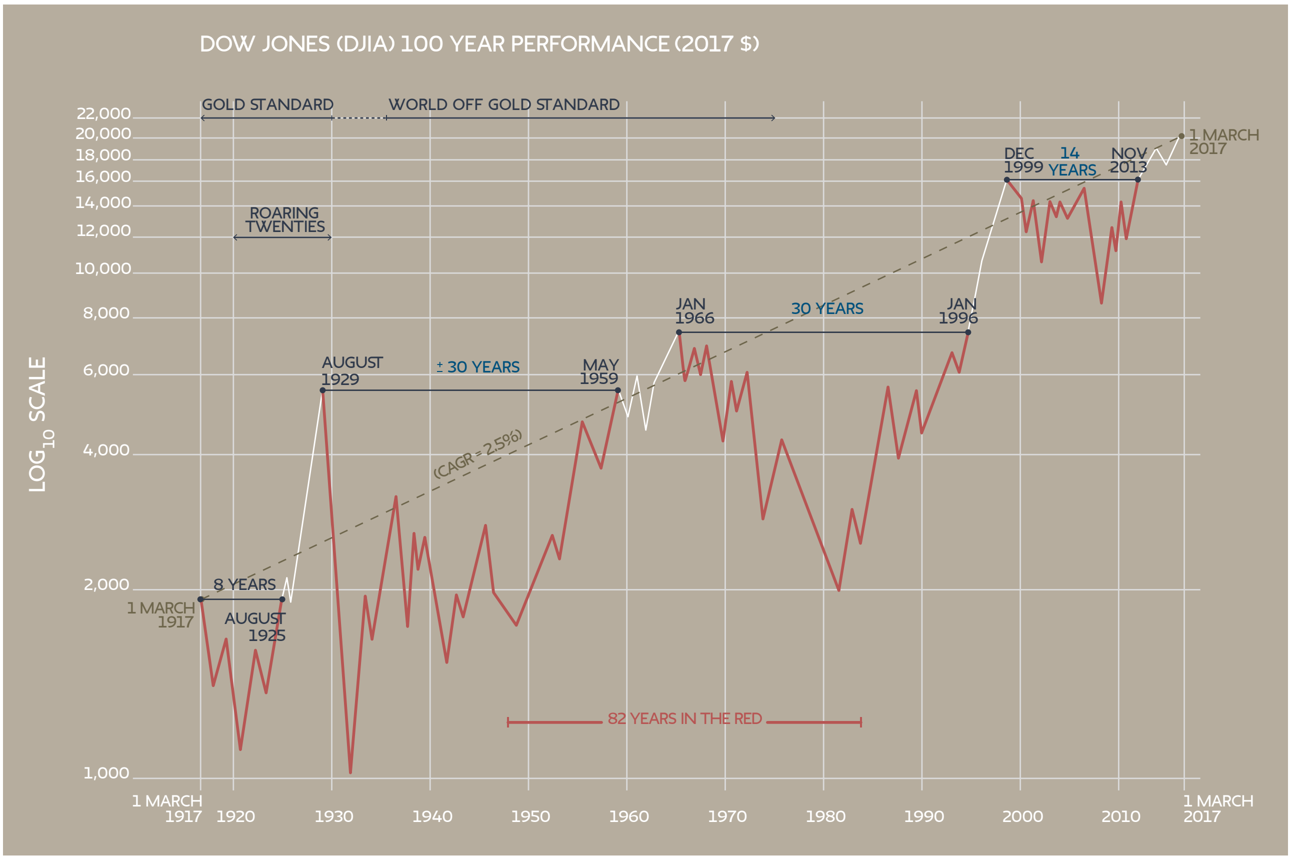
The trend is to passive

Diversification as a strategy delivers little more than a smoothing out of short term variance in returns, which adds little value to long-term investors. Passive investing has become a favourite way to achieve diversification. The investment industry has seen a marked shift over the last two decades out of active into passive funds. The proportion of institutional equity investments in active management, though still around 60%, is down from 80% three years ago. In the last year there has been a massive outflow from active funds into passive funds, especially exchange traded funds (ETFs). In 2016 $360 billion flowed into ETFs, followed in the first two months of this year by another $131billion. This phenomenon has been dubbed "flowmageddon" by Morningstar, and many commentators attribute the current surge in share prices to this inflow. There is a risk that if these funds move out prices will drop rapidly. But that is simply a matter of blaming the messenger.

Passive funds offer diversification on the cheap – and so they should because passive managers' efforts as mentioned above cannot deliver superior performance and the equity market does not necessarily deliver adequate returns in the long-term. By contrast, active managers have been struggling to beat market returns after the deduction of their much higher fees. More than 80% of active funds have failed to beat their benchmark indices. Active management is certainly under pressure. Even Warren Buffet in his most recent newsletter has weighed in behind passive investment. However, the underlying argument for active management remains convincing particularly in an era of low returns and high volatility.

Super-focused makes sense

Staying passive and accepting the average return is not exactly inspiring particularly in a context where overall returns are expected to be low. Since the average market return represents a distribution of all managers returns it is tempting to seek out managers at the positive tail of the distribution. Easier said than done. Nevertheless, a strategy of super-focused investing makes a great deal of sense. Invest in the best managers one can find whose best ideas involve super-focused portfolios. Achieve diversification across managers in order to avoid clustering rather than to reduce variance in returns. But one final word of caution: whatever you do you are almost certainly going to experience at least one large negative shift in the stock price of each security. Oxford Metrica research into large stock price shifts in the global 1,000 companies has shown that there is more than an 80% chance of a negative impact of up to -30% over a five-year period. That is a serious consideration. Our subsequent research focused on specific events and traced their impact on prices. It indicated that crises can be turned positively but to achieve this a range of active management responses is required. These are factors investors and investment professionals alike would do well to bear in mind. In short in the words of the late Sir John Templeton, the great international investor, "Trouble is opportunity".



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