April 17, 2015

We can't help it. Charles Gave inspires us so routinely that his musings are, once again, the highlight of this month's *Guest EVA*. I had an immediate and visceral reaction to his April 10th published essay *How Indexation Killed Growth*. As you'll see, he calls index investing stupid and compares it to Socialism—and that's just the first paragraph!

What bothers Charles also concerns me and my Evergreen colleagues. Passive investors have a high probability of achieving average performance and little risk of falling short.

I'm reminded of Howard Marks' (Co-Chairman of Oaktree Capital Management) essay, Dare to be Great. His asset allocation conclusion was: "Can't lose usually goes hand-in-hand with can't win."

As mean-reversion investors who are not afraid to forge an unconventional path in the face of all sorts of scrutiny, we disagree with many of our peers who pursue overt (or, in some cases, stealth) indexing strategies. If we managed our client portfolios to minimize business risk as opposed to maximizing returns, we could virtually ensure average performance, too. (We concede that late in a bull market it would be nice to run with the herd but we've seen repeatedly how poorly that turns out in the fullness of time.)

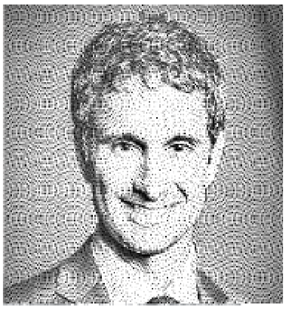
Charles takes his thesis on the dangers of brain-free investing a step further, citing low dispersion among money managers and the herd mentality as a systematic failure. A world where indexing is the dominant asset management style is a momentum-based world, and one that fosters boom and bust outcomes. And, finally, it is one that misallocates capital and stunts economic growth, dual patterns we've seen in abundance over the last 15 years. (Note: the S&P has had an average annual total return of just 4% since December 31, 1999, and the US economy has grown at a limp rate of 1.8% per year in that same timeframe.)

In a departure from our *Guest EVA* routine, we're also including a Real Vision TV link. Real Vision TV is the world's first on-demand video channel for finance that, in its short history, has earned a pristine reputation for content. Delivering the highest quality economic, financial, and geographical insights began as a mission for our friend and colleague Grant Williams, co-founder of RVTV, and it's now become a reality.

Accordingly, it comes as no surprise to us that the GaveKal team continues to be highlighted by Real Vision. Evergreen's Hong Kong-based global macroeconomic research affiliate has a stable of expert analysts. Among them is Will Denyer, who is a dedicated US economist.

Will has been extraordinarily accurate with his predictions over the last few years. In this interview, he tackles the somewhat convoluted notion of being bullish on the US economy and cautious toward our equity markets. Will also discusses the impact of the energy price drop, his view on where we are currently in the economic cycle, the impact of looming policy changes, and the affect these items could have on US financial markets. Click here to watch the interview. (Please note it works best in Firefox or Chrome.)

Lastly, as a special offer to EVA readers, Real Vision TV is providing a $100 discount to anyone who uses the code EV-GAV while subscribing at www.realvisiontv.com. It was a long time coming, but Grant is finally reciprocating for when I picked up his green fees at our last golf outing. Much obliged.



MARK NICOLETTI
Director, Family Office Group
To contact Mark, email:
mnicoletti@evergreengavekal.com

HOW INDEXATION KILLED GROWTH
Charles Gave

Indexing, as I have written before, is a form of socialism, since capital is allocated not as it should be—according to its marginal return—but rather according to swings in the market capitalization of the underlying assets. It is hard to think of a more stupid way to allocate this scarce resource.

In this new world, the goal of every money manager is to achieve a performance as close as possible to the index against which he is benchmarked. As a consequence, the dispersion of results among money managers has become smaller and smaller over the years. Today you can even buy programs telling you how much IBM stock you should buy versus Johnson and Johnson in order to control your "tracking error". As always in economics, there is what you see and what you don't. What most people don't see is how the spread of indexation has led to a collapse in the growth rate of the economy.

Building a portfolio is a very complex exercise. In a perfect world, one would start with the "expected" marginal increase in the return on invested capital of different investments. Once satisfied with a given position, one should try to ensure that the increase in the marginal return is not too correlated with other positions in the portfolio. The name of the game is to find assets with the same return on invested capital (ROIC) over the long run, but a negative correlation over the shorter term (for example, US shares versus. US government bonds over the last 20 years).

This aims at the Holy Grail of money management, which is to achieve a decent long term return, together with a low volatility of that return. As one can see, this involves a massively complex price discovery exercise, starting with an examination of the marginal variations of ROIC, followed by consideration of the prices at which one can buy the available assets, and finally ending with portfolio construction.

In such a world, one would expect the distribution of performances to be very wide. Indeed, a large dispersion of performances should reassure us that capital has been properly allocated. After all, not everybody can win the jackpot.

Alas, today's world is not perfect, and this is not how capital is allocated. Instead capital is allocated according to the market capitalization of the assets under consideration. So nowadays, capital is directed to an investment if it outperforms. In simple terms, this means that capital is channeled to companies enjoying an increase, not in their ROIC, but in their share prices. In a world in which investments are made according to the marginal ROIC (i.e. the past), these two tended to overlap. As a result, indexation worked, but only as long as no more than about 5% of assets were managed by "free-riding" indexers.

Not in today's world. Today indexing has become the dominant asset management style, and investments are dictated by market cap and changes in market cap; which is simply another way of saying that capital is now deployed according to momentum-based rules. This was very visible in 1999-2000, and is almost as visible today.

Intellectually, the old method of investment was based on a "return to the mean" approach. When the price movements of an asset became excessive compared to its expected ROIC, then one bought—or sold—the asset. Today, capital is allocated only according to marginal variations in the price of the asset. The more it goes up, the more money managers invest in it. The more it goes down, the less managers own.

A return to the mean methodology leads naturally to a stable, but moving, equilibrium. Momentum-based investing inevitably creates an explosive-implosive system, which swings wildly from booms to busts and back again. And if monetary policy is as silly as it has been since 2002, these swings will be even more pronounced.

The closer we get to a bust, the tighter the performance dispersion among money managers, as the poor fellows trying to manage efficiently and professionally lose their clients to benchmark optimization algorithms. I don't have the necessary data, so cannot prove it, but I would not be surprised if a sharp fall in the dispersion of money managers' results is a reliable warning that a bust is approaching.

The goal of every socialist experiment is for everybody to earn the same salary. In the world of money management, we seem to have achieved this remarkable ambition. Hurrah! Of course, if everybody gets the same results, then no one is going to get fired for underperforming, which is great news for the people administering the capital (I hesitate to call them managers). But—and here is what we do not see—our capital is being massively misallocated, all the time.

People ask me why we have no economic growth. Why on earth do they expect economic growth in a socialist system?