MORNING BRIEFING
March 7, 2017

Is Active Style Passé?

See the collection of the individual charts linked below.

(1) A blatantly biased defense of active investing. (2) Is the deluge of passive money a contrary indicator? (3) Buffett's last will and testament. (4) A passive melt-up. (5) Passive investors prefer low fees over cheap stocks. (6) Active managers did fine during previous two bull markets. (7) The choice is picking a passive index or actively picking the winners and losers in the index. (8) Stay Home investment strategy has beaten a passive global index. (9) Passive investing can feed on itself and distort capital allocation. (10) Passive investing is an active choice.

US Strategy I: Active Defense. Those who manage money, and those of us who advise money managers, believe that active investing isn't dead. Of course, we are biased. Maybe it's wishful thinking, but the recent deluge of attacks on this style by its critics, who tout the advantages of the passive investment style, might be a signal for contrarians. As money pours out of active into passive funds, there is a danger of a stock market bubble (a.k.a. a melt-up) forming as a result. If it bursts, active funds are likely to outperform passive ones. In addition, Election Day seems to have marked the end of the Age of Central Banks, which followed the financial crisis of 2008, and the beginning of Trump World. Arguably, there might be less correlation in terms of performance among various types of stocks in the latter environment than in the former.

Warren Buffett has joined the debate on the side of passive investing. Apparently, he views himself as a rare successful active investor. According to his annual shareholder letter: "Both large and small investors should stick with low-cost index funds." He added, "When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients." His main beef seems to be with hedge funds rather than all active mutual funds. According to a 3/1 *Chicago Tribune* article, "Three years ago, he provided similar advice to the trustees of his estate: 'Put 10 percent of the cash in short-term government bonds and 90 percent in a very low-cost S&P 500 index fund. ... I believe the trust's long-term results from this policy will be superior to those attained by most investors ... who employ high-fee managers.'"

A 3/3 CNBC article noted that last Wednesday's huge rally in stocks, the day after Trump's first speech before Congress, might have been fueled by passive investors: "A big factor was buying in a single exchange-traded fund. According to data from Bank of American Merrill Lynch, the benchmark SPDR S&P 500 ETF (SPY) saw a huge inflow of $8.2 billion on Wednesday, its largest for a single day since Dec. 19, 2014." Apparently, these passive investors liked that Trump acted more presidential than he has in the past. Now consider the following:

(1) *Betting passively on valuation.* For many years, Joe and I have shown that the current bull market has been driven by corporations buying back their shares and paying dividends to investors, who probably reinvested lots of the cash in stocks. The buybacks made sense, especially if they were financed with funds raised in the bond market, as long as the after-tax cost of those funds was below the forward earnings yield of the S&P 500. That's been the case since the beginning of the bull market, evidenced by the $3.2 trillion in buybacks by the S&P 500 corporations from Q1-2009 through Q3-2016

(*Fig. 1*).

Joe and I have been using the average of BoA Merrill Lynch data for AA-AAA and BBB-A yields as a proxy for the cost of money raised in the bond market (*Fig. 2*). The after-tax cost is actually lower since interest costs are deductible as a business expense. (That might change under the Republicans' tax reform plan.) The bond yield has been below the forward earnings yield since 2009. The valuation model based on the so-called Fed's Stock Valuation Model (which I so named back in 1997) shows that in February stocks were 57.5% and 23.1% undervalued using the 10-year Treasury and corporate bond yields (*Fig. 3*).

The reciprocal of these two yields can be used as "fair value" measures of the S&P 500 P/E. Used as an asset allocation model based on the Treasury yield, the P/E should be 41.3 based on February data. Used as a corporate finance buyback model, the P/E should be 22.8. Both are well above the current P/E of 17.6 (*Fig. 4*).

Both fair-value P/Es seem excessively high since they nearly match (22.8) or well exceed (41.3) the record-high S&P 500 forward P/E (25.2). That's especially true if bond yields move higher. If they don't, then that would imply weak economic growth, which would mean anemic growth in earnings. In this scenario, higher P/Es would only be justified if investors believe that there won't be a recession in the foreseeable future.

Then again, if the recent melt-up simply reflects individual investors pouring money into passive stock funds, then it could continue. In this case, valuation multiples would lead the melt-up, until something happens to scare investors out of those passive funds, which could trigger either a correction or a nasty meltdown. It is obviously a bit late in the game to start only now to be a long-term investor given that stocks aren't cheap no matter how valuation is sliced and diced.

(2) *Betting actively on sectors.* In defense of active investing, let's recall that many active managers overweighted the S&P 500 Information Technology sector during the second half of the 1990s. I turned bullish on the sector on March 20, 1995, in a *Topical Study* titled "The High-Tech Revolution in the US of @." During the bull market of the 1990s, the Tech sector rose 1,697%, well outpacing the S&P 500's passive gain of 417.0% (*Fig. 5*). Many active managers also overweighted the S&P 500 Financials sector during the 1990s as the banks were benefitting from deregulation. This sector rose 608% during the bull market of the 1990s.

During the previous bull market, from 2003 to 2007, active investors tended to overweight Materials, Energy, and Industrials, which I dubbed the "MEI" sectors and recommended overweighting. The MEIs were beneficiaries of the global economic boom led by emerging economies, particularly China. During that bull market, Energy, Materials, and Industrials rose 223/154/125% respectively, outpacing the S&P 500's passive return of 95.5% (*Fig. 6*).

(3) *Betting actively on countries.* Investing has become increasingly global since the end of the Cold War in the late 1980s and since China joined the World Trade Organization in 2001. On a global basis, the All-Country World MSCI stock price index would be an obvious choice for a passive investor (*Fig. 7*). For active ones, it would have been best to overweight the US during the 1990s, underweight the US during the 2000s, and overweight the US since 2010. That's clear from the ratio of the US MSCI stock price index to the All-Country World MSCI ex-US stock prices index (*Fig. 8*). This conclusion is irrespective of the currency, though it was more pronounced in dollars than in the rest of the world's currencies in aggregate.

The same conclusion obviously follows by examining the actual performance derbies of the major country/region MSCI stock price indexes. Here is the one for the previous bull market (in dollars): Emerging Markets (367.4%), EMU (215.4), UK (142.3), Japan (123.4), and US (96.7) (*Fig. 9*). Here is the one for the current bull market (also in dollars): US (250.5), Emerging Markets (92.5), Japan (85.7), UK (82.0), and EMU (79.0) (*Fig. 10*).

Joe and I are still recommending a Stay Home over a Go Global investment strategy, as we have been since early in this bull market. However, it has had a great run, and we are looking for opportunities overseas. We see some in Emerging Market Economies, where valuations are certainly more reasonable than in the US. However, Trump's potential protectionism may be weighing on some of them. Europe is also cheap, but populist politicians may be a much more serious threat to the region's economy, while US populists may be more supportive of US economic growth. Populists aren't threatening to disintegrate the US the way they are doing in the Eurozone. (We are betting, of course, that California won't secede from our union.)

(4) *Betting actively on industries.* Since Election Day, the so-called Trump trade has generated some obvious industry winners and losers from his proposed policies. Here are some of the winners through Friday's close: Investment Banking & Brokerage (35.9%), Diversified Banks (32.8), Regional Banks (32.5), Technology Hardware Storage & Peripherals (24.3), Semiconductor Equipment (22.5), Construction & Engineering (22.1), and Steel (21.9) (*Fig. 11*). Here are some of the losers: Apparel Accessories & Luxury Goods (-13.6), Department Stores (-11.7), General Merchandise Stores (-5.8), Agricultural Products (-5.3), and Retail REITs (-2.5) (*Fig. 12*).

US Strategy II: Passive Melt-up? Record fund flows have poured into passively managed funds and out of actively managed ones. Meantime, the S&P 500 index has soared. Is passive investing driving the melt-up in US equities? "Could the millions of people investing on autopilot be pushing an already expensive market even higher?," questioned a 2/24 *WSJ* article.

Without coming to a definitive answer, the article suggested that there are plenty of investors today who aren't bargain-shopping for stocks. Rather, they intend to buy and hold for the long term "regardless of whether entire markets are undervalued or overpriced." Yah, sure, let's see how long they remain long-term investors during the next correction! In any event, I asked Melissa to have a closer look at the recent fad of passive investing and the run-up in equities. Here is her take:

(1) *Wagging the dog*. The 3/9/16 issue of *The New Yorker* included an article titled "Is Passive Investing Actively Hurting the Economy?" It noted that "a market that has more passive than active investors will behave differently than markets have in the past." Imagine that "more and more money will pour into a set of firms largely independent of the considerations that have traditionally guided investors." More passive money could distort markets by pushing more funds into the largest firms, "whether these companies are actually performing strongly or not" because stocks are typically indexed by market capitalization.

In the article, global co-head of Goldman Sachs' investment-management division Timothy O'Neill explained that a greater share of market participation in index funds essentially "guarantees that the most valuable company stays the most valuable, and gets more valuable and keeps going up. There's no valuation or other parameters around that decision." Until now, active investor decisions counteracted passive ones. But the rise in significance of passive funds may be disrupting that balance.

Some evidence of such disturbances has occurred on a large number of recent occasions when significant stock price fluctuations have occurred at the end of the day. Two strategists were recently quoted in Bloomberg attributing that movement to passive funds rebalancing new inflows. Although temporary, the movement suggests that passive funds seem to have an increasing ability to influence market activity rather than follow it as intended. That could be especially true given the greater weight of passive to active funds in the market.

(2) *Tidal wave.* Flows into passive US equity funds totaled $262.8 billion y/y through January, while actively managed ones lost $266.2 billion over the same period, according to a 2/14 Morningstar Research report. During the month of January, the bleeding continued with $20.8 billion coming out of actively managed US equities and $30.6 billion flowing into passive funds. Of the $6.7 trillion in assets held with US equities, almost 50% of that is now passive.

In a 2/9 *NYT* op-ed, Vanguard founder Jack Bogle described the phenomenon as "a tidal shift to index funds—actually, more like a tsunami." He wrote: "Since 2008, mutual fund investors have liquidated more than $800 billion of their holdings in actively managed equity mutual funds and purchased about $1.8 trillion of equity index funds."

(3) *Cost matters*. Lots of investors seem to be more interested in seeking out low-cost funds rather than discounted stocks. Vanguard has "dominated" in terms of inflows for both passive and active funds, according to Morningstar. Investors obviously are attracted to the investment management company's low-cost model. Morningstar observes that despite an overall decline in fees for both passive and active funds over the past several decades, there is still a "significant fee gap" in equity funds.

(4) *Inflated index*. A 10/9/15 *NYT* article, titled "The Ease of Index Funds Comes With Risk," provided a bit of evidence that passive investing can lead to overpriced assets with calculations from S&P Capital IQ: "Non-Russell 2000 index stocks carry a median price-to-book value ratio of 1.34. But index stocks are accorded a 61.9 percent valuation premium at 2.16 price-to-book as of June 30. The premium has been in place each of the last 10 years but has been rising. In 2006, for example, it was just 12 percent."

More broadly, although less recently, the abstract of a 2011 academic research study stated: "This paper explores the impact of flows into S&P 500 index funds on corporate valuations. The results show that money flow into S&P 500 index funds is inflating the values of companies in the index relative to those outside of the index."

Business Insider picked up an in-depth 5/1 blog post from Philosophical Economics, which explained why prices could get distorted in a market overrun with passive investors. Obviously, active investors set prices as they should because they're "the ones doing the fundamental work necessary to know what the securities themselves are actually worth."

If the majority of investors in a market went passive, it would jeopardize the markets ability to function properly. Because if "all other players in a market have opted to be passive and not place orders, then 'price' for the entire market can effectively be set" by a single individual investor even a very small one.

(5) *Trump trades*. Despite the sheer increase in the volume of passive assets, the coming of the Trump administration has provided more opportunities for active management in the markets. That coupled with the Fed's anticipated change in course should result in greater market dispersion, a 1/16 *WSJ* article foretold.

But will this prospect be enough to stem the tide of outflows from actively managed funds? The answer to the question might lie within the article's title: "Every Stock Picking Opportunity Is a Way to Lose Money Too." Less sophisticated investors who are attracted to low-cost passive funds might continue to vote with their feet.

Melissa and I wrote in our 8/17 *Morning Briefing*: "Indeed, investing is never a passive activity because an active choice to invest or not to invest always has to be made. That means that investors always will need investment advice. That's good for our accounts, who are all active managers, and good for us." More specifically, it would be impossible to create a portfolio composed of all of the various types of assets in the world, so deciding to invest a particular passive fund is still a decision that requires knowledge and/or guidance.

CALENDARS

US. Tues: Merchandise Trade Balance -$48.5b, Consumer Credit $18.3b. **Wed:** ADP Employment 183k, Productivity & Unit Labor Costs 1.4%/1.6%, MBA Mortgage Applications, Wholesale Trade Inventories. (Bloomberg estimates)

Global. Tues: Eurozone GDP 0.4%q/q/1.7%y/y, Germany Factory Orders -2.5%m/m/4.3%y/y, Japan GDP (annualized) 1.6%q/q, RBA Rate Decision 1.50%. **Wed:** Germany Industrial Production 2.6%m/m/-0.6%y/y, China Foreign Direct Investment -4.2% y/y, China Trade Balance $27.5b, Japan Coincident & Leading Indicators 105.4/114.3. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for LargeCap and was at a record high again for MidCap. LargeCap's is 0.1% below its late January record high, and SmallCap's was down for a third straight week to 1.1% below its early February record. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings rose to a 28-month high of 8.1% y/y from 7.9%, which compares to a six-year low of -1.8% in October 2015; MidCap's improved to a 25-month high of 9.5% from 9.3%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's fell to 12.1% from a 31-month high of 12.5%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax rate changes: LargeCap 10.6% and 12.1%, MidCap 10.6% and 13.9%, and SmallCap 12.3% and 18.3%.

S&P 500/400/600 Forward Valuation (*link*): Valuations stayed relatively steady last week, most at multi-year highs. P/Es have been melting up recently and beginning to reflect the impact of lower tax rates on corporate earnings, but the 'E' still remains low as analysts await legislative changes to the tax rate. LargeCap's forward P/E rose to a 13-year high of 17.8 from 17.7. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E edged down to 19.1 from a 15-year high of 19.2; that compares to a three-year low of 15.0 in January 2016 and a record high of 20.6 in January 2002. SmallCap's rose to 20.0 from 19.9; that's up from a three-year low of 15.5 in February 2016, and compares to a record high of 20.9 in April 2002 and a 15-year high of 20.5 in early December when Energy's earnings were depressed. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.92 and MidCap's 1.37 are at or close to record highs, while SmallCap's 1.08 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Q1 earnings estimate revision activity slowed last week for the S&P 500 sectors as the Q4 earnings season began to wind down. The Q1 consensus was steady w/w for six of the 11 S&P 500 sectors, fell for five, and rose for none. Sectors with the biggest w/w percentage declines in their Q1 forecasts: Real Estate (-0.9%), Energy (-0.6), and Consumer Discretionary (-0.4). The S&P 500's Q1-2017 EPS forecast fell 11 cents w/w to $29.59, and is down 3.3% from $30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of

10.3% y/y, the strongest growth since Q3-2011, with the forecast down from 10.5% a week earlier and 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are higher for 2/11 sectors and lower for 9/11. The Q1 forecast for Real Estate is up 3.6%, and Energy's has risen 1.2%. Industrials is down the most (-6.5), followed by Materials (-5.9), Consumer Staples (-3.3), and Health Care (-2.2). The S&P 500's Q1-2017 forecasted earnings gain of 10.3% y/y would be its third straight gain after four declines and the highest since Q3-2011. All 11 sectors are expected to record positive y/y earnings growth in Q1-2017, and four are expected to beat the S&P 500's y/y earnings gain of 10.3%. Analysts expect Energy to report a profit relative to a year-ago loss and no longer think Industrials and Telecom will record y/y earnings declines as they had expected five weeks ago. That's an improvement from the 9/11 sectors rising y/y in during Q4-2016 and Q3-2016, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. The latest forecasted Q1-2017 earnings growth rates vs. their blended Q4-2016 growth rates: Energy (returning to a profit in Q1 from a year-ago loss vs. 5.4% in Q4), Financials (16.0% vs. 11.5%), Tech (13.6, 12.3), Materials (11.0, 7.1), S&P 500 (10.3, 7.9), Industrials (4.0, -0.9), Consumer Staples (2.8, 7.3), Health Care (2.7, 7.1), Telecom (2.5, -1.5), Real Estate (1.5, 8.7), Utilities (1.0, 10.1), and Consumer Discretionary (0.9, 5.4).

S&P 500 Earnings Season Monitor (*link*): With over 97% of S&P 500 companies finished reporting Q4-2016 results, their revenue and earnings surprise metrics are mostly weaker than at the comparable point of the Q3 season. On a positive note, their y/y revenue and earnings growth comparisons are the highest since Q3-2014. Of the 487 companies in the S&P 500 that have reported, 68% exceeded industry analysts' earnings estimates by an average of 3.7%; they have averaged a y/y earnings gain of 10.0%. At the same point in Q3-2016, a higher percentage of companies (72%) in the S&P 500 had beaten consensus earnings estimates by a larger 6.4%, and earnings were up a lower 4.3% y/y. On the revenue side, 51% beat sales estimates so far, coming in 0.2% above forecast and 4.4% higher than a year earlier. During Q3, a higher 54% of companies beat forecasts and results beat by a similar 0.2%, but revenues rose a lower 2.6% y/y. Q4 earnings results are higher y/y for 69% of companies versus 70% at the same point in Q3, and revenues are higher for 72% versus 67%. We don't expect these figures to change much as the remaining 13 companies report Q4 results, but the results to date suggest that Q1-2016 was the bottom for y/y revenue growth and that Q2-2016 was the earnings growth bottom.

US ECONOMIC INDICATORS

Manufacturing Orders (*link*): Capital spending and orders took a step back in January after a strong finish to 2016. Nondefense capital goods shipments ex aircraft (used in calculating GDP) slipped 0.4% last month (narrower than the initial decline of -0.6%) after rising four of the last five months of 2016 by 2.7%. The comparable orders measure (a proxy for future business investment) fell 0.1% (smaller than the preliminary loss of -0.4%) after rising six of the last seven months of last year by 4.1%. These core shipments expanded 6.6% (saar) during the three months ending January, based on the three-month average, the strongest growth rate since October 2014. Real core orders increased 8.4% (saar) over the comparable period, the best since September 2014. Headline factory orders rose for the sixth time in seven months, up 1.2% m/m and 5.3% over the period to a new cyclical high. The yearly growth rate accelerated 3.9%, the best since July 2014. In January, billings for transportation orders jumped 6.2%, reflecting a 62.2% surge in defense and civilian aircraft orders of 62.2% and 69.8%, respectively. Excluding transportation, orders edged up 0.3%, slowing from December's 2.4% as gains in industrial (6.6%) and construction (2.0) machinery orders were partially offset by declines in electrical equipment (-2.6) and computers & electronic products (-1.9) ones.

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