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Our 'Actively Passive' Investment Strategy

"The stock market is a giant distraction from the business of investing." – Jack Bogle

In our last commentary, we highlighted the relationship between the market's earnings yield and its long-term average return of approximately 6.67% since 1925. In response, several clients have asked us whether this should be viewed as an endorsement of passive, rather than active investing. This is a popular question in financial literature today, with many suggesting the recent financial crisis provides unequivocal proof that a passive approach is better than active. However, in order to offer a proper answer, we need to first define the essence of the question. What people mean today when discussing passive versus active investing is really whether one should "index" or "pick stocks?" As is often the case, we think this is the wrong question to ask. As we explain why this is wrong, we hope to answer both the right and wrong questions at the same time.

What is Active Management?

The most basic problem with the above question is how "Active Management" is simply painted with one brush. Active management has come to mean something very different over time. John Bogle, considered by many to be the "Father of Indexing" recently published a book about (and aptly titled) "The Clash of Cultures" and borrowed Keynes' distinction of investing as "forecasting the prospective yield of the asset over its whole life" and speculation as "forecasting the psychology of the markets."[1] What most people think of as active management today is actually more akin to speculation and momentum trading than true investing.

In practice, active management has become what we popularly call "trading" and this is evidenced by the explosion in portfolio turnover at the average investment fund. **Bogel laments how "in 1950, the average holding [period] for a stock in a mutual fund portfolio was 5.9 years; in 2011, it was barely one year."[2] As of 2011, annual turnover of U.S. stocks was over 250% per year![3]**

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[1] Bogle, John C. (2012-07-05). The Clash of the Cultures: Investment vs. Speculation (Kindle Locations 774-776). Wiley. Kindle Edition.
[2] Ibid, (Kindle Locations 1197-1200).
[3] Ibid, (Kindle Locations 525-528).

Consequences of High Turnover:

This explosion in portfolio turnover has profound consequences for investors. Most frighteningly, it has created a system in which the vast majority of stock market participants are no longer real stakeholders in the success (or lack thereof) of our country's publicly traded businesses. Is it any surprise then that a 2004 working paper from the NBER found that "55% of managers would avoid initiating a very positive NPV project if it meant falling short of the current quarter's consensus earnings?"[4] This means that management, in aggregate, specifically passes over projects that will increase a firm's actual value (NPV=net present value) in order to smooth the trajectory of earnings. When the entire purpose of management is to maximize firm NPV and managers admittedly are not doing this because of their guess at how markets will behave, we know there is a problem.

This should be shocking, though in practice, it's easy to rationalize. Corporate management is simply responding to the fact that the vast majority of investors are participating in the "Keynesian Beauty Contest" of predicting shifts in psychological sentiment rather than buying fractional ownership in real businesses. Last month we explained our belief that the existential purpose of a stock market is "to provide companies a means through which to raise capital in order to invest in their businesses, and [for] investors to allocate capital in order to generate a return." These turnover numbers tell us that markets have moved very far from their essence. Today's markets more closely resemble an arena in which strategists compete for increasingly low-margin arbitrage opportunities. And sadly, corporate managers have become willing participants in this game.

Randomness vs. Investing:

In explaining the parable of Mr. Market we often reference Benjamin Graham's observation that "in the short run the market is a voting machine, but in the long run it is a weighing machine." This game of arbitrage is reflective of an important market reality: the short-term is the arena of randomness, while the long-run is the home of the investor. When people colloquially speak of "active management" today, they are implicitly speaking of this short-term arena because that's where so many of today's market participants operate. As the domain of randomness, it comes as no surprise there is little persistence in returns from active investors other than amongst the bad ones.

Bogle emphasizes that "beyond the crazy world of short-term speculation, there remain commonsense ways to invest for the long term and capture your fair share of the returns that are earned by our public

[4] Graham, John R., Campbell R. Harvey and Shiva Rajgopal. "The Economic Implications Of Corporate Financial Reporting," Journal of Accounting and Economics, 2005, v40(1-3,Dec), 3-73.

corporations," with the most important being a focus on the long-term, with an emphasis on the fundamental value of businesses. While Bogle's name is inevitably tied to indexing, his point is far broader and applies to how active managers should operate as well.

Michael Mauboussin of Credit Suisse, one of our favorite strategists on Wall Street, did a study to find what the best performing fund managers from 1996-2006 had in common. Sure enough, there were four tell-tale traits shared by these top funds that run completely contrary to what has become of active management today. Here is the relevant excerpt covering these traits:

- Portfolio turnover. As a whole, this group of investors had about 35 percent turnover in 2006, which stands in stark contrast to turnover for all equity funds of 89 percent. The S&P 500 index fund turnover was 7 percent. Stated differently, the successful group had an average holding period of approximately three years, versus roughly one year for the average fund.'
- Portfolio concentration. The long-term outperformers tend to have higher portfolio concentration than the index. For example, these portfolios have, on average 35 percent of assets in their top ten holdings, versus 20 percent for the S&P 500.
- Investment style. The vast majority of the above-market performers espouse an intrinsic-value investment approach; they seek stocks with prices that are less than their value. In his famous "Superinvestors of Graham-and-Doddsville" speech, Warren Buffett argued that this investment approach is common to many successful investors.
- Geographic location. Only a small fraction of high-performing investors hail from the East Coast financial centers, New York or Boston. These alpha generators are based in cities like Chicago, Memphis, Omaha, and Baltimore.[5]

From the beginning at RGA Investment Advisors, it has been our existential mission to adhere to these first three traits, and while we cannot claim adherence to the forth, we do strive to operate with an "Off Wall Street" mentality. **The combination of a low turnover strategy, with a focus on fundamental valuation is consistent with Bogle's studies and the points that make "passive" an effective strategy when compared to "active." In that vein, we think of our strategy as "actively passive" for how it combines the benefits of passive strategies, with its own active twist to enhance returns and better manage risk.**

[5] Michael J. Mauboussin. More More Than You Know: Finding Financial Wisdom in Unconventional Places (Updated and Expanded) (p. 17). Kindle Edition.

While we have discussed this over time, it's worth repeating for the sake of completeness: our active twist is thinking about companies as businesses, running them through our checklist, and asking ourselves "what would a rational businessman pay in order to own this company's cash flow?"[6] [7] When we find companies that Mr. Market is offering us for less than what a rational businessman would pay, then we have the makings of an investment opportunity.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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[6] "Our Research Process" RGA Investment Advisors http://www.rgaia.com/research/
[7] "My Investment Checklist" Compounding My Interests http://compoundingmyinterests.com/compounding-the-blog/2013/3/4/my-investment-checklist.html

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