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FROM THE DESK OF THE CIO

The Current Opportunity

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For some time now, and indeed since the crash of 2008-2009, there has been a steady chorus of voices in the investment industry touting the benefits of index-based equity investing. Frankly, for a couple of reasons, they aren't wrong for the average investor. First, they provide an excellent source of diversified asset allocation, which is a significant factor of return variation to harness for most long-term investors. Second, as with most buy-and-hold strategies, they allow the opportunity for investors to avoid the pitfalls of which Benjamin Graham warned in the late 40s, "In the short run the market is a voting machine, but in the long run it is a weighing machine." Passive strategies, when implemented and held for extended periods, enable investors to avoid the short-term "voting" head-fakes that were central tenets to Graham's caution. This enables investors to realize the longer -term benefit of the "weighing" dynamic. Still, the one area where index investing can be problematic is when masked as active investing, which often carries with it excessive management fees associated with active management overhead.

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-Benjamin Graham

Closet Indexing

Something known within the industry for some time but just now coming to appropriate light for the retail investor is that many equity mutual funds, while touting being actively managed, end up being closet index funds.[1] Regardless of the strategy they follow, their performance over time, both up and down, tends to closely track the fund's respective benchmark index, with a performance drag often defined entirely by the assessed management fee. In any given year, this may result in a positive outcome for the investor due to the bailout effect created by market beta. However, the reality is that the investor is not getting the value for which they've paid.

On average, actively managed open-ended mutual funds and ETFs charge a fee of 75 basis points, or 0.75%, while their passively managed counterparts, ones designed to mimic the performance of a stated index, cost on average 17 basis points, or 0.17%.[2] As the issue raised by closet indexing now becomes clear, the investor is paying upwards of four times the fee for the same performance, or typically worse performance when active management fees are netted out of performance. This issue has gotten so pervasive that new rules have been promulgated to address notice to investors.[3]

SWS Partners, LLC is an independent advisory firm that focuses on matching clients with their own individual investment and planning needs. At SWS, we provide you with custom-tailored advice and we deliver clear, straightforward communication and pricing. It's an approach that's long overdue in the financial industry: Paying for your goals and not someone else's.

The Weighing Machine

In the short run, the market behaves like a popularity contest, with stock prices changing rapidly based upon posturing by trading-oriented speculators, which often can occur with little to no change in the underlying intrinsic value of the stock.

Regardless of one's view on Benjamin Graham's investment philosophies, his views on the market's short- and long-term dynamics as a "voting" versus "weighing" machine lends itself as a timeless cautionary tale for the average investor. In the short run, the market behaves like a popularity contest, with stock prices changing rapidly based upon posturing by trading-oriented speculators, which often can occur with little to no change in the underlying intrinsic value of the stock. Many times this results in investors chasing headlines and fads instead of focusing on the underlying value of the equities they own. The retail reaction can also occur in a significantly delayed fashion to professional traders who are moving in and out of positions based on factors that have little to do with the long-term value of a company. This results in the outcome of the market acting as a pain-inflicting voting machine.

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However, over a longer period, such as a decade or two that encompass multiple business cycles, the price of any security tends to converge upon its intrinsic value, erasing the adverse impacts that investor psychology can cause. Tools available to assess how far off course a given stock may have deviated from its long-term intrinsic value include discounted flow statements, sum-of-the-parts valuations, and terminal value calculations, all of which help unveil return on invested capital relative to a firm's cost of capital. These valuation frameworks help decipher short-term mispricings that represent a divergence from long-term value.

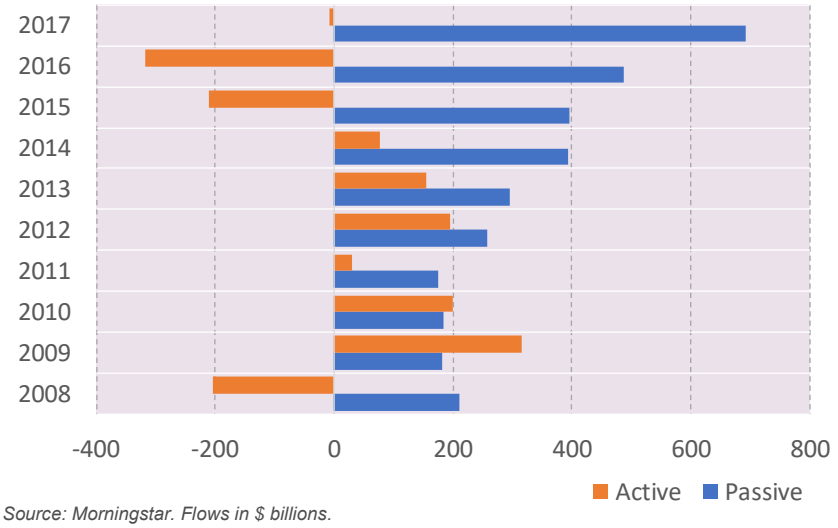
Retail investors tend to have strong propensities for poor returns in their equity portfolios as short-term trend followers. They fall prey to the "voting" machine, never reaping the benefits that the "weighing" dynamic can deliver.

History has shown that the majority of retail investors are short-term trend followers and, therefore, have strong propensities for poor returns in their equity portfolios.[4] They fall prey to the "voting" machine, never reaping the benefits that the "weighing" dynamic can deliver. This basic premise underlies nearly every argument for advising the average investor to rely upon low-cost index-based mutual funds versus higher costing actively managed mutual funds.

While this premise is not new, in recent years it has taken hold as the predominate approach for retail investors and, as such, resulted in an explosion of index-based products. With this vast and continuing proliferation of index products, capital flows from actively managed mutual funds to index based funds have been pronounced. In fact, over the past decade $3.3 trillion have flowed into index-based U.S. equity funds. This is over 13 times the size of money flowing into actively

Over the past decade $3.3 trillion have flowed into index-based US equity funds, over 13 times the size of money flowing into actively managed US equity funds.

Active vs Passive U.S. Equity Flows



Source: Morningstar. Flows in $ billions.

While index-based investing may represent the best opportunity for the average retail investor to benefit from the market as a weighing engine, it also means that trillions of dollars are indiscriminately pouring into poorly performing stocks. By buying an index-based fund, an investor is, by definition, owning the performance of all underlying positions, good or bad. Further, with investment companies dedicating vast resources to the creation and marketing of additional indexed-based products, such as factor-based or "smart beta" strategies, the fundamental exercise behind value discovery is becoming an art performed by fewer market participants.

Opportunity for Alpha Generation

Currently there are $12.2 trillion dollars invested in passive strategies globally and growing.

Currently there are $12.2 trillion dollars invested in passive strategies globally and growing.[6] As the size of the passive market continues to increase, in turn driving out more active management participants, fewer rocks will continue to be left unturned that otherwise could reveal hidden gems for the intrinsic value seeker. This is problematic because ownership of securities is increasingly predicated on index composition, leaving fewer investors able to capitalize on security mispricings. This could arguably lengthen periods where stocks remain in pricing "penalty boxes." As such, we believe the environment over the next decade will create an optimal situation to utilize a definable, repeatable investment process that is honed to uncover relative value. Disconnects in intrinsic value from pricing, along with floodgates open to the masses heading towards indexing, creates the perfect storm for actively managed strategies that can sort through the distracting noise of short-term voting machine.

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About the Authors

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Mike joined SWS in 2017 as its CIO and leads portfolio management, risk management and research for the firm. Before joining SWS, Mike was a portfolio manager on $4 billion of long-only equity portfolios at the Ohio Public Employees Retirement System (OPERS). He leverages over fifteen years of experience on both the buy-side and the sell-side to bring an institutional research and portfolio management framework for SWS investors today.
Prior to OPERS Mike was responsible for investment bank equity research at FBR Capital Markets. He received his Bachelor of Science in Economics, Finance concentration, from the Wharton School at the University of Pennsylvania and is a CFA® charterholder.

Philip Kessler, JD
Founder, Managing Partner
Phil is a founder and Managing Partner of SWS Partners, LLC. In addition to managing the operations of the firm, Phil focuses his efforts on serving the ultra-affluent through effective estate and investment planning and by identifying private equity investments, business acquisitions, and investments in alternative assets.
As a veteran attorney and financial advisor, Phil has spent nearly twenty years working for, representing and/or advising affluent and ultra-affluent individuals and their families on some of their most sensitive questions and concerns. This has allowed him to develop the expertise and experience to deliver multidisciplinary solutions focusing on the unique financial and estate planning needs of these clients.
Throughout his career Phil has been actively involved in the review and analysis of private equity investments, has served as an advisor to early stage technology companies and is currently an advisor to IKOVE Venture Partners.

Citations:

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