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Asset Management

# Looking Forward

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*"From each according to his ability, to each according to his market capitalization" – Karl Marx*

The market returns for 2019 were outstanding but, for us, one of the most memorable events was Encana, a Canadian natural gas company, moving its headquarters from Calgary to the United States. Certainly, the news reported this as a commentary on the Canadian business environment, but the quote that remained with me was from Encana's CFO, Corey Code:

"We estimate today that less than 10 per cent of our ownership is comprised of passive accounts, far less than the 30 per cent average for our U.S. peers."

Interestingly enough, the key reason that Encana decided to relocate was the existence of a greater number of passive investors in the U.S. Encana determined that more money would flow into its equity once it is listed in the U.S. not because it is necessarily a better investment, but simply because it changed its address. If passive investing is such a bonus, Encana will not be the last company to relocate. This quarter, we decided to consider the implications of this statement for markets and investors alike.

As a starting point, consider how a capitalist system is supposed to function; firms compete with each other and get allocated capital from investors based on the investment case for each corporation. Typically, corporations are allocated capital based on factors such as their business plan, historic returns, and market growth, to name a few. With the continuing huge inflows into passive investing, now, every corporation receives an allocation of capital regardless of the investment merit of each holding. To paraphrase Karl Marx, "from each according to his ability, to each according to his market capitalization". It seems that the system of careful capital allocation has become a sprinkler system of capital to all companies that show up. So, how big is the distortion?

Currently, within the S&P 500, the top 10 stocks receive 25% of all new capital and in the NASDAQ, the top 4 companies are allocated a whopping 30% of new capital. Similarly, in Canada, the top 10 stocks receive over 30% of new funds. The companies with large market weights not only dominate the returns of the index but get the largest portion of any new dollar that flows into the index. But, the question is whether their prospective investment returns are that much better than the rest of the markets. Or, more to the point, are the most valuable stocks the best place to put more capital to work? For the past year, the answer has been an unreserved yes. If you were not index weight in these names, it was difficult for an active manager to outperform. The question for the future is whether the size of the company should be the sole determinant for investment.

Like all of the large market indices, the S&P 500 index is not strictly a passive investment because there is a committee that decides what companies to include or exclude. Thus, instead of a portfolio management team choosing companies, that decision is left to the governance group with a simple majority of the members deciding what companies' funds will buy or sell on the instant of announcing any new index inclusion or exclusion. Even a passive index has human judgement attached to it. A study from the 1990s indicated that the price bump from index inclusion could be as large as 5-7%. It is hard to believe that stocks that are not index constituents are systematically undervalued by that large of a margin.

The lynchpin for index strategies to function is the pricing of securities. Essentially, all securities have to be efficiently priced. Now, the question is who are those guardians that are charged with keeping prices accurate? The answer is active money managers. Alas, here is the key insight into passive investing - you don't know with perfect foresight who the good and bad active managers are, so you let them fight it out to set an accurate price. Over time, returns are exchanged between the poor managers and good managers and both parties incur costs for research and portfolio management that are recouped from their investors. Then, as a passive investor, you become a free-rider on the research efforts of the active managers and, there, you have the proverbial free lunch - you benefit from efficiency without paying for it.

The first problem is that the popularity of index funds starts to undermine the foundation for their attractiveness. According to JP Morgan, only about 10% of U.S. equity investments are done by traditional discretionary traders. Morningstar also reported that passive investors made up 50.2% of the U.S. fund market. As such, fewer investors are doing the necessary research and are instead focusing on the largest constituents of the indexes. Smaller companies have fewer and fewer analysts following their stocks. Moreover, these small companies also have a smaller pool of investors that are willing to invest.

The second problem is that inflows into an index fund purchase all stocks regardless of price. This piling-on effect serves to push prices of index constituents up as long as the money keeps flowing into the passive strategy. Indeed, the size of money flowing into index strategies can dominate the final moments of trading as each index fund tries to ensure that their trades are completed as close to the closing price as possible. The financial performance of the company is secondary to the fill price in relation to the index. Over time, stock prices have to be linked to the underlying cash flows of the business, not the flow of money into the stock.

The third problem is liquidity. For an active manager, the size of the particular position is dictated by how quickly it can be liquidated. For instance, the maximum size might be equivalent to two days of average trading volume. For index funds, there is no such consideration. For example, the top 3 index providers own the equivalent of a month's trading volume for the S&P constituent IPG Photonics. For indices that include smaller companies, the liquidity problem is even worse. On ordinary days, liquidity is not a problem but if there is a situation where there is concentrated selling, we could see the prices of these firms drop more significantly than expected.

The fourth problem is governance. Active managers must review the proxies for their portfolio companies and vote on issues such as compensation, environmental concerns or changes to shareholder rights. Index providers typically vote in line with management which may not be in the interest of shareholders. Moreover, recently both Vanguard and Blackrock, two of the largest index fund providers, have voted against any climate-related resolutions. With index funds providing so little management oversight, corporate management has even less to fear from angry shareholders. Shareholders were meant to care about the companies they invest in, not just throw their money in and hope for the best.

The fifth problem to discuss is a focus on market segments that are the most conducive for index strategies. Not only does more money flow into the major weights in the index, but it also flows into those segments that lend themselves to indexing, namely large capitalization stocks. Thus, other market segments like small and micro cap stocks are allocated even less money. Since the allocations follow flows rather than underlying investment returns, it would not be surprising to find that indexing leads to a misallocation of capital.

We have pointed out some things to consider as investors stampede into index funds. However, the movement into index funds continues and its success is hard to argue. However, for long term investors like ourselves, we do not believe that just because a company has a large index weight, it deserves a greater proportion of investable assets. Security prices must be justified by the cash flows generated by the business. It is upon this criteria that we invest our clients' money.

Source: Scari, C. (2016). "On the Changes to the Index Inclusion Effect with Increasing Passive Investment Management," Joseph Wharton Scholars. Available at http://repository.upenn.edu/joseph_wharton_scholars/5

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