



SOME THINGS ARE WORTH PAYING FOR

This quarter we are taking a look back at the academic origins of active investing and indexing, and then walking through the rationale behind certain strategies employed in our portfolios.

We intend to cover the investment aspects of active, passive, and liquidity in this piece and then expand on others in the coming quarters. Our point is to build towards a discussion of how all of these strategies are currently integrated into HH portfolios and why it's not simply active investing versus indexing. Every strategy comes with a "cost"—not just in terms of the risk taken on, for example, but literally: How much managers charge you in management fees to participate in a specific fund.

If the historical basis of Modern Portfolio Theory and the thinking that underpins current-day investment management strategies is old hat to you, please feel free to jump ahead to page four, where we begin our discussion of current positioning. But if you're of a mind to revisit these revolutions in the investment canon, or are unfamiliar with how theories of investing have evolved over the last century, please consider beginning right here.

THE ROOTS OF MODERN INVESTING

In the early days of investing, "Intelligent Investors" were taught to buy stocks with certain redeeming fundamental qualities. Low debt, low price-to-earnings and low price-to-book ratios were understood to ultimately yield high return on equity, high return on assets, and high return on invested capital. This is considered "value investing." Benjamin Graham in the 1920s and Warren Buffet today recommend that investors seek companies that have sound balance sheets, strong cash flows, and a compelling success story. When Warren Buffet made a billion-dollar investment in Apple this past May, you can be sure it was done on the basis of the company's highly appealing fundamental characteristics, not because it's the largest company in the world.



THE NATURE OF ACTIVE INVESTING

Berkshire Hathaway has scores of financial analysts pouring over public financial data and meeting with executive management teams all over the world. If Buffet is going to buy a company, you'd bet your last hotcake that he knows exactly where they're generating their cash flows. These highly trained analysts have large travel budgets and the best command significant salaries that Buffet is happy to support in pursuit of his next billion-dollar investment. This is called "active" investing; mutual funds often have a similar team out there going through a similar process.

Active investing requires time and money, and often has a bias that will go in and out of favor. Such biases may include, for example, buying stocks in companies that have a record of dividend increases, or those with great management teams, or those that have a large proportion of sales in emerging markets. These biases might help their choices beat the market, but they might not. They'll always require decisions to be made by the investor: Is this the right time to follow this strategy? Is my manager providing enough value relative to what I'm paying them?

MATHEMATICS APPLIED TO PORTFOLIO DESIGN: THE GENESIS OF MODERN PORTFOLIO THEORY

In 1952, a student of the mathematics of optimization theory, Harry Markowitz, was trying to solve a decision problem on how to choose the best portfolio. He determined that, with a set of predetermined assumptions, proper diversification could minimize a portfolio's variance for a given level of return. This was dubbed the optimal portfolio or the Markowitz Efficient Portfolio. It was beautiful in its mathematics and was only contemporaneously made possible by the advent of the powerful new computers of the 1950s.

Markowitz's theory was built on how an asset's returns correlated with other assets. He used variance as a proxy for risk because assets whose prices were more volatile were seen as more likely to produce losses (this is now considered something of a simplification). And he published the whole package in a broadly titled paper called "Portfolio Selection."

The world of mathematically designed portfolios sprang to life and gave birth to a series of additional investment theories that shaped the investment world over the next 50 years. From 1961 to 1966, Jack Treynor, William Sharpe and Jan Mossin helped define the Capital Asset Pricing Model (CAPM – pronounced "cap-em"), which allowed investors to calculate the required rate of return they should expect given an investment's level of risk. CAPM further defined the concept of "Beta." Beta is the covariance between a specific security and the rest of the market as a whole. In other words, Beta is a measure of the systematic risk you assume when you buy an investment.



While you can diversify away the unsystematic (or idiosyncratic) risk of owning too much of a particular investment (like a single stock), you cannot diversify away the systematic risk that is common to all assets of a given type.

In 1970 Eugene Fama introduced the “Efficient Market Hypothesis” (EMH), the hypothesis that asset markets are, per se, efficient. The idea here is that current asset prices reflect new information quickly and the stock market is therefore a powerful pricing mechanism in and of itself. In other words, Warren Buffet-like scrutiny shouldn’t matter.

The combination of Markowitz’s theory, CAPM and the EMH form the basis for what is now commonly referred to as Modern Portfolio Theory (MPT). The primary insight from these Nobel Prize-winning academics was that investors should not expect to earn a premium for risks that can be diversified away. Rational investors are “mean-variance optimizers,” meaning that they will seek the greatest amount of return for the least amount of risk. In choosing such a portfolio, they will have diversified away all risks associated with individual investments and only be left with the risk of the market as a whole.

As such, the primary result of the CAPM is that the “optimal” portfolio to hold is always the market portfolio, defined as the portfolio containing all global financial assets held at their market weight. That is the only portfolio that contains risk that is systematic, or undiversifiable.

THE BIRTH OF THE INDEX FUND

In 1971, Wells Fargo Bank applied these academic theories in creating the world’s first index fund, which replicated the Standard & Poor’s 500 index (S&P 500) for the Samsonite Corporation’s pension fund. The thinking underpinning this investment solution was that the S&P 500 was a reasonable proxy for the “market portfolio” as identified in the CAPM. This solution ultimately found its way to the retail public thanks to the efforts of John Bogle of the Vanguard Company. His charge, as inspired by a July 1975 article in Fortune Magazine, was to provide an alternative for mutual fund investors: “a no-load mutual fund with low expenses and management fees, about the same degree of risk as the market as a whole, and a policy of always being fully invested.”

But herein lies a problem: What is “the market”? In the context of the CAPM as noted above, the market is a theoretical bundle of investments that includes every type of asset available in the world’s financial markets, with each asset weighted in proportion to its total presence in the



market. If Bogle were being true to academic thought, his portfolio would include all public and private forms of stocks, bonds, cash, real estate, etc. and implemented in such a way as to eliminate fees, transaction charges and taxes.

Of course, as smart as Bogle may be, developing this “alternative” was not feasible. So he followed a more expedient path—in similarly replicating the Standard & Poor’s 500 index.

Consider this: If you use the S&P 500 as a proxy for “the market,” what you actually get is an incredibly skewed top-heavy investment whereby the largest 20 names (i.e., 4% of the companies) represent 30% of the performance. This occurs because the index is capitalization-weighted (cap-weighted, for short), meaning that the largest companies exert the largest influence on the performance of the index. By buying the index today you end up owning a relatively large proportional stake in Apple, Microsoft, Exxon, Johnson & Johnson, GE, and Amazon. In essence, Bogle co-opted the academic underpinnings of true “systematic investing,” opting instead to build a low-cost investable representation of a capitalization-weighted index, now commonly referred to as “passive” investing.

Passive investing is widely available today in most mainstream assets such as U.S. stocks, U.S. bonds, International Stocks, Emerging Markets and listed Real Estate to name a few. However, many markets have inefficiencies, and where those inefficiencies are persistent, we would consider paying for access and/or talent that could capitalize on those inefficiencies – rather than simply buying a product that replicates the market.

Current positioning

A SPECTRUM OF SOLUTIONS

Active investing and passive investing are the two ends of a spectrum of solutions. The argument that seems to be playing out in the marketplace is that “cheap” (i.e., passive investing) is always best. At Halbert Hargrove, we believe there are benefits and drawbacks to all strategies. We agree that investors should be very cautious about what they’re willing to pay for. If your active mutual fund looks like an index, smells like an index, and quacks like an index, then you shouldn’t be paying 1.50% per year in management fees. Likewise, some passive index funds charge more than 3% per year in management fees. First and foremost, investors should know what they’re getting, and they should be getting what they pay for: Caveat Emptor.



Currently, we have moved out of traditional active management for all of our U.S. and developed non-U.S. large cap equity investments. We utilize both an inexpensive factor-based solution and a very inexpensive cap-weighted index sleeve. We've shifted this way because we believe these strategies will provide a higher return after fees than a more traditional active approach and that your investment management fee budget is better spent elsewhere.

The most inefficient markets are often the ones that are the most difficult to access for investors. This can be due to the lack of availability of the underlying investments. In addition, the investment itself is frequently too small to warrant the attention of the multi-billion-dollar investment funds most retail investors are exposed to. In many cases, these investments are not readily converted to cash or able to be sold at a moment's notice and are thus considered "illiquid."

PARTICIPATING IN ILLIQUID MARKETS

There are benefits to participating in illiquid markets as long as you don't plan on accessing the capital in the near term. For example, the most common illiquidity benefit (premium) that most people can relate to is the difference in interest you earn based on the maturity date of a Certificate of Deposit (CD). Currently, the national average for a 1-year CD is 0.29% while the national average for a 5-year CD is 0.83%. Investors are earning an additional .54% per year for their willingness to lock up their funds over a longer period of time. The illiquidity premium exists in many markets: private equity, hedge funds, direct real estate, and lumber, to name a few.

We have several investments in our portfolios that should provide an illiquidity premium: the All Asset Variance Risk Premium fund, Reinsurance funds, and the newly acquired Alternative Lending fund. All three asset types provide access to marketplaces that are difficult (if not impossible) for large investment platforms to take advantage of. The nature of the underlying investments likewise require illiquidity given their contractual obligations.

Reinsurance contracts, for example, are one-year commitments that are bespoke, limited in supply, and lack a secondary market (there is no exchange in which to list them for sale). The reinsurance companies need to be assured that the capital will be there should an event occur—a benefit they're willing to compensate us for. To that end, in the last two-and-a-quarter years since making these investments, our reinsurance funds have returned between 6% to 9% per year while traditional fixed-income benchmarks have barely kept pace with inflation.



Given the illiquidity of the underlying investments, we access these markets through “interval” versions of 1940 Investment Company Act mutual funds. These interval fund structures allow the fund sponsor to manage the orderly liquidation and redemption of mutual fund shares. Our three interval funds will be available for sale on a quarterly basis and will be staggered such that our investors have monthly liquidity from the group. While we’re confident in the fund sponsor and the benefits of the underlying investments, we also recognize that liquidity is a virtue. To that end, we intend to limit our exposure to these investments so that the vast majority of the portfolio (i.e., ~90%) is available to our clients within 5 business days.

THE OBJECTIVE: MANIFOLD SOURCES OF RETURN

Along with the previously discussed themes of Convergent and Divergent, we build portfolios seeking manifold sources of return. In many cases, we are attempting to access systematic sources of return. Some of these sources of return are inexpensive, such as cap-weighted equity risk and non-cap-weighted factor-based equity risk. Others may be relatively more expensive—illiquidity risk, credit risk, variance/option premium harvesting, and natural/non-market risk are cases in point.

As your fiduciary, our challenge is to parse through the availability of solutions and determine how and where to allocate investment management dollars. As the next few quarters unfold, we will be reviewing in greater depth our latest methods directed at this ongoing challenge—and the value they’re adding to portfolios.

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