Economics Cometh Undone?

Many challenges to classic economic principles have arisen since the turn of the century. Whenever we become aware of one of these new 'principles,' Sweetgum Labs (SGL) maintains a suspicion of their long-term sustainability since economic laws override trends. Negative interest rates, QE infinity, rising debt levels and political pressure on the Fed are just a few that you may hear mumblings about on the news. However, nothing is affecting financial services more than the future of ETFs and robo-advisors. Both are clear disrupters of classic valuation methods.

Just two decades ago, ETFs were a radical new idea that the typically conservative investment community was not willing, nor ready, to accept. In fact, when we attempted to bring them into our practice as a fresh-faced advisor, many colleagues dismissed them as unproven, even going so far as to describe them as lazy investing due to their passive nature. However, once the 2008 crisis unfolded, ETFs immediately became financial darlings. Now, we are reading each month that old, active funds are capitulating, shuttering their hedge funds, or selling their active funds to larger competitors. What do we believe this means for the efficiency of capital markets and for our clients when ETFs are firmly embedded in our robo-account in the future?

Key Points

- Our concern is that without a human to explain the weaknesses of index investing (bloating valuations of FANGs) this cycle of passive index investing has a breaking point.
- Everyone forgets the emotional baggage that coincides with a recession. In a panic people quickly react and without slow thinking they may make the wrong move.

First, we make the disclosure that SGL does not fear "the Robo" as a job disrupter. We have personally vetted some of them to use as a custodian for our client's assets and have found them to be generally well-run companies. From our perspective, they can reduce time on-boarding clients and reduce the time commitment clients must endure to establish a sound plan. The technology can merge portfolio management with the financial goals clients input into the program. The algorithms are also able to nudge the hybrid advisors and clients on topics that human error inevitably forgets.

Index Effect

The index effect is a well-documented market anomaly which, according to a 2010 paper titled The Index Effect, is defined as a "market inefficiency that stocks experience abnormal returns and abnormal trading volumes when included in or excluded from an index." The paper was able to conclude through empirical research that positive price and volume effects for equities do occur when included in an index. Abnormal returns from an anomaly should be arbitraged away, but if market forces overrule this do these distortions lead to bubbles for included or opportunities for excluded securities?

Index Madness

Indexes were originally built to answer the question "how is this investment doing compared to its asset class?" Indexes are built to simplify the potentially thousands of securities price data points into one average return to compare to a single security we wish to analyze. Depending how the index is constructed, they have different strengths and weaknesses. At a glance, however, they make something complicated seem simple. Fast forward to the present, and there are 3.28 million indexes while there are ~43,000 public companies in existence. Indexes have now made things much more confusing to the general public. As planners, we are at the mercy of clients picking obscure indexes resulting in confusion in assessing their portfolio management performance. Admittedly, we prefer to look at things through various lenses for a clearer, more comprehensive picture, but a line must be drawn.

Occasionally, we observe an article that points out the weighting issues inherent in indexes: "if the 200 smallest companies in the S&P dropped to zero overnight, we still wouldn't get a 10 percent correction in the S&P 500!." This should alert investors about the dangers of placing too much value on indexes and focusing more about the needs of their own specific plan.

How Robos Fit in

The inspiration for this piece was a Wall Street Journal article describing how Vanguard is pushing a Robo-only advisor. For most Americans that lack a financial plan, any help is useful. Our concern is that without a human to explain the weaknesses of index investing (bloating valuations of FAANGs and other in vogue stocks further) this cycle of passive index investing has a breaking point. We can't predict when, but economic principles are similar to laws of physics in that they can bend but they can't break. The other aspect is that without the human advisor explaining that multiple indexes exist to compare investment performance of a single security, client questions can become statements of advisor incompetence which will lead to fear of the unknown. The market hates the unknown and the unknown can lead to a market exit. Sitting on the sidelines is a main reason for falling behind in a plan.

Conclusions

Individuals financial plans are difficult enough to implement because each client has their idiosyncrasies that planers must contend with. When you add esoteric industry jargon and anomalies that grow to become principals, we have seen how client confidence erodes. Another important observation is that allocations morph and today's 80/20 aggressive allocation will one day be the 30/70 income hoarder. Creating a time-line of performance to accurately compare to indexes over a long period is data driven madness prone to errors and distracting to the core root to the purpose of planning. Comparing security performance to index returns are important but are just one factor into the multi-factor model that goes into choosing or retaining a manager.

We at SGL are observing the potential for a bubble in index funds and have some concern on the structure of ETFs in general. We believe that through solid research using industry trends, mosaic theory and common-sense, an active manager can still produce alpha in their portfolio. However, we see index investing as an important tool to fill the gaps in asset classes that we don't find worthy of active managers. Finally, in historical context, we have been in a raging bull market for over a decade. Everyone forgets the emotional baggage that coincides with a recession. In a panic people quickly react and without slow thinking they may make the wrong move.

John Baranauskas, CFP®
Founder/CEO, Sweetgumlabs

Description of Terms:
FAANG – FAANG is an acronym for the market's five most popular and best-performing tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google.
QE – Quantitative easing (QE) is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to increase the money supply and encourage lending and investment.

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