Martin Capital Partners

Quarterly Point of View
'Passive'?

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There's been great debate of late arguing the merits of 'passive' versus 'active' investing. Like many things in life, labels often obfuscate rather than enlighten. Every individual or entity invests with a purpose and a goal. Some of these are clearer than others, but at the very least, each investor is seeking to maintain the purchasing power of their dollars over the course of time for future needs. All market participants have the option to decide their desired investment path to achieve this outcome. Passive and active are just misnomers. Everyone is 'active'.

Merriam-Webster dictionary defines active in this sense as 'characterized by action rather than by contemplation or speculation'. Once a market participant has invested their money in hopes of preserving the purchasing power of their dollars over time, they are no longer 'contemplating'. They have just placed an active bet, no matter what strategy or vehicle they have employed. The S&P 500 is the most famous of the 'passive' investment funds and is owned and managed by S&P Global, which prior to just last year was McGraw-Hill, essentially a publishing company with roots to 1888. According to David Blitzer, Chairman of the Index Committee: "The S&P 500 is maintained by a committee of market professionals. We publish a detailed methodology document which includes guidelines for selecting stocks and other changes to the index…there are no rigid or absolute rules for the S&P 500; the Index Committee have some discretion in selecting stocks or responding to market events." Committees, discretion, no rigid or absolute rules… This doesn't sound very 'passive'. A 2014 book titled *Global Value*, by Meb Faber, the CIO of Cambria Investment Management, further illuminates thought on this subject by stating, "It is ironic that the largest and most famous index, the S&P 500, is really an active fund in drag. It has momentum rules (market cap weighting), fundamental rules (four quarters earnings, liquidity requirements), and a subjective overlay (committee input). Does that sound passive to you?" Important, active decisions are being made regarding where other people's money is placed – in the world's largest 'passive' investment.

For investors this is a highly important (and often uncontemplated) distinction. Highly important because investors often believe they aren't 'taking a position' on the market when they invest in an index fund, yet they absolutely are. Whether acknowledged or not, they are investing in a strategy, and prudent investors should understand any strategy in which they invest. Maybe we can consider this concept 'point 1' of this piece, but it's not necessarily where I want us to direct our thinking right now. Primarily, we believe investors need to be aware that the structure of the market has changed because of the unrelenting flows of 'passive' capital, and to digest the potential implications of this change.

At the end of the 1990's passive mutual funds and passive ETF's (Exchange Traded Funds) made up only 10% of the U.S. equity market combined. Today they account for 40% and expanding rapidly, with

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roughly 70 cents of every new dollar directed there.[1] Since December of 2008, the height of the Financial Crisis, there's been an ocean-sized spread of almost $2 Trillion allocated in favor of 'passive' over 'active'.[2] Through the first five months of 2017 alone, $338 billion poured into passive mutual funds and ETF's (after a record $506 billion of inflows in 2016), on pace to exceed $800 billion this year. That would amount to a 60% leap from 2016's record, and almost double that of 2015.[3] Incredibly, there are now more than three times as many equity ETF's as there are the number of large-cap stocks in the United States.

There is no way this kind of 'ownership change' can be digested by the markets without side effects. Some say the side effects are positive - a quick, easy, cost effective way to 'own' the markets, or sub-sectors thereof. There's truth to that view in part, however, the potential negative implications are not often highlighted. The probability seems high that some of these repercussions will be very impactful, so thoughtful investors should ponder them. Vanguard founder Jack Bogle himself has even warned that ETF's influence on stock trading "has reached mammoth proportions." From our vantage point, there are several major implications to consider.

Impaired Price Discovery

The process of determining the price of an asset in the marketplace is referred to as the 'price discovery mechanism', and for markets to be healthy, well-functioning and liquid, it requires a wide range of outlooks and decision-making methods. Of primary importance in price discovery is the independence of decisions makers, representing a variety of opinions. Said another way, a good and ultimately more stable market, requires participants to disagree. When there is disagreement, one wants to buy, when another wants to sell, and a price is determined. What happens when this process declines or stops? Taken to its extreme (when participants uniformly agree) the market ceases to function properly, creating risk that prices deviate substantially from any measure of reasonable value – both to the upside and to the downside. When 70% of new asset purchases in the market are done by those vehicles that buy (or sell) all stocks simultaneously – not bothering to come up with an opinion about the merits of its individual constituents – price discovery breaks down. One negative side effect is 'groupthink', which ultimately leads to asset bubbles on one end, or panic lows the other.

Rising Systemic Risk

In "How Index Trading Increases Market Vulnerability" by Rodney Sullivan and James Xiong, published in 2012, the authors examined the impact of rising assets under management in index products and the associated high trading volume that subsequently takes place. They studied 32 years of trading by U.S. stocks with market capitalizations exceeding $100 million, and concluded that the rising level of capital devoted to index products through the years has played an important role in driving stock correlations higher. In other words, the co-movements of U.S. stocks have increased. This makes sense, as assets flow into and out of these funds, buy and sell orders are created for all stocks in the index at once without regard to their individual merit. Therefore, we should expect trading volumes and prices to move more in line with each other. The negative side effect is that the benefits of diversification, a divergence in individual stock price movements that help mute overall portfolio volatility, have declined for U.S. stocks. The study's authors assert that, "In short, the growth in trading of passively managed equity indices corresponds to a rise in systemic market risk…put another way, investors' equity portfolios are increasingly moving in lockstep with swings in the overall market. All equity investing, indexed or otherwise, is thus plainly a riskier prospect for investors." A very recent example of this phenomenon took place on June 9th, when previously robust-performing technology stocks abruptly reversed course and exhibited their worst declines in almost a year. Volume for the tech-heavy Nasdaq 100 Index spiked to a 10-year high, and its corresponding ETF (Powershares QQQ) dropped 2.5%, with almost all companies – regardless of their specific situations – moving in tandem. The next day the ETF saw almost $2 billion in total withdrawals, also the highest in nearly a decade.[4]

Concentration of Ownership

The immense and growing passive index business is dominated by just three asset management firms: Vanguard, BlackRock and State Street. A 2016 study titled "Hidden Power of the Big Three" by Fichtner, Heemskerk and Garcia-Bernardo, of the University of Amsterdam, analyzed the ownership stakes the three entities have amassed, and hypothesized on their impact.[5] Some of the author's findings are eye-opening:

- In 40% of all listed companies in the United States, the 'Big Three' (as the study calls them) in aggregate already constitute the largest shareholder.
- In the S&P 500 Index specifically, the Big Three combined represent the largest owner in 438 of the 500 companies – or 88% of all the index's constituents.
- The 438 firms of which they are the largest holders, account for 82% of the entire market capitalization in the United States.
- BlackRock alone now has approximately 2,000 stakes in U.S. corporations that exceed 5%. This is over 50% of all U.S. listed corporations.
- Vanguard itself now has a greater than 5% position in 491 of the S&P 500's companies – up from just three (3) in 2005. [3]

At this juncture, it's difficult to ascertain all the specific consequences of this concentrated ownership, but there are certainly broad-based questions we must ask ourselves as risk-aware investors. Most obviously in our minds, how will this affect corporate governance and its relationship to proxy voting? Larry Fink, CEO of BlackRock was quoted as saying, "As an indexer, our only action is our voice and so we are taking a more active dialogue with our companies and imposing what we think is correct."[5] This is a telling statement… When he refers to 'our' companies he is talking about a massive swath of corporate America, given the statistics cited above. What happens for instance when BlackRock's view of what is 'correct' contains undisclosed, or at least unacknowledged, conflicts of interest? In April of 2014, the New York Federal Reserve told a gathering of international regulators of the potential risks of securities lending - a huge business for BlackRock (and all of the Big Three), who lends out shares they own to market-makers and short-sellers, in return for a fee and collateral. The extremely profitable business line for these asset managers was labeled "banking in its most basic form"[6] in the New York Fed's estimation, yet without bank regulation and backstops. Given the rapid growth and incredible scale these firms have amassed, it is fair to ask whether this could enhance overall market liquidity risks in the event of a financial panic. This is one example, therefore, of a potential conflict of interest. How will these firms approach a business line that currently gushes cash, yet could, during a crisis, further imperil the very assets they are supposed to be 'overseeing' in their index-linked investment vehicles? The study from the University of Amsterdam concluded, "Thus when seen together, the Big Three occupy a position of unrivaled potential power over corporate America…we witness a concentration of ownership not seen since the days of J.P. Morgan and John D. Rockefeller." As of this date, regulators have yet to attach the SIFI designation (Systemically Important Financial Institution) to these firms, but this is something to keep a close eye on. The Big Three, as you might imagine, are lobbying fiercely to prevent it.

We believe that the massive, structural shift in the market to passive ownership of equities, will not be without complication. If what we surmise, an impaired price discovery mechanism, rising systemic risk and unhealthy concentration of ownership are forces that begin to play out, investors may have to navigate more, not less risk in the marketplace.

More than ever it's vitally important for investors to think and act 'independently', and to understand what they are trying to accomplish, and how they are trying to accomplish it. As we often state, a fundamental goal of ours is to employ a sensible investment philosophy that our clients understand and agree with. This increases the probability of long term success by minimizing complexity and confusion – which often leads to poor decision making, particularly at points of market stress. Additionally, we choose to focus on which businesses are deserving of our funding and which are not. We make reasoned judgments, allocating our capital to those enterprises with sustainable competitive advantages, long-run earnings power and the lasting value of large and growing streams of dividend income. Joel Greenblatt, founder of the highly successful Gotham Capital and author of several best-selling books, has bluntly stated, "choosing stocks without knowing what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot."

Please feel free to call or email with questions you may have regarding our strategies or Martin Capital Partners in general. You can also find information on our website at www.martincp.com.

It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

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Chief Investment Officer
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Statistical and analytical data provided by Factset.