PRICE**VALUE**PARTNERS

Systemic risk

" 'February 2018: the Beast from the East is a clear sign of Climate Change'

'February 2019: the Sahara plume is a clear sign of Global Warming'

See how the narrative gets twisted to suit the agenda ?"

- Tweet from #Marcher, 27 February 2019.

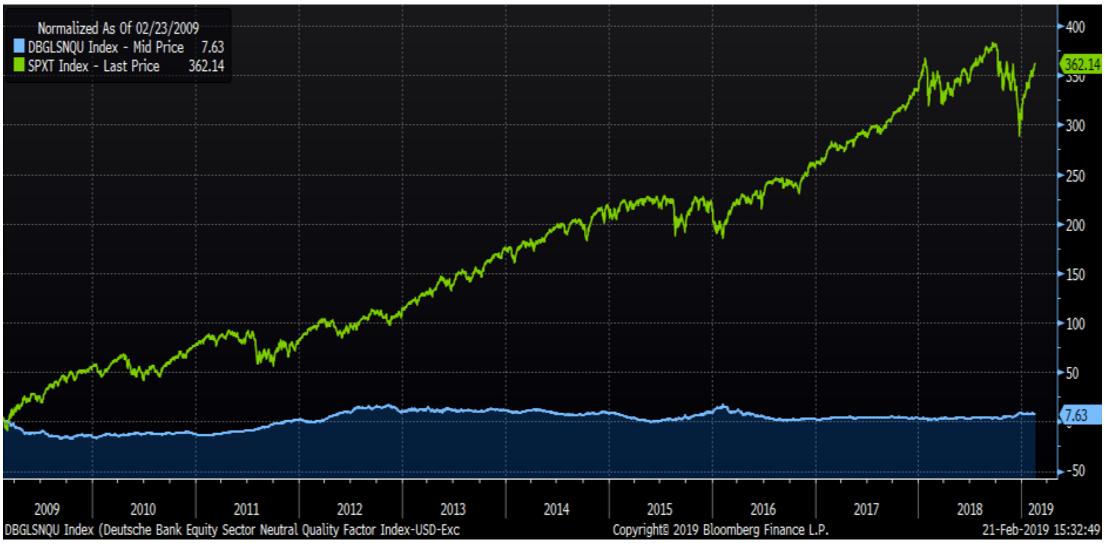
Our own jury is out when it comes to climate change. Whether or not our climate is changing – and we recall the 1970s experience of being told by climate alarmists that a new Ice Age was heading our way – it is a bit of a stretch to conclude that human activity ***must*** be causing it, given that the biggest power source in the universe is something called the Sun.

There is a similar problem in attributing characteristics to financial markets that might or might not be fairly comparable to those of climate or weather. The financial market certainly constitutes a complex system. Whether a long term change in behaviour by this system amounts to a permanent change in its character we leave to others to debate. But such is one of the intriguing suggestions by Ben Hunt in his latest Epsilon Theory newsletter; that capital markets are being transformed, through bureaucratic manipulation, into a political utility:

> After the systemic near-death experience of The Great War, French President Georges Clemenceau famously said **"wars are too important to be left to the generals"**.
>
> After the systemic near-death experience of The Great Financial Crisis, all political leaders – *of both the Right and the Left* – are saying **"asset prices are too important to be left to the investors"**.
>
> How have political leaders wrested control of price-setting from investors in the 2010s, just as they wrested control of war-setting from generals in the 1920s? I'll start with a simple but (for many) painful fact, the end result of capital markets transformed into a political utility.
>
> **For the past 10 years, ever since the end of the GFC, active investing in general and value investing and quality investing in particular have failed.**

And not just failed a little, but failed a lot.

The green line below is the S&P 500 index, including dividends. The blue line below is a market neutral Quality Index sponsored by Deutsche Bank. They look at 1,000 global large cap companies and evaluate them for return on equity, return on invested capital, and accounting accruals … quantifiable proxies for the most common ways that investors think about quality. Because the goal is to isolate the Quality factor, the index is long in equal amounts the top 20% of measured companies and short the bottom 20% (so market neutral), and has equal amounts invested long and short in the component sectors of the market (so sector neutral).



You've made a grand total of not quite 8% on your investment in this Quality-focused index … not per year, but over the last DECADE.

Over the same time span, your passive investment in the S&P 500 has almost quintupled. With dividends, it's up more than 360%.

For the past TEN YEARS, Quality has been absolutely useless as an investment strategy.

Have the Quality stocks in your portfolio gone up? Yes, but it's not because of the Quality-ness of the companies. It's because ALL stocks have gone up, Crap and Quality alike. In lock step, with nary a blip either way.

And yes, I'm using this Quality index as a proxy for active portfolio management of all types. *Because it is.* Sure, quality – like beauty – is in the eye of the beholder. But the core bias of every discretionary manager, regardless of asset class or geography or whatever corner of the investment world they play in, is always the same – *buy the good stuff and avoid the crap.*

For the past decade, all of your smarts … all of your efforts … all of your time … all of your money … every resource you have devoted to distinguishing between good stuff and crappy stuff in large-cap public equity markets … has been wasted. I'm not using the word "wasted" in a pejorative or judgmental sense. I'm using it in the technical sense. It has given you no better results than the less smart, less hard-working, less devoted, less well-resourced investors who just plopped their money willy-nilly into crappy stuff.

It's not fair.

But it is the truth.

As a result, your business model – which requires you to charge enough in fees to cover the cost of all these resources you have wasted – has been squeezed and squeezed and squeezed. Because no one is going to pay you more for less. Marketing alpha can only go so far. And when that runs out … well, it's "family office" time.

Now here's the kicker.

The failure of active management is not an accident.

The political rule-setters for markets don't give a damn about rewarding quality companies and punishing crappy companies, much less rewarding smart investors and punishing stupid investors. They care about not doing 2008 again. Ever. Under any circumstances. They care about providing a rising tide that lifts all boats. And so that's what we're going to get.

The intentional transformation of capital markets into a political utility is the common thread of ALL of it … all of the QE, all of the ZIRP, all of the negative interest rates, all of the forward guidance, all of the "communication policy", all of the Fed puts, all of the Dodd-Frank theatre, all of the regulatory blindness towards too-big-to-fail banks, all of the Trump tweets about the market, all of the CNBC appearances by White House apparatchiks, all of the Chuck Schumer "buy-backs are evil" op-eds, all of the Green New Deals, all of the show trials to come (and there will be show trials). All. Of. It.

This is what a change in the financial services Zeitgeist feels like. This is what a change in the financial services Zeitgeist IS.

Given that Ben analyses the markets through the lenses of game theory and history, we should also acknowledge that his take on markets above is a narrative – because, aside from price action itself, the *Ur* characteristic of all markets, ***every*** commentary about the markets is a narrative.

In their latest Graham & Doddsville newsletter, the students of Columbia Business School posit a supposition to the dean of the School, Glenn Hubbard, namely

the idea that common ownership of firms in the same industry through passive index funds could, in theory, be anti-competitive. [Bloomberg's Matt Levine] writes that "..the premises of the theory – that managers are responsive to shareholders, that shareholders are increasingly diversified, and that the joint interests of companies in an industry can conflict with the interests of consumers – 'all seem, not just reasonable,

> but like basic textbook stuff'." Martin Schmalz, a finance professor at Oxford and a leading proponent of the theory, asks, "Is there any plausible story for why these secular changes in the ownership structure of firms would *not* lead to a lessening of competition?"

Whatever the impact on competition, what seems clear is that, while low cost indexation carries obvious price advantages for consumers of index funds, it also comes with one gigantic qualitative disadvantage: it isn't investing, but rather the opposite of it – namely entirely undiscriminating market exposure. It's akin to going to the restaurant and saying: just put a bit of everything on the menu into a big bowl, and I'll just eat that.

It's clearly easy for an avowedly active asset manager to pour scorn on passive indexation, but that brings us back to Ben Hunt's awkward observation that, in the US equity market at least, indexation has beaten every other strategy for the past decade. A sea change in market behaviour, or "merely" a weird statistical coincidence ?

For us, it's far too early to say. At a philosophical level, though, the *reductio ad absurdum* of indexation is not just to own a piece of everything in one market, but a piece of everything in ***every*** market – not just stocks but property and bonds and deposit rates too, and God only knows how little genuine value persists in many of those pockets of bureaucratic intervention throughout the world today.

While we try to keep an open mind as to the shifting dynamics of market behaviour, we also maintain a belief in the fundamental immutability of human nature. That belief cautions us against concluding that it's ***really*** different this time. The great value investor Benjamin Graham gave a quote from Horace pride of place in his ground-breaking *Security Analysis*:

> Many shall be restored that now are fallen, and many shall fall that now are in honour.

Since that was written over two thousand years ago, we suspect its relevance may yet outlive even the "Powell put".

www.pricevaluepartners.com @timfprice

Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here. You can access the archive of our regular 'State of the Markets' podcasts, with Paul Rodriguez of ThinkTrading.com here.

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