MAI VIEW

VOL. XVII, NO. XIII www.macro-allocation.com MARCH 20, 2017

Passive Aggressive

Investment capital is in the process of shifting to fit investor objectives that have always been there but never satisfied. Passive investing, which is to say gaining mostly long exposure to stocks and bonds, is nothing new. ETFs are innovations for the majority of investors that directly or indirectly just want to be in the market. ETFs currently total about $2.6 trillion and PwC projects that figure to double by 2020, all at the expense of active management.

To be sure, ETFs are derivatives priced in the open market based on discrete supply and demand. As with all free-floating share listings, ETF prices are based on sentiment. Distortions between ETF performance and the performance of the underlying shares within the ETF can be especially stark when consensus opinion becomes very one-sided. We get it, but ask yourself this: will the fees saved by ETF investors over time offset the potential periodic distortions between ETFs and their component prices? It is a question we all must answer for ourselves.

Our take is this: good, cost-effective active management is more important than ever to a minority of investors seeking alpha or positive real returns over time.

Structural Shift

The popularity of ETFs has profoundly changed the asset management business. Long-only active management with higher fees using specific strategies to outperform a market must prove its value *to prospective passive investors* each year or risk redemptions. For them, good will and sound logic lasts only so long in a world where central banks are actively supporting markets (or managing them higher).

ETFs should not be scorned by old-school portfolio managers, like me, who resent the diminishment of the importance of knowledge and experience. Rather, ETFs and other passive vehicles should be used by active managers to gain long and short exposures to asset classes, sectors and geographies that fit their views and strategies.

Many in the equity markets recall a time when the basic choice among investors was growth or value. The better investors and allocators among us ultimately found that there was always room for both, and that owning expressions of each provided a better balanced, better risk-adjusted equity portfolio.

This is analogous to today's investment environment in which the debate is active versus passive management. The smart play is to use both, or better yet, to find active managers that have reduced their fees and that embrace passive vehicles to express their views. (Full disclosure: The principals of MAI are floating a private fund in 2017 with modest fees that will use long and short positions in ETFs to express MAI views.)

Move On

Bad press surrounding ETFs stems from an asset management industry that, for most of the last thirty five-years, charged higher fees necessary to maintain a vast human infrastructure of portfolio managers, analysts, administration personnel and marketing teams and channels that attracted capital from the broadest cross section of investors.

ETFs are decimating assets-under-management of most conventional mutual funds and have begun to eat into hedge fund allocations as well. Who can blame passive investors and their advisors? Equities have risen, active managers have grossly underperformed and have been slow to reduce fees, and central banks are ensuring against bear markets. Such a setup has created a challenging headwind for higher-cost conventional active managers and a tailwind for ETF asset gathering.

In *Get Angry*, we argued passive investors will eventually suffer and that professional investors and allocators should remind themselves why they initially entered the business, and that they should begin to ply their knowledge again.

Table 1: World Equity Returns

ANNUAL PERFORMANCE (%)

Year	MSCI World	MSCI Emerging Markets	MSCI ACWI IMI
2016	8.15	11.60	8.96
2015	-0.32	-14.60	-1.68
2014	5.50	-1.82	4.36
2013	27.37	-2.27	24.17
2012	16.54	18.63	17.04
2011	-5.02	-18.17	-7.43
2010	12.34	19.20	14.87
2009	30.79	79.02	37.18
2008	-40.33	-53.18	-42.01
2007	9.57	39.82	11.66
2006	20.65	32.55	21.49
2005	10.02	34.54	12.06
2004	15.25	25.95	16.93
2003	33.76	56.28	36.18

Source: MSCI

The way to do this is by first recognizing the facts on the ground: there is a smaller market for active management than passive management presently and active management is in the process of shifting from conventional to "alternative" investing. It is crazy that investing to beat the market has become the domain of alternative investing, but that is the case now that speculating in the markets has become culturally seen as "saving".

Pigs Get Slaughtered

Most of the money supporting ETF asset growth is coming from investors ignorant (or willfully ignorant) of risk. As with active investing, ETFs provide mostly long exposure. Unlike active investing, the higher cap-weighted indexes move beyond sustainable value, the more likely ETFs will disappoint investors.

We do not necessarily endorse investment classifications; however, if the accepted convention has shifted from 60% equity/40% bonds to 40% DM equity/10% EM equity/30% bonds/20% alternatives, then professional allocators should use their alternative basket to offset – not enhance – their passive, all-long, all-the-time allocations. The way to do this is by first recognizing sustainable and unsustainable trends.

Fundamentals suggest the growing likelihood of long exposure to certain asset classes will produce negative real returns. Better talent within those asset classes will not be able to make up the difference through better asset selection. After all, the most influential determinant of returns is the level of overall sponsorship of the asset class. There will always be room for exceptional public stock pickers, venture capitalists and private equity financiers, but their performance will produce positive absolute real returns in a down market only if they keep an un-diversified portfolio containing uncorrelated businesses.

Investors, like large pension funds, using their alternative basket to allocate to managers that provide them leveraged long exposure to markets will be harmed greatly if/when bull markets end.

Sophisticated investors should allocate capital within their alternative basket to thoughtful managers using idiosyncratic strategies seeking returns uncorrelated to market indexes, or that seek exploit the passive market's inability to look forward; candidly, that seek to actively exploit thoughtless investing.

As with all strategies in all markets, there are two basic ways to use ETFS – directional and arbitrage strategies. Professional ETF traders calculate the spread between the prevailing prices of ETFs on exchanges and the value of their underlying components so they can arbitrage out the difference. Directional positions in ETFs are taken by everyone else; traders, investors and allocators with certain views of equity indexes, industries and sectors, interest rates, credit, geographies, commodities, FX exchange rates, gold and someday Bitcoin.

The old saw that bulls and bears make money but pigs get slaughtered should not be forgotten. ETFs providing bad exposure are pigs that will punish investors. *ETFs may be pigs gobbling up ignorant capital, but that is precisely why they can produce a lot of bacon for wise investors*. Why not do the slaughtering?

This piece may seem self-serving for a PM launching a fund with a strategy described herein, but it was also written by a PM who has managed successful funds since 1996, recognizes the shifting investment landscape, and sees a very compelling opportunity.

Paul Brodsky
Macro Allocation Inc.

Property Notice & Disclaimer

The information contained in this document is for general information purposes only. It is provided by Macro Allocation Inc to Subscriber/Members, and, while we endeavor to ensure the information is up-to-date and correct, we make no representations or warranties of any kind, express or implied, about the completeness, accuracy, reliability, suitability or availability with respect to this document or the information, products, services, or related graphics contained in this document for any purpose. Nothing in this document should be taken to constitute professional advice or a formal recommendation, and we exclude all representations and warranties relating to the content and use of this document. Any reliance you place on such information is therefore strictly at your own risk.

In no event will Macro Allocation Inc, its affiliates, and employees be liable for any loss or damage including, without limitation, indirect or consequential loss or damage, or any loss or damage whatsoever arising from loss of data or profits arising out of, or in connection with, the use of this document.

Through this document you may infer that other sources of information mentioned in it could provide suitable analysis related to issues on which you may act and suffer damages. Any mention or reference herein does not necessarily imply a recommendation or endorse the views expressed or implied by it.

Macro Allocation Inc reserves the right to revise and amend this disclaimer notice from time to time and any revised version will be deemed to be applicable from the first date of publication of this document.