ETF Mania Targets Brands

Just when you thought the Passive/ ETF mania had met its climax yet another outrageous new fund starts trading.

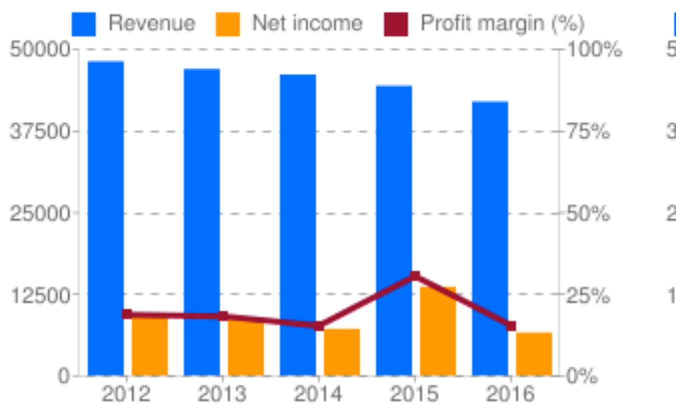
A few months ago I wrote a Piece called ETF Is the Markets BFF where I, like many analysts and pundits, came to the conclusion that all of this hot money pouring into ETF's and passive management was bad for structure of the market. It degrades true price discovery and piles a disproportionate amount of investors and capital into the same stocks creating bubbles and eventually air-pockets to the downside.

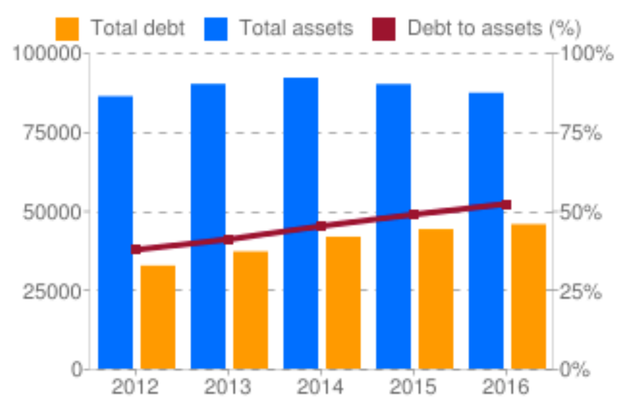
Yesterday I came across an article on MarketWatch discussing a newly incepted ETF called the Brand Value ETF (NYSEARCA:BVal). The main objective of the fund is to invest in companies that have strong brand recognition with the idea that there is intangible value that can be extracted making them viable investments. This investment thesis is short sighted and flawed much in the way that many ETF strategies are as discussed in my previous article.

At the core of any ETF are companies not just brands. These companies have revenues, earned income, cash flows, debt payments, taxes and every other business metrics that need to be considering when putting capital to work. Merely buying into companies based on brand strength and recognition in the hopes of tapping into intangible value that has yet to be extracted is a misallocation of capital. Prudent investing requires there to be an emphasis on companies with sufficient growth, profitability, as well as being financially sound. Buying Macy's because it's in the mall and has brand power or buying Netflix because many people recognize the company is not a sound investment strategy and will not be profitable in the long term. There may be some correlation between strong brands and strong investments but it definitely should not be the sole or main metric used to determine investments.

Take the example of Coca-Cola (NYSE:KO). Coke has arguably the strongest brand in the world. It is consumed in every nation on the planet with the exception of N. Korea and Cuba. Over 10,000 Drinks from Coke are consumed daily and has a reported brand worth of 83 million! There is no doubt the company has a rich history and reach like no other but does that automatically make it a viable investment option? Anyone employing brands as the sole metric for investment would say so but when you look deeper the story changes. Coke is currently trading at nosebleed valuations at a 31 P/E. This means that if you could buy all of coke it would take you 31 years to make your money back using current earnings figures.

Over the past five years revenue and earnings have declined while debt has accumulated. YOY Revenue is down over 11% while net income growth has declined 20%.





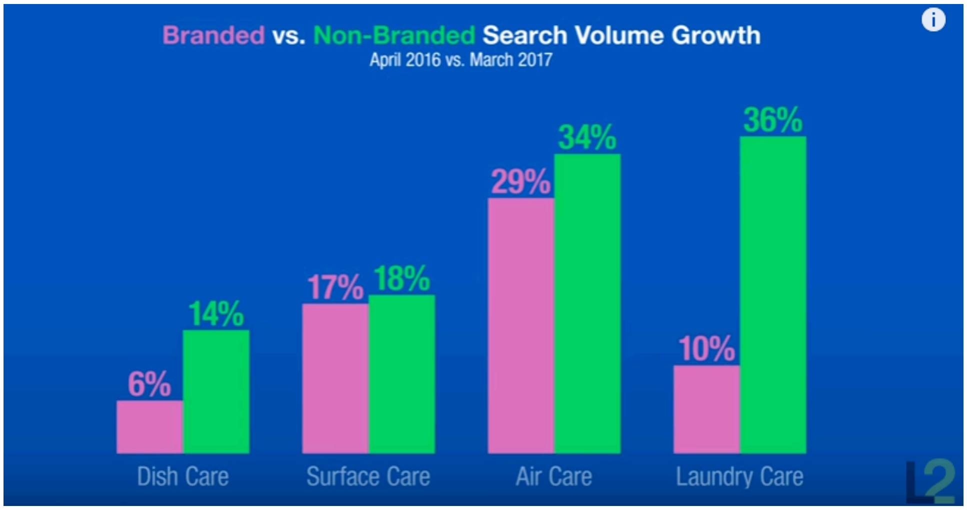
Coke has continued to raise its hallowed dividend year after year but has lacked the cash flow from operations to continue this sustainably. If this trend increases or even continues it is likely that the dividend won't be raised for the first time in decades sending income investors running.

Nevertheless following a strategy based on brands would blindly invest in coke without any thought of the growth outlook or the stability of their balance sheet. It should also go without saying that that same investor would probably put little thought into selling at the first sight of turmoil which perpetuates the problem with passive investing and can cause a cascade of selling.

Disney is also an example of a company with a famous brand. The Disney parks, Pirate movies, ESPN and ABC all contribute to the strength and recognition of their brand. Like coke this is still no reason to dive in pocket first. Moreover, ESPN continues to hemorrhage subscribers and overall eyeballs while sister station ABC has had an 8% decline in viewership YOY. This is a big problem for Disney as their media networks makes up just over 40% of their revenue stream. In the Long term it is likely that Disney will do just fine and continue to thrive as a company but all of these negative trends and business fluctuations have to be considered before investing. A strong brand is simply not enough.

This ETF has other shortcomings as well as brands are becoming less and less of a factor in consumer purchases. In addition, technology and the advent of E-commerce has contributed to this change in trend. Amazon's web and Echo platforms algorithm is designed to prioritize price so as to help the customer find the best bargains. Although this may be good for the customer it is terrible for "brands" as it eliminates their markups and pricing power as well as leads to less sales. Ordering through Amazon’s Echo also diminishes the appeal of packaging and logo's that brands have perfected since customers are not looking at the product and are ordering items verbally.

According to L2 inc. research Non branded products search volume is outgrowing that of branded search volume. As displayed below these phenomena is happening across product lines.



E-commerce and voice technology is only going to continue to grow across the developed world and will act as a huge headwind for brands in the years ahead. This is certainly a big picture type analysis but one worth knowing before investing in a fund that merely pitches brands.

Ultimately the point of all of this is not to shoot down 1 lowly ETF that to this point has little to no trade volume. The larger goal is to emphasize the shallow nature of many of the current ETF's trading in the market. Shallow funds will attract shallow investors and when sh#t hits the fan it won't be a brand that keeps them from selling the fund into capitulation. These investors do not care to recognize or appreciate the earning power of the underlying companies of these ETF's. They don't care about the disproportionate weighting of certain stocks within the fund. They don't even care about strength of the balance sheet. All they care about is catching 1 way ticket on the bull market train. Unfortunately this ride happens to be two way trip and the way back down is going to a lot faster and more violent than many of these investors believe. As the saying goes, *"Bull markets take the escalator up and the elevator down"*. Prudent investors will hopefully not find themselves on the Brand Value elevator on the way down.