June 2014 Alvine Capital Newsletter

June Newsletter - Don't be a passive investor

Key issue: investors are being dragooned into ever simpler, passive index type products that appear to offer an easy formula of low cost and superior performance.

Key recommendation: anytime a strategy, market or fad becomes hot is always time to question sustainability. A new generation of niche activists can yet provide value for money and dynamic performance.

Investors increasingly captivated by ETF and other passive index tracking strategies

The Facts speak

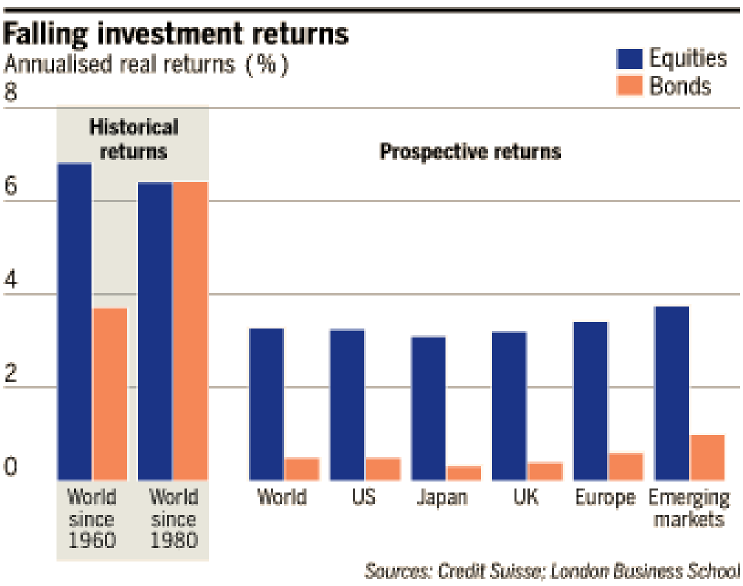
A new study by Portfolio Solutions and Betterment (source: Business insider-June 13) makes very clear reading. Comparing ten different asset classes over a fifteen year horizon, the research showed that index funds outperformed against a comparable actively managed strategy by an astonishing 82-90% of the time.

'This study further deepens the evidence that an all-index fund portfolio is difficult to beat' commented Alex Benke CFP and Product Manager at Betterment.

Fees - one direction down

In the halcyon days of the 1980's and 90's a strong bull market allowed most investment professionals of whatever ilk to charge fat management fees. In this era so many active players were subject to lighter scrutiny and could grow their business as the market roared. **A rising tide raised all boats.**

However when **returns evaporated together with the onset of a bear market** at the dawn of the millennium generous fee income could no longer be taken for granted. This, coupled with far **greater information flow garnered by easy internet comparison**, has led to a sharp emphasis on cost optimisation.



'If returns are relatively low and you are charging 1-1.5% on a fund you are probably gobbling up to half of the expected return. I don't think that is sustainable' Professor Paul Marsh London Business School (source: FT.com 10/2/13.)

Index funds and ETFs have been at the forefront of providing easy to understand, and vastly lower fee charges. Gone are the days when obfuscation, and difficult to understand and irregularly provided statements could suffice.

The relatively **simple composition** and structure of these funds have allowed computerisation to greatly reduce the cost of assembling these portfolios. **Vast economies of scale** have also helped.

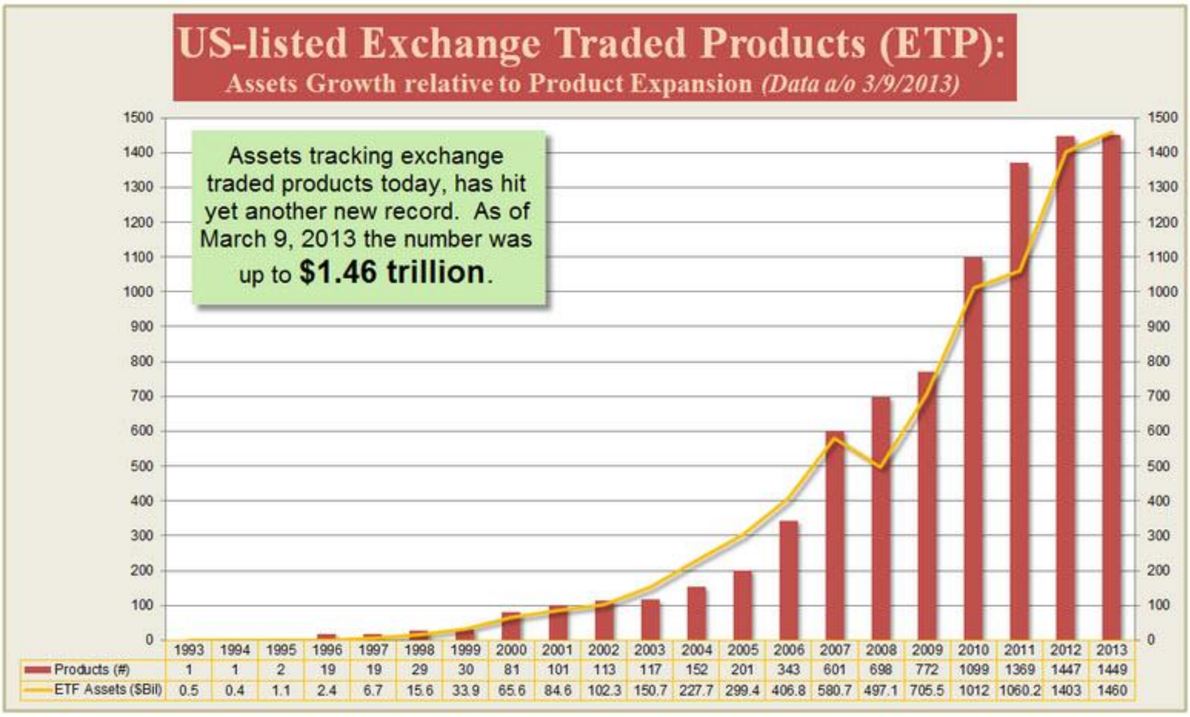
Churn - most stocks will always be part of a portfolio

What do Schlumberger (oil services), Motorola (technology) and MeadWestvaco (paper and packaging) have in common? They are all members of the S&P 500 fifty year old club, having been members of this American big-cap index for more than half a century.

Index trackers are going to hold the vast majority of their assets in the larger bigger capitalised stocks that tend to be always in their relevant indices. Churn, and all the attendant costs will be minimal. **Holding a portfolio of blue chip stocks for the long term with very little change can be a pretty simple, but effective way of generating real investment return.**

Choice - ETFs proliferate

We have come a long way from the early days of Index tracker types simply replicating a few major indices such at the FTSE 100. A multitude of instruments can now fine tune strategies across a swathe of the investment universe from Frontier markets, to industry segments and small caps.



Investors can now access genuine low-cost, liquid options.

Judge your own risk

The great thing about passive investing is it gives you little choice, you are either in a market or not. Activist managers can, and do make judgements about macro, sectors switching and other key factors in deriving overall positioning.

In this way investors can leave these decisions to professionals who are better able to evaluate risk. These are typically the expectation for absolute return managers who may use a wide spectrum of assets - bonds, derivatives, futures etc, to bolster or smooth total returns. Indexes can and are often violently volatile. **Five years into a massive bull market, many clients might be forgiven for no longer wanting to blindly follow an index deeper into over-bought territory.**

Niche opportunities

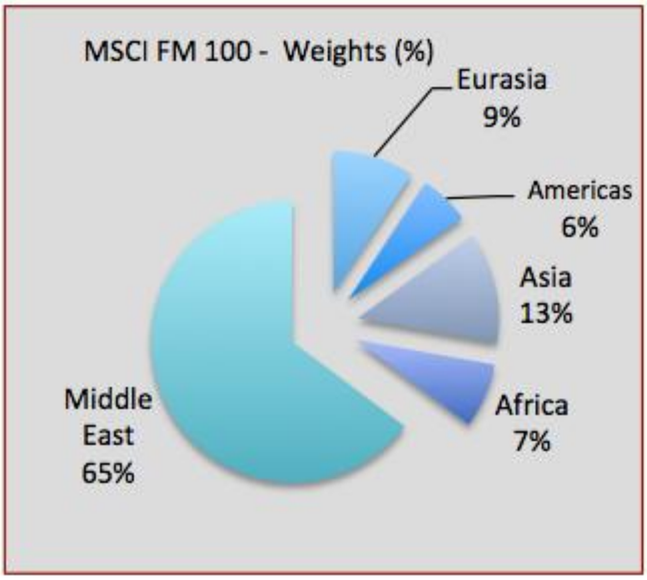
A niche is by definition a smaller opportunity that the heavy, almost macro-style tracker strategy. These can be **start ups** that can only grow and prosper by out-performing the market. It is there that genuine innovative investing takes place.

Globalisation and abundant information will give extra advantage only to those that are prepared to explore **new opportunities** and markets that by their own modest size cannot be reached by lumbering passive funds.

The makeup of an index

For a big cap index, or ETF product based on the S&P 500 or FTSE most of the stocks will be core holdings. As such an investor will probably get the broad based market exposure they want.

However other indexes can give different outcomes, and often the bizarre make up of how these are put together may not give what was sought.



Frontier index - an overweight of Middle Eastern exposure (source: Blackrock iShares ETF)

Clients looking to access fast growing Frontier markets by purchasing the iShares Blackrock ETF which is based on the MSCI Frontier 100 might be surprised to find that the **top three holdings are all Kuwaiti**, and the following two Qatari and UAE. In total **50% of this ETF** is from just these three countries, all of which may be interesting investment opportunities but are hardly at the edge of the global frontier story. **Concentration of risk** in this part of the world may also not be ideal.

Even for more mainstream plays, investors have been burned by the **high proportion of former Soviet natural resource** stocks that have listed on the FTSE. Big cap indexes always tend to have a **high concentration of financials** something which was painful in the 2008 meltdown.

The In and Out club

The value to companies and their sponsoring brokers, to be an index is high and getting higher. Once a stock has been elevated then all the index trackers have to buy it, and generally at the same time. This tends to cause a 'pop' in the price.

'Does inclusion in the S&P 500 suddenly make Facebook more profitable? Did inclusion in the benchmark add magic to Facebook's business model? NO, and those index funds will now have the **privilege of paying about 4% more** for the stock than before the announcement' James Osbourne a financial planner in Colorado (source: Minyanville.com 26/12/13.)

Arbitragers are very quick to profit from these changes, with a similar effect taking place with those securities that have to be sold once they are ejected.

Chasing your tail

Just a bit too easy...

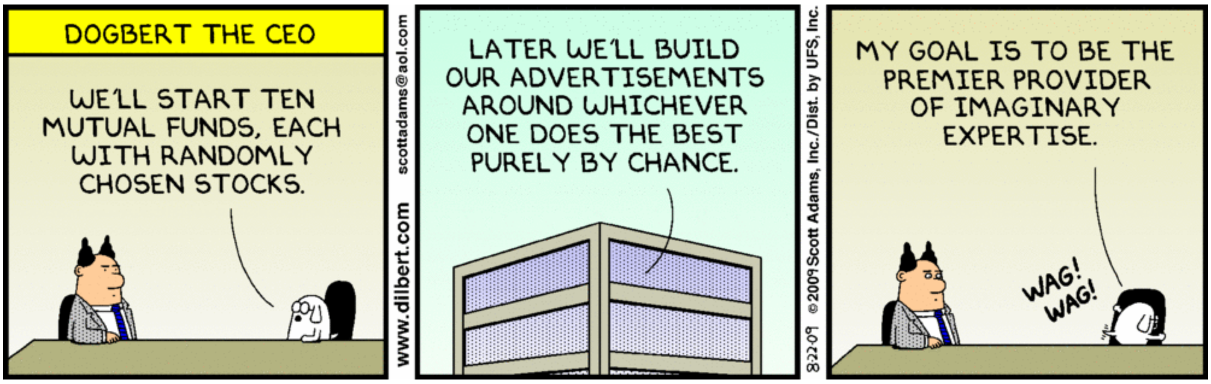
***Any* investment strategy** that is so universally recommended starts to arouse our concern. The history of financial markets should remind us that as they say in the small print---past performance is no guarantee of future success---the nature of human emotion points us to believe that crowded trades will not do well.

Ben Graham explained the definition of markets in the short run is voting machines. In the long run they are weighing machines.

Index funds tend to buy good past performance as that's why the stock was in the index in the first place, but this is less a guide of who will perform in the future.

'Passive investing has become self-fulfilling simply because of the weight of money following it' Chris Gilchrist director of Churchill Investments (source: Moneymarketing.co.uk 27/9/10). Until recently CTA momentum systematic funds were drawing an increased fan base, but since 2012 most of these strategies have fallen away. It is a mathematical formula that all these weight of money trades eventually fall under their own weight. It may take a little longer as more and more money is still chasing this trade, but eventually it will too fail.

Conclusion - thanks but no thanks



All investors owe a debt of gratitude to the rise of passive index products. As part of the revolution in accountability, and fee compression it is difficult to see how these objectives would have been achieved without the competitive pressures brought to bear on the industry.

Traditional asset management afforded scant information, high management fees and little explanation of investment strategy. There is still much to do with too many so-called active managers in reality hiding behind quasi-index investing and illustrious brand names.

Fancy corporate brochures often conceal a strange desire to hug very conventional portfolios, but with the drag of still high fees.

What investors should be looking for are nimble, innovative managers that generate real alpha, at the same time allowing dynamic asset allocation.

Model Portfolio - the ECB's turn

'I am very worried about France' Rianer Bruederle (leader of the FDP and former ally of Merkel.)

With the Euro elections showing a groundswell of deep dissatisfaction with the state of affairs right the way across the continent as fringe parties performed. So Germany's worse nightmare of France's weakness continues forcing a more emollient Bundesbank approach to monetary policy. Draghi announced not only a further easing in the discount rate but that more was yet to be done.

With the Fed and the Bank of England seeing macro-prudential fine tuning of the economy as the right way to rein back excess, rather than higher rates, the same old story of rising rates has resumed.

For that reason we remain overweight risk assets.