

UNINTENDED CONSEQUENCES

With investment markets, oftentimes what appears logical and beneficial can create unintended consequences that can be very harmful to a large number of investors. We will present two examples that we believe fit this description. The first relates to passive investments in the S&P 500 Index, and with this example, the consequences to investors have already been realized.

The second example relates to passive investments in commodities (oil, metals, agriculture, and livestock), where the growth is still accelerating and the consequences are yet to be realized by investors. We will also explore whether there are any unintended consequences for the general public that are being realized today.

S&P 500 Indexing

An acceptable strategy over many years has been to allocate a reasonable portion of an equity strategy to a passive investment like the S&P 500 Index. Throughout the entire 1980s and 1990s, as index investing was growing, the vast majority of all index investing was done by purchasing this single index. Of course, this index represented most of the capitalization of the US equity market, so the strategy made good sense. The investor strategy was to accept “average” by simply buying “the market.”

Passive investing means that the investor accepts the investment holdings and structure as is. The investor does not evaluate the fundamentals of the underlying holdings and try to determine if the price being offered is too high or a good value. There is no valuation process.

If we define “success” in terms of growth, the S&P 500 Index investing strategy was very successful. Trillions of dollars flowed into this strategy over the years. The valuation of the S&P 500 Index went from 8 times earnings in 1982 to over 30 times earnings 1999. Because this index is capitalization weighted, investors were essentially buying the largest 25 to 50 stocks in the US; the other 450 or so stocks in the index had very little effect on the return of the index.

As these few large stocks were purchased through the index investing strategy, their prices appreciated beyond their fundamentals, i.e., there was no way for the companies to generate future cash flows that justified the stock price. Remember, the passive investor is satisfying a specific target allocation, so the plan is to buy and hold this investment indefinitely, regardless of valuation. The tremendous growth of the indexing strategy caused these US mega-cap stocks to keep moving up in price, regardless of their earnings.

The unintended consequence of this investment technique is to create characteristics similar to a Ponzi scheme. The difference is that the S&P 500 reflected real businesses with real value. The similarity to the Ponzi scheme is that the value-devoid technique resulted in the latecomers’ paying significant alpha (i.e., above market returns) to the early sellers, i.e., the value conscious investors. The correction for the over-valuation of these mega-cap stocks began coincident with the tech bubble crash in March 2000, and the price/earnings multiple for the S&P 500 has been cut in half, from 35 times earnings to approximately 15 times earnings currently.

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Commodity Indexing

So, this is what happens when passive investing in a particular strategy grows more than is justified by the value of the underlying securities. The latecomers always lose. The early comers can win, but they must exit to do so, and with a passive allocation strategy, exiting is not in the plan. Of course, the S&P 500 is huge; it is “the market.” What happens if this type of passive investing takes place in a market that is much smaller, say less than 1% of the S&P 500? The simple answer is that over-valuations can move farther, faster.

The same passive strategy is currently taking place with commodity investments. A risk-controlling product resulting from the severe 2000 to 2002 bear market was that consultants and the funds that they advise have been increasingly recommending a fixed allocation to commodities, something in the range of 2% to 5%. Of course, these institutional funds do not buy barrels of oil, bullions of gold or actual pork bellies. They prefer simplicity and liquidity, so they invest in commodity index funds. The index funds are buying commodity futures contracts, and as the contracts move toward maturity, they roll their positions by buying calendar spreads.

According to data published by Goldman Sachs, Bloomberg and the Commodities Futures Trading Commission (CFTC), the dollar value of the futures contracts in the relevant commodity index funds have grown from \$13 billion to \$260 billion since 2003. This is a 20-fold increase in less than five years. Are these commodity index funds as good a value when they are capitalized at \$260 billion as they were at \$13 billion? Similar to the S&P 500

Index investing, these new and growing participants in the commodities futures business are not speculators. They are not valuing the fundamentals and planning to sell their commodity allocation when the price exceeds the fundamentals. They are buy-and-hold investors, regardless of the pricing.

Just like with the quasi-Ponzi scheme described earlier, the growth rate is accelerating. As the prices of these commodities rise, the popularity of the investment technique rises, and this further pushes up the prices. Investors, both passive and active, are attracted by the rapid increase in prices, and they are flooding into commodities using these passive index funds. This investor behavior also artificially inflates the size of the market. Is the growth of the market due to natural demand for commodities or is it simply feeding on itself through the passive investors? Regardless of the China demand, ethanol production, and other commodity escalation rationalizations, we see Wall Street barreling investors toward another brick wall.

Price at the Pump

With regard to an investment strategy, valuation-wise, we are much closer to the end than the beginning of the scheme, so buyers best beware. But another important question relates to our general economy. Does this massive growth of investments in commodity index funds by these giant institutional investors affect the price that the man on the street pays for gas, food, jewelry, or other commodities that comprise the indices?

According to the CFTC, the commodity futures prices as represented in the commodity index funds are the benchmark for

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the prices of the actual physical commodities. Based on this assessment, the demand driven by the passive commodity index fund investor is roughly an additive to the demand driven by the commodity consumer.

In recent testimony before the US Senate, Mike Masters made a convincing argument for how the rapid growth of these buy-and-hold index investors is pushing up the price of the commodities to the consumers. As Mike noted, while these passive investors have no malicious intent, the investment technique is creating an unintended consequence to our economy and citizenry.

Price in the Portfolio

Our concern must be with the price in the portfolio rather than the price at the pump. We have no problem with passive investment vehicles, and we may selectively use them to capture the risk/return benefits of a particular asset class more cost effectively. However, we will not blindly disregard the current valuation (return) because of a historical analysis that supports a reduction in volatility (risk). Risk is not just about volatility. As Peter Bernstein recently said, "Risk management should be a process for dealing with the consequences of being wrong."