MOI GLOBAL

Active vs Passive Investing

This article is excerpted from a letter by Luis Sanchez and John Pelly, co-founders and managing partners of Overlook Rock Asset Management, based in New York.

Passive investing with index Exchange Traded Funds ("ETFs") is all the rage now. Here we'll briefly discuss what they are, why they're such a great product for generating wealth for their investors (when used properly!), and how we view Overlook Rock's strategy as being distinct from (and superior to) the index ETFs out there. In particular, we'll focus on the "gold standard" ETFs: tickers SPY and IWV. We'll save a more detailed discussion for a future write-up.

For those unaware of how ETFs work, think of them as a bundle of stocks that are sold as a unit. A manager (an investment corporation) constructs a bundle of stocks according to a set of rules and offers that bundle as a single security that you can buy and sell on a stock exchange (NYSE, NASDAQ, etc) with your broker (Merrill Lynch, Schwab, TD Ameritrade, etc). Roughly, when you buy/sell an ETF, the manager goes out and buys/sells the shares that make up that stock bundle, holds those stocks in the investment vehicle, and creates new shares of the ETF that you wind up holding.

Index ETFs are designed to track market indices. These products have proliferated significantly over the last decade – there are ETFs to track all manner of "indices." Two in particular that we focus on for this discussion are the SPDR S&P 500 Trust ETF(ticker "SPY", managed by State Street Global Advisors) and the iShares Russell 3000 ETF(ticker "IWV", managed by Black Rock). The SPY consists of the 500 largest US stocks and the IWV consists of the largest 3000 stocks (including the 500 stocks in the SPY). The SPY and IWV are good proxies for the US stock market as a whole.

Again – we'll save a lot of juicy details about the benefits and risks of index investing for another, purpose-built write-up. But for now, we'll just say: We believe index investing is a foolproof way to get rich over time, provided:1) you do it the right way and 2) you can't find a better way.

If we (John and Luis) were investing in SPY and/or IWV the "right" way, that would look roughly as follows:

- Dollar cost average: Periodically invest our cash in roughly equal amounts on a regular basis-once a month or quarter, over several years. If we had a large amount of cash upfront, we'd spread it over 4-8 quarters.
- Invest with a long term horizon: We would not invest any money that we would need to access in the next 5+ (ideally 10+) years.
- Stick with it: Stay invested and do not sell holdings when there's fear and panic (i.e. big drops).

Those steps are listed in increasing order of difficulty. Especially the last step. It can be excruciatingly difficult for many to hold onto their holdings when a recession hits and the market drops 20, 30, 40%. Numerous studies show how people pull their money out just at the bottom and put it back in close to the top. As a species, humans' default emotional wiring is not well equipped to handle financial markets.

But those who follow the general instructions above would definitely get rich. Why? Because they are broadly participating in the incredible economic engine of the United States in a very low cost, effective manner.

Absent adding any real economic value, the vast majority of other investment products out there just can't measure up. The sad fact is (with lots of data to back it up) that most other investment products out there under perform the S&P 500. They're either "closet indexers" (mirroring the index but charging higher fees), or "(hyper)active managers" that don't have the discipline, drive, or emotional fortitude to invest in a way that can repeatedly generate superior performance.

We want to emphasize that SPY and IWV are great ways to get rich, over a long period of time.

However, we'd like to get us and our clients richer faster (who wouldn't?). We believe we've found a way to do it. Read on.

As mentioned above, passive ETFs (including SPY and IWV) pick stocks according to a set of rigid rules. For SPY / IWV, the process is:

- Pick the 500 (SPY) or 3000 (IWV) stocks with the highest market capitalizations.
- Hold each stock in a ratio equivalent to their market capitalization size.
- Adjust the portfolio periodically to reflect steps 1-2 (once a quarter for SPY, once a year for IWV).

Quite simply, these are pretty brain-dead rules:

- Picking a stock just because its market capitalization is high, and in proportion to the market cap size, is like buying a car solely because its expensive. If the dealer doubles the price, you would own twice as many…?!
- Re-balancing like clockwork every quarter (for SPY) and every year (for IWV) is incredibly simple and in fact gamed – many active managers buy stocks (either new or increasing in portfolio weight) in anticipation of what SPY, IWV and others like are going to buy. This drives the prices of those stocks up ahead of the ETF purchases, enriching others at the ETF investor's expense.

And yet, every dollar you invested in SPY 5 years ago (starting June 28, 2013) to the last trading day of the quarter we write about (June 29, 2018) would be worth just under $1.87, for a compound annual rate of return of 13.3%. Maybe a brain dead scheme can work?

Let's look at another 5 year period: March 15, 2004 to March 9, 2009. Over this period an investment in SPY would have turned $1 into $0.66, a compound loss of 8.1% per year.

That takes a bit of shine off SPY! Now, for those of you that know your financial market history, you'd know that March 9, 2009 was the absolute bottom tick of SPY during the Great Recession. So you could legitimately argue we carefully picked the start and end dates to prove how bad SPY can be. Fair enough – but also keep in mind that that 13.3% number is coming from the other side of that very low point, and is a very unrealistic assessment of what we can expect from SPY over the long run, and extremely unrealistic of where SPY could go over the next 5 years. On the whole, it is far, far more likely to be much less than 13%.

Empirically, the data show that the "long run" (10+ years) average returns for SPY is in the 8-10% per year range. This assumes you stay invested that entire period and reinvest your dividends.

Not a bad long term expectation, but at Overlook Rock, we think we can do better. Here's why:

We have developed a set of rules that are much more profitable than those embodied by SPY and IWV as outlined above. They are derived from first principles regarding what makes for a valuable business by looking at a company's fundamentals, then empirically tested over almost 20 years of historical data. In aggregate, the companies selected by these rules should meaningfully outperform SPY and IWV over time, even net of our fees.

We evaluate the entire universe of stocks, scouring for those that are cheap relative to earnings, high quality (have sustainable competitive advantages), or are paying decent dividends. We sell when those criteria no longer hold, and put clients into other cheaper, higher quality, or greater dividend paying names. By systematically keeping the portfolio focused on these 3 characteristics, we expect to dramatically improve on passive products.

That's why we set our bogeys as SPY and IWV, and report them alongside our performance. SPY and IWV are both simple, easy ways to outperform 80%+ of the investment managers out there. If we can't beat both the SPY and IWM over the long run, net of fees,we need to find a new job.

We believe this is a higher standard than most investment managers are willing to live by – in other words, perfectly appropriate for our clients.