The Crowd

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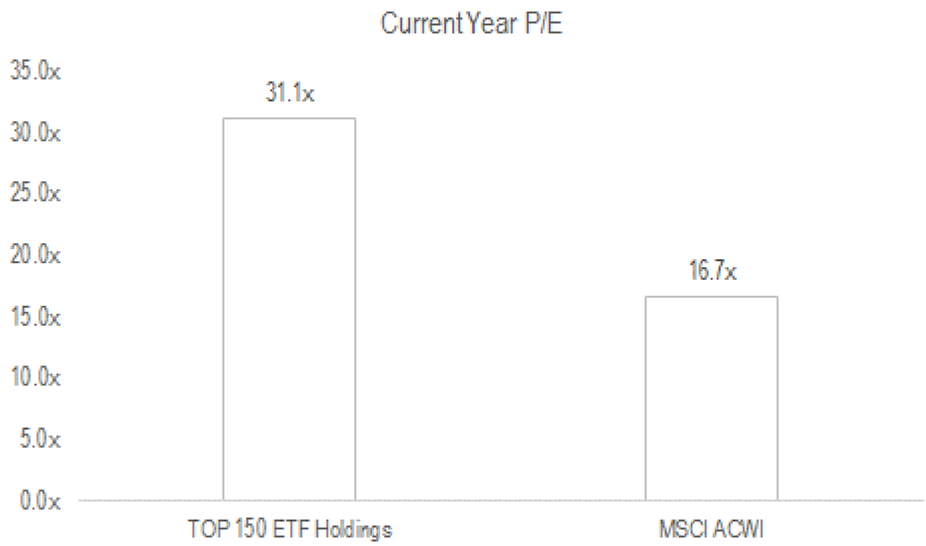
After years of watching value managers lose ground to more popular investment strategies, including passive ETFs, as well as the growth and momentum styles, we believe it seems likely that the overall number of value investors populating the market has ebbed over this time-period. In an industry where the majority of practitioners show a preference to blend-in based on existential considerations this phenomenon should not only be expected, but seen as an ideal source of opportunity for the steadfast bargain hunter. Ironically, the industry-wide pursuit of convention, and the misplaced satisfaction found in rising near-term performance measures eventually coalesces into higher levels of risk.

From our perspective, the circumstances described above, and the opportunities they create exist today. The popularity of ETFs and strategies embracing growth and momentum has in our opinion created a situation where the tail is wagging the dog. Our first observation is that the shares most commonly held among ETFs carry materially higher valuation multiples relative to the market index. To understand the effect of ETFs herding into a rather narrow basket of equities, we looked at the average valuation for the 150 most commonly held stocks among ETFs to learn if these stocks traded at a premium to the rest of the market. Indeed, we found that the top 150 stocks held among ETFs trade at an average P/E of 31.1x compared with 16.7x in the MSCI ACWI Total Return Index for global stocks. Moreover, even when we remove the so-called FAANG stocks, the average only declines to 30.2x.



Source: etfdb.com, Templeton and Phillips Capital Management, LLC.

Our second observation on this phenomenon is joined at the hip with our first observation. We see the second risk component that investors are overlooking as a thinly veiled correlation among the majority of ETFs. Given the rapidly growing number of ETFs in the market, these funds tend to increasingly hold the same set of stocks in common.

Let us take Apple as an example. As you know, Apple is one of the largest tech companies, and to clarify, one that we generally view favorably for a long-term investor. However, by our count, Apple is now held by 155 ETFs. Notably, among these ETFs we find some odd-couple strategies cohabitating Apple that contradict each other. For instance, Apple is held by six value ETFs, five momentum ETFs, and ten growth ETFs. While we can argue that a growth company like Apple can fall out of favor and become a value, the contrast between value and momentum is too stark. We suspect if investors in the Deep Value ETF (DVP) knew they were commingling in a stock with the Powershares Momentum Portfolio (PDP), they might take issue.

This raises the important question, why are these disparate buyers trafficking in the same stocks? The answer we believe is liquidity. ETFs must find highly liquid stocks that make the purchase and redemption of shares-in-kind a fluid process for the ETF manager. This helps explain to us why the Catholic Values ETF (CATH) also owns Apple, even though Apple has historically been linked to child labor in the cobalt mines within its supply chain. We believe CATH, like all other ETFs requires liquid stocks in its portfolio, forcing it to make concessions on its investment mandate and hold stocks that are much like, if not the same as the remainder of its ETF brethren.

We believe when enough ETFs crowd into the same stocks, the ETF investor innocently picks up correlation across their portfolio (which undercuts the benefit of diversification). This erosion can occur irrespective of the ETF’s name, or its purported strategy. Interestingly, these risk-correlation circumstances surrounding ETFs seem mindful of investor complacency leading up to 2008, as it related to CDOs and other debt instruments.

Back then, we believe investors became complacent to underlying risk following years of rising asset prices. At that time, the individual debt positions these instruments held was often mislabeled and increasingly correlated due to the extreme loosening of credit standards across the board. This risk dynamic flourished and spread as investors were either not paying attention to, or did not understand the underlying risk. To be sure, we are not “against” ETFs in principal but rather, we see their popularity creating an unrecognized risk in the market.

Putting it all together, we see potential danger for these investors as we suspect they are unknowingly herding into a rather narrow band of commonly held stocks that appear inflated in price. Most importantly, and above all else, when the market eventually corrects, we also believe that these same stocks most commonly held among ETFs will represent a fertile hunting ground for the most attractive bargains. These factors seem likely to become exaggerated in ETF strategies that necessitate holdings where liquidity in the underlying is insufficient, and pro-rata selling across a basket of securities could create very attractive opportunities on a bottom-up basis. In these special cases it seems possible for bargain hunters to purchase the ETFs themselves at a discount to NAV.

Not surprisingly, for the independent-minded bargain hunter the current opportunity set lies well outside of the ETF thoroughfares. Likewise, when the market eventually declines we believe investors inhabiting names primarily outside of the major ETF holdings possess a better chance to preserve investor capital. In sum, it has most often been the case that market downturns create the proving grounds for value managers as they are tasked with offering the dual service of capital preservation and opportunistic bargain hunting to create future returns. We believe that the only way this is possible to invest differently from the crowd, and this time will be no different.