Indexing the Past

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The investing world is topsy-turvy. Trillions of dollars of negative interest rate bonds are currently outstanding, meaning that many bond investors are suddenly paying interest to borrowers, instead of collecting it from them. The Russell 2000 Index is on a run of being far less volatile than not just the S&P 500, but even the S&P "Low Volatility" Index.

Those are both examples of why the standard active vs. passive debate misses the point. Very certainly, for some asset classes and in some periods, investing via pre-set formulas and categories can serve investors nicely. But, just as surely, for other asset classes, and in other periods, those very same formulas and categories can result in bad choices and results.

Passive investing has those two sides for a very simple reason: its recipes are generated exclusively from historical data, relationships and patterns. But, assuming that classifications and patterns derived in one circumstance will be true in another ignores the most basic fact of all: *that data and metrics only describe the world that creates them*. There is, after all, a very good reason we don't travel to Europe with the original Fodor's of 1936.

Today's financial world disputes many of the most basic assumptions of yesteryear's investing "truths." Even the most basic of all, modern portfolio theory, is befuddled by the fact that huge swaths of "risk-free" assets are now priced, at issue, to generate losses. Just as Fodor didn't suggest taking the Chunnel to France in 1936, Markowitz couldn't imagine bonds yielding literally less than nothing.

Rapid change also undermines the categories used by investment professionals and products. Perhaps Brazil, Russia, India and China were indeed the key "emerging" economies not long ago; now they could not have more diverse prospects, despite the clever acronym their initials create.

When the picture changes, old formulas and descriptions stop being useful ways of characterization. Today, that picture is rapidly transforming in ways that directly undercut many bedrock investment principles.

THE GREAT DISRUPTOR

Today's disruptors are many. Globalization, gathering force for decades, turned into a financial hurricane in August and was cited by the Fed as a reason not to raise rates in September. In the meantime, the steady rise of the "winner take all" digital economy—where a handful of companies dominate their respective segments—has undermined the very idea of sector investing, and made the Nasdaq Index's overall performance reliant on a tiny handful of companies.

But as agents of change, both pale in comparison to the stalemate central bankers and politicians have staged against the invisible hand of free markets. Our financial universe is no longer driven by fundamentals, such as supply-and-demand, and the rhythm of classical business cycles. And that redraws the investing map in profound ways.

Overwhelming government and central bank intervention, bailouts, and even explicit asset price management have dominated markets since the Great Financial Crisis of 2008. An endless cascade of central bank asset purchases has resulted in the Fed owning almost a third of all Treasury notes and bonds. Thanks to its highly inventive new liquidity mechanisms, banks have $2.6 trillion of "excess reserves" parked there. "Quantitative easing" has been elevated from the arcane to daily television fodder.

Initially, the good-faith idea was to prevent a meltdown of the core operations of the global markets; but somewhere along the way, serious mission creep set in, and then spread around the globe. Now, versions of these extraordinary medicines are prescribed for daily use by governments and central banks everywhere, setting sanguine expectations of rising markets and full employment in every country.

Those policies have, of course, created a chorus line of stocks and bonds, all kicking higher together. As a result, almost every style of indexed investing has worked well. Uncritical financial asset accumulation has proven a boon; it matters not which boats you buy when they're all rising with the tide.

But beware learning the wrong lesson from this recent history—and of investing by formulas that have benefited from them. To state the obvious, that chorus line may not adapt well to different interest rate music; as you might guess, in the options market, implied correlations recently hit a six-year low.

Even more fundamentally, we are now at the mercy of unprecedented and poorly understood dependencies, with unknown consequences for "normal" financial logic. Case in point: China's bond sales (to support both its stock "market" and its currency) was one important factor that kept Treasury prices from rising during the late summer mini-crash…and that scrambled the reasoning behind, and results of, certain strategies, such as risk parity strategies, which are based on fundamentals and had been very successful for many years.

But who needs the options market to tell us that? We've seen the start. Think how gross overinvestment in the oil patch was hidden for years, until, suddenly, it became obvious, translating into disastrous performance for many energy-related stocks and bonds. Think how no one questioned a bond issuer with commodities to sell to China until the recent reckoning that has left many questions about their ability to repay. Think how media stocks were nearly all collectively "repriced" over just a few days recently.

NOT JUST PRICES, STRUCTURES

The volatility that policy pronouncements can unleash won't just move markets; it is likely to expose structural flaws in investment products that may have thrived during the halcyon days of limitless, easy money. Some of those products depend on plumbing that works during placid markets, but under stress, acts more like an old home's furnace in the winter.

These flaws have now leapt to the headlines: several ETFs experienced profound price dislocation amid the recent turmoil, as their system for adjusting imbalances between their price and NAV faltered. "Authorized Participants" who are meant to arbitrage these values into synch couldn't get off their trades for several reasons (a condition possibly exacerbated and exploited by high frequency traders, who can move faster than traditional market makers…another of the many game-changers we face).

As homeowners learned in 2008, many kinds of assets—even excellent ones—are easier to buy in a bull market than to sell in a bear. Product wrappers cannot magically change illiquid assets into ones that trade in nanoseconds. No one should mistake large trading volume on the way up for certain liquidity on the way down.

AND SO?

Future economic outcomes now appear to be more unpredictable compared to when fundamental factors and normal business cycles are in control. Given the primacy of policy makers in markets, investors are increasingly sensitive to the impact of the complex interplay of factors only somewhat related to finance, such as geopolitical goals, domestic policy and game theory.

And so: investing is harder. Recurrent economic dynamics can be captured into models that may achieve modestly useful predictive power. Valuation metrics that functioned well before the era of zero-rate policies are suddenly of questionable utility.

An investor's ability to draw distinctions is now essential. All domestic high-yield bond issuers are not the same; nor are all emerging market credits. A specific company's ability to withstand currency disruptions, or its strategic value to a potential acquirer, or a sustainable advantage against global competition might indicate it's a buy; but uniformly rising markets appear less likely to benefit all.

Asset classes aside, more precise, focused strategies will rise to the top, too. Some aim to profit from divergent monetary policies by identifying trends in currencies or commodities. Some try to generate value by prodding target companies to take specific actions. And some seek profit from both winners and losers as the market starts to differentiate between them.

Yes, those last two paragraphs mean that it's important to either be a great investor yourself, or to invest with one. That could mean paying somewhat higher fees than you would with passive strategies. But, whereas you sometimes don't get what you pay for (the old expression is wrong—don't you sometimes overpay for things?), you never get what you don't pay for. Right now, I believe real expertise is necessary to investing success.

Investors should remember: All ideas have a shelf life. In a period of hyper-rapid change, old categories, metrics and recipes may not capture what's next. So invest through them at your own risk.

ABOUT BOB RICE

Bob Rice, Managing Partner of Tangent Capital, is a financial expert, best-selling author and a frequent guest speaker on several national business news programs. Bob uses his 25 years of experience in non-traditional investments as an advisor, lawyer and principal to work with advisory firms engaged with Neuberger Berman. He is the author of *The Wall Street Journal* bestseller, *The Alternative Answer*. Bob has served as a financial products partner at Milbank Tweed; the CEO of a publicly traded technology company (the successor to his own startup); and a trial lawyer for the U.S. Department of Justice.

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