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Inefficient Market Theory

Synopsis: *Active fund managers are quietly talking about the best investing environment of their careers. Credit the fund flows into ETFs and passive investments.*

Takeaways: *Passive flows are lifting or lowering the prices of companies that aren't exposed to the underlying investment dynamic. Many industries are being disrupted. Larger pools of assets are chasing larger stocks, and ETFs are trading based on fund flows rather than fundamentals.*

Mutual fund flows have been trending strongly away from active managers toward passively-managed mutual funds and ETFs, and the trend is accelerating. So why does active manager Chris Davis, CEO and Chairman of Davis Selected Advisors, describe today's investment climate as "a dream environment?"

"Everything that is happening that is bad for our business will be good for our investors and our investment results in the long run," he says. "For a firm made up of investors in our own funds, we'll make a lot more money from ten percent better results than ten percent more assets under management. For us, this period of asset flows into passive funds is wonderful, and let it go further."

Categories by passion

As Morningstar's Don Phillips has pointed out for decades, there are two broad categories of active fund managers in the investment marketplace. In Category One, which includes most funds, many of the larger firms are far better at marketing than managing; they come out with new trendy funds, and their more traditional offerings will generally hug the indices, meanwhile charging five to ten times as much as an ETF that mirrors the same index.

Category Two is made up of fund families run by people who have a passion for investing. These firms tend not to put much time and energy into marketing; instead, they devote a correspondingly greater percentage of their resources into research and security selection. Their

funds tend not to correlate closely with the indices, probably because they score very high on the active share measurements.

This latter group of managers, in recent years, has lately been finding more and better investment opportunities than ever before in their careers, as many of the investment decisions in the marketplace—driven by passively-managed funds and ETFs—have become largely automated. The phenomenon is somewhat complex. But after a series of interviews, it's becoming clear that—for a variety of reasons—the unprecedented shift of fund flows into passive and away from active have put a wind at the back of many of the more thoughtful portfolio managers in the mutual fund space.

Inexplicable correlations

So what factors are favoring active fund managers in the passive-dominated marketplace? David Giroux, Vice President of T. Rowe Price Group and co-chair of the company's asset allocation committee, points first to an otherwise-inexplicable rise in correlated movements of the stock prices of companies whose fundamentals don't seem to be correlated at all.

"As an investor," Giroux

explains, “you want to have situations where fundamentals move away from the underlying stock price, either positively or negatively. That’s where the alpha opportunities can be found.” An example of this opportunity came when interest rates went up, which caused momentum investors to buy ETFs that invest in the financial sector.

“That inflow dragged higher the stock prices of a lot of companies that were not really

were getting no negative impact from lower energy prices. So the ETFs were having to sell those securities, and they were trading lower on the markets.

“As a portfolio manager who runs a multi-asset-class strategy, we were getting day-in, day-out opportunities to buy \$10 million non-energy high-yield bonds two to three points below where they traded the day before,” adds Giroux, “just because supply and demand had been misplaced.”

the changes that are challenging their businesses are happening more rapidly.”

How is this related to passive fund inflows? “If you’re doing your research and taking a long-term view, you can have a meaningful underweight to the companies that are being disrupted,” Giroux explains. “At the same time, we can overweight the companies that we believe will benefit from those secular changes. The passive strategies can’t make those increasingly important distinctions.”

“The ability to assess these changes, the impact of a shift to electronic payments, cloud computing, digital and social media away from print and broadcast media, will be crucially important to the long-term investor,” adds Sharps. “These things are happening very quickly. In this environment, more than ever before, there are entire industries on the cusp of being upended. Think of the implications of autonomous driving or artificial intelligence. An index manager won’t be evaluating that. They won’t be asking what Airbnb means for the Hiltons, Marriotts, Expedias and Pricelines, or what autonomous cars means to the auto industry. If you’re a fundamental investor with a long time horizon, you have much better odds of being on the right side of these trends, and maybe also avoiding some of the carnage that results.”

Index fund flows are driving stock prices up and down indiscriminately when certain stocks are not exposed to the underlying factors. the result is growing market inefficiency.

exposed to that factor,” Giroux says. “If you’re the owner of some of those names, that provides you with an opportunity to reduce your exposure. Even though the fundamentals hadn’t changed, the money moving into the ETFs that owned those companies caused their prices to rise.”

Another example? “Remember back in the fourth quarter of 2015, when people were selling out of ETFs that invested in high-yield bonds because they were worried about their energy exposure?” Giroux continues. “It turns out that energy exposure was only 20% of the index. When all those investors moved out of the ETFs, they weren’t just selling energy exposure,” he says; “they were also selling a lot of consumer bonds, telecom bonds, things that

Business Disruption

Giroux and Rob Sharps, T. Rowe Price’s Group Chief Investment Officer, point to another area where active managers can find greater opportunity in a market where the fund flows are passively-dominant. “I’ve been in this business for 18 years now,” says Giroux, “and I’ve never seen a time when more business models are coming under secular challenges. There has been so much disruption, like Amazon displacing traditional retail, or Internet companies challenging traditional service providers.”

Adds Sharps: “The companies that are affected, like IBM, Wal Mart and others, are big constituents of the benchmarks, and

Selective inefficiencies

Beyond that, the indexing

phenomenon could be driving the markets toward systemic inefficiency more quickly than the fund flows might indicate. People who are not worried about how prices are being set will cite research showing that the investment markets would be relatively efficient up until the day that passively-managed funds account for 90% of the total assets.

Davis concedes that, in this indexing-dominated environment, there is still a great deal of market efficiency around short-term data processing and momentum investing. But he's seeing dramatically less active management participation in his firm's particular sweet spot—investment decisions designed to outperform over a 3-, 5- or 10-year period.

Why? Because many managers are avoiding the potential consequences of long-

term investing in a world where everything is compared to short-term index results.

"I was speaking with a very well-regarded hedge fund manager recently," Davis says, "and I said to him: *if I gave you a stock that was 100% guaranteed to outperform over the next three years, but two of those three years it was going to underperform, and I couldn't*

and fewer people fishing for them."

The more money that is concentrated in larger pools of assets, the more money has to be shoveled out the door to keep those larger pools invested. The result: less competition for the best ideas of opportunistic managers who invest in special situations.

Marcus also agrees with Sharps and Giroux that the business

Business models are being disrupted by the Internet and tech faster than ever before. But who's making those decisions in a passive fund?

tell you which two. Would you buy it now to be guaranteed the outperformance?

"He said: *I wouldn't go near it,*" Davis reports. "He said: *I can no longer afford to be under for a year. My world has changed.*"

Big flows, less competition

David Marcus, founder and manager of Evermore Global Advisors, says he's having the time of his life as a portfolio manager. "Right now, more than I've ever seen in my career, all the big passive funds and ETFs are bidding against each other for a relatively small number of fish in the pond," he says. "They're all chasing the big fat whales and giant groupers, because they have to manage the huge flows they have to put to work."

Meanwhile," he says, "I'm able to chase the smaller fish—at a time when there are more of them

realities are changing very quickly across the economic landscape, and the active manager who is paying attention has an advantage over passive funds who don't make distinctions. But he's looking at a different type of shift.

"It's no secret that the whole business world, and especially in Europe, is restructuring," Marcus explains. "Companies need to be more efficient than they were in the past, they need to be hungrier and more aggressive in how they do business, and not everybody is going to make it. You aren't drawing those important distinctions if you're managing an ETF. In that world, it's all about managing to the fund flows."

In addition, he says, echoing Davis, even those investors who might be attracted to the companies that the smaller managers are looking at are not really competing for them in the same way. "A lot of the funds that CAN invest in

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these restructuring companies that we look for are only interested long after they've finished the restructuring process," Marcus explains.

For example? "There's a company in Belgium that everybody calls CFE, which is in the dredging business but also has traditionally also been in construction," says Marcus. "As

interested," says Marcus, "because now it's a pure play, instead of being a conglomerate that doesn't fit comfortably in whatever theme they're trying to build."

Another example? "A couple of years ago, Siemens decided to spin off Osram, which owns Sylvania, which is in the lighting and light bulb business," says Marcus. "If you owned 100 shares

Short perspective

The most active of the active managers are those who run long-short funds, among them Caldwell & Orkin in Atlanta. The perspective of managers who take short positions is interesting because, on the one hand, they're seeing a lot of what appear to be terrific fundamental opportunities in overvalued stocks, and yet many of those stocks have continued to rise as this long extended bull market floats all boats. This raises the possibility that a dam is about to burst in the equity markets.

"The government interventions have been so aggressive that downturns have been quickly met with accommodation," says Patrick Fleming, who co-manages the Caldwell & Orkin Market Opportunity Fund. "If you're passive, you haven't experienced a significant downturn since 2009," he adds. He references not only the Fed's bloated balance sheet, but overseas, where the Bank of Japan now owns 62% of all Japanese ETF assets and the Swiss National Bank owning \$61.8 billion worth of U.S. stocks.

Add that to huge investor inflows into passive portfolios, and you get what company CEO Michael Orkin refers to as "the socialization of stock picking." "When the government or individuals put money into the index," says Orkin, "it goes to the individual stocks with no allocation of resources depending on the risk/reward characteristics

The passive funds and ETFs have gotten so big they're fishing for fat whales and giant groupers. Smaller managers can chase more and smaller fish.

it happens, dredging is one of the greatest businesses that you could be in, because almost every port in the world is too shallow for the new ships that are being built today."

Dredging companies, he says, trade at 7-8 times cash flow in the markets. However, most investors look at the lowest-common-denominator business in a firm, which in this case means that CFE was valued on its construction operations. "Construction, if you're really good, might trade at 5 times cash flow," says Marcus. "Which explains why CFE was trading at less than five times cash flow."

The firm has been selling off its construction businesses, and Evermore was able to buy the company at 45 euros—five times cash flow—early in the process. Three years later, the stripped down company was selling at 100. "That's when the ETF gets

of Siemens, you got two or three shares of Osram. They threw it away like it was a piece of dirt."

Marcus did some homework on this piece of dirt, liked what he saw and bought up shares being sold by the Siemens shareholders, who didn't know what to do with them.

"It was a company that came out at five times cash flow, and started doing things they couldn't do when they were covering inside the giant," he says. "They downsized, they closed plants that were inefficient, and because the company had never traded before as a standalone business, the indexes weren't interested in it."

Eventually, Osram was trading in the mid-40s, at which point the indexes better understood where the company fit in their portfolios. "I might have been the one to sell it to the index funds," says Marcus.

of the individual stocks.”

In that environment, he says, exposure becomes more important than analysis.”

Fleming says that when the firm has been correct in its short position calls, they’ve learned to quickly harvest those profits. “The very next day, after the vote has been placed on the fundamentals, you’re back to having a passive dominance, especially if the stock is owned by the ETFs,” he says. “You’ll see it start to recover the original price, even if the fundamentals haven’t changed.”

Think about what that means about today’s valuations. The clear implication is that there are many companies, hiding out in the indices, whose fundamentals don’t justify their current valuations. If the world’s governments ever were to become less accommodative, if investor inflows ever became more discriminating, then the markets might abruptly reflect underlying reality. That would be a field day for investors who take short positions. At the same time, passive investors could wake up to a whale of a correction.

Add to that another factor. “Many corporations have been accessing the bond markets for share repurchases, which has been another tailwind behind their stock performance,” says David Bockel, Caldwell & Orkin’s chief compliance officer and portfolio manager. “As interest rates go up, it could impair that a little bit. It will be interesting to see what kind of impact that could have on the markets as well.”

ETF vs. non-ETF bond markets

What about the bond market? Have inefficiencies and opportunities cropped up there as well? Carl Kaufman, Vice

ETF bonds,” he says.

As an example, Kaufman talks about bonds issued by the R.R. Donnelly company. “Their bonds used to trade at 5% yields for five year paper,” he says. “Not

When the world's governments and investors put billions into index funds, the result is the socialization of stock picking.

President and Managing Director of Fixed Income at Osterweis Capital Management in San Francisco, says that in the high-yield space that he invests in, bonds can be placed in two very different categories.

“There are two monster high-yield ETFs (HYG and JNK) and a few smaller ones,” he says. “The larger benchmark issues that the ETFs invest in will be bought and sold frequently, are very liquid, but they also tend to be priced more richly.”

This, he says, is a high-friction environment. “The ETFs are always bidding on up days and on down days they’re always selling,” Kaufman explains, “so the friction can be 1/2 to a point plus their fees, which are about 40 basis points. So typically, the high-yield ETFs have lagged the benchmark by about 1.5 points or so, which is friction plus fees.”

In contrast, active fund managers like Kaufman tend to trade in the second tier of bonds, where the spreads are wider. “I can almost guarantee that I’m going to do pretty well just by buying non-

cheap, not rich. It was fine.”

Those bonds were large enough issues to be eligible for ETF investing. But then the company split into three parts, and two of the resultant companies retired some of the debt by floating issues of \$350 million and \$400 million respectively.

“Those offerings were too small for the big guys to care,” says Kaufman. “They couldn’t get it done at the former pricing; they ended up selling 7- and 8-year paper, one at 8.25% and the other at 8.75%. So when we invested,” he says, “we got pricing that was probably 200 to 300 basis points higher yield than we would have if those had been billion-dollar issues.”

Kaufman says that another factor in the bond market is dealer liquidity. “After all the regulatory changes, if a 500 bond lot comes up for sale, the dealers don’t want that on their books,” he says. “So they show it to the street and the street puts a bid on it.”

So? “Instead of the dealer pricing those bonds, I get to price

them,” says Kaufman. “Sometimes I buy them a little below the bid, depending on the market conditions, sometimes I just buy them a tiny bit above the bid, as opposed to buying them on the offer.”

Incremental differences in price, he says, can mean a short-term yield of 4% as opposed to what would have been 2% or 3% if the dealer had purchased the bonds for its own inventory and

be lifting offers in bonds one day and then hitting bids in the same bonds the next day, and paying for the round trip transaction [the difference between the bid and offer]. Our advantage,” he adds, “is knowing what to avoid.”

Reddy cites an example of a small 350-bond lot that went on the market almost a point and a half below where it had traded just three days before. In another case, bonds that were trading at 2.5%

Wide price swings used to come from naive retail investors. Now the whole market looks like that retail impact.

then looked for buyers. “With short-term paper, you don’t need a lot of price movement to get a big difference in yield,” says Kaufman.

At the even smaller end, Venk Reddy, founder of Zeo Capital in San Francisco, isn’t afraid to trade with the big ETFs. “We see a lot more pricing getting pushed around by fund flows than by underlying fundamentals,” he says—once again citing the recipe for inefficiency that T. Rowe Price is eyeing. Reddy’s particular specialty is higher-quality, shorter duration high-yield bonds, with an eye to smaller trade sizes.

In that market, Reddy says, the ETFs are captive to the fund flows; they may be selling a particular bond today and buying it back tomorrow—at whatever the market will bear. “You often have the situation,” he says, “where an index fund, especially ETFs, will

were suddenly, days later, trading at a 1% yield.

“Historically, these weird price swings would have come from naive retail investors,” he says. “But when you combine brokerage firms not willing to use balance sheets with prices getting pushed around by ETFs, now the entire market looks like what used to be only the subset that had this retail price impact.”

The obvious strategy in this increasingly inefficient market is to be patient and know what the securities are actually worth. “Our counterparties sometimes get frustrated,” says Reddy, “because we say: *I don’t care where it’s trading; here’s where we want it.* And we wait for it to come to where we think it is an appropriate purchase. If it never gets there, we don’t buy, and that’s okay.”

Better investors

Finally, and perhaps most simply, the fund managers who exhibit a passion for investing are enjoying fewer but better investors.

“We have a saying here: *You can’t do what everybody else does and expect a different result,*” says Davis. “But for years, at every client meeting, we would always get the same questions: *Why are you overweighted financials? Why are you underweighted consumer staples? We’re used to managers that slightly overweight or slightly underweight. But you don’t look anything like the index.*

“Now we find that the clients who have stuck with active management are actually encouraged that we don’t look anything like the index,” Davis adds. “We’re in a world where people accept that if they’re going to be interested in active, you’d better not look like the index. All of those restrictions—*are you value? Are you growth? Are you small cap? Are you large cap?*—are becoming discredited. For an investment culture like ours,” he says, “where we look at industries without regard to market cap or geography, this is a wonderful environment to invest.”

Marcus says he’s enjoying his relationship with the RIA community more than he ever did before, and he believes there’s a bifurcation going on in the RIA community, where advisors who aren’t interested in investing have gravitated toward the passive funds, while those who do more research are finding him.

“This is a business of intermediaries,” he says, “and we’re down to a core of long-term investors who have an alignment of interest with us, who know exactly what we’re doing on behalf of their clients, and why. They’re more knowledgeable, they participate and pay attention at the conference calls, and they aren’t jumping in and out of the fund the way people used to do,” he adds. “They’re the kind of investors you want, who, when we hit the inevitable rough patch, will say: I know this strategy is going to have some lumps from time to time, but I’m comfortable with it. If it’s news to them that special situations and catalyst-driven investments have lumps,” says Marcus, “then our team did a bad job of communicating what we do.”

Risk is deviation?

Let’s be clear: the trend of greater fund flows into passively-managed instruments is going to continue, in part because so

many investors and institutional managers have been taught by the academics that passive is and always will be superior, in part because the definition of risk has changed. Until the tide goes out and exposes all the boats that have risen as the waters have gone up, until active fund managers can establish track records that prove that judgment beats exposure, people will continue to flock into ETFs and their passively-managed counterparts.

In this environment, “risk” has been redefined not as the chances of a loss but as the possibility of deviation.

“We had a long-time client who manages the portfolio of an insurance company, who is personally invested in our funds,” says Davis. He said to me: *I’m a believer. I believe judgment, alignment and experience are all strengths. But, he said, for my job, I cannot recommend an active manager after a period of underperformance. If I stick with you, there’s an 80% chance I’ll be*

glad I did, but a 20% chance I’ll lose my job—and I can’t take that risk on behalf of my family.

“For a lot of pension advisors, consultants and even individuals,” Davis adds, “we’ve moved into an incentive system that pushes them away from a focus on the absolute outcome toward a focus on deviation from the benchmark. Safety,” he says, “equals mediocrity in this new environment.”

That makes it more difficult for funds like his to attract new investors. But the wind in his marketing face is more than compensated for by the wind at his investing back.

“I really like the world that we’re going into as an investor,” Davis says. “My partners and I, we feel like we are at a perfect spot in our careers for this to happen, because we’re right in a sweet spot as far as managing our portfolios, and we think this trend is going to continue until people suddenly realize, hey, maybe those managers who outperformed are not an anomaly.”■

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Osterweis Fixed Income

Inside Information “Inefficient Market Theory”

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ETF refers to exchange-traded fund.

Short dated high yield ETFs are generally passively managed and track an index while short-dated high yield funds maybe be actively managed and have various investment objectives. ETFs may have lower fees than mutual funds. ETFs may be traded by investors throughout the day while mutual funds are only traded once per day. ETFs maybe be more tax efficient that mutual funds.

Active Share is a measure of the percentage of holdings in a portfolio that differ from those of the benchmark. It is calculated by taking the sum of the absolute value of the differences of the weight of each holding in the portfolio versus the weight of each holding in the benchmark and dividing by two. Where the benchmark is the Russell 2000 Growth, the iShares Russell 2000 Growth ETF is used as a proxy.

Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of an investment and compares its risk-adjusted performance to a benchmark index. The excess return of the investment relative to the return of the benchmark index is an investment's alpha.

A basis point is a unit that is equal to 1/100th of 1%.

Cash flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.

Duration measures the sensitivity of a fixed income security's price (or the aggregate market value of a portfolio of fixed income securities) to changes in interest rates. Fixed income securities with longer durations generally have more volatile prices than those of comparable quality with shorter durations.

Fed refers to Federal Reserve.

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(Over Please)

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 Holding	 % of Total Portfolio
Rite Aid Corp. 9.25%	3.7
Regis Corp. 144A 5.50%	1.9
CHS/Community Health 8.00%	1.4
Shearers Foods / Chip 144A 9.00%	1.4
Herc Rentals Inc. 144A 7.50%	1.3
Navistar Intl. Corp. 8.25%	1.3
Ally Financial Inc. 8.00%	1.3
AK Steel Corp. 8.375%	1.3
ADS Tactical Inc. 144A 9.00%	1.2
Ruby Tuesday Inc. 7.625%	1.2

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