

Passive Negligence II

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Almost a year ago, we stumbled upon a topic that is currently generating much discussion in the financial media. In [Mm Mm Good](#), published August 2016, we highlighted the Campbell Soup Company (CPB) and the utility sector to show how yield-starved investors were chasing dividend stocks to dangerously high valuations. The following quote from the article highlights the risk inherent in CPB's valuation: *"This concept of a no-growth company with soaring valuations is alarming. The price of CPB would have to drop 30% to return to its post-recession average P/E. If that were to occur, it would take 16 years' worth of dividend payments to recoup the price loss, assuming dividends remain stable"*.

When writing that article, we assumed that a hunger for yield was the primary driver of excessive valuations in those relatively safer sectors. We did acknowledge, however, that there were other factors. Unbeknownst to us at the time, the shift from active to passive investing was one such factor playing a growing role in creating valuation divergences.

We followed up the article in November of 2016 with [Passive Negligence](#). This sequel, of sorts, discussed valuation divergences and economic inefficiencies occurring as a result of the growing popularity in passive investing and the related decline in value/active management strategies. The following quote summed up a concern we had then and one that is even more troubling today: ***"Typically, market index changes are the result of the movement in underlying constituents. Today, market index changes are the driver of the underlying constituents"***.

Valuation Regulator

Passive index funds can play an important role in portfolio management. However, when such passive styles of investing grow in popularity to the point that they are overly influential in setting prices, problems tend to arise. In fact, the ongoing massive shift of capital toward passive strategies argues that the healthy process of price discovery is being destroyed.

Value/active managers are vital for efficient asset pricing in the long run. By simply buying what they believe to be cheap and selling what they think is expensive, they help keep valuations and fundamentals in sync over the long run. When their role is diminished, as is frequently seen in bubble manias like today, these investors lose their ability provide the market with necessary checks and balances. For example, in the late 1990's value/active investors were eschewed in favor of those chasing technology stocks to record-breaking valuation peaks. This type of passive management created absurd pricing distortions that eventually resolved themselves when investors broadly re-awakened to the reality of fundamentals. As the bubble burst in the year 2000, the popularity of value/active investors spiked and valuations normalized.

According to Bloomberg, Vanguard, primarily a passive fund manager, saw net inflows of \$2 billion a day in the first quarter of 2017. In the same quarter they raised \$121 billion of new cash, beating the prior quarterly record by almost 50%. Vanguard is just one of many passive managers exhibiting massive growth. This growth is coming largely at the expense of value/active managers, the regulators of valuation.

Toilet Paper

The implications of this dynamic may be illustrated through a simple example:

Imagine walking down the paper goods aisle in your local grocery store in search of toilet paper. Instead of picking out your preferred choice you just blindly take the first one you see. This act on its own would not be meaningful, but imagine if most shoppers chose toilet paper in a similar manner. Manufacturers that produced higher quality product could lose the advantage of differentiation and their additional cost of providing a higher quality product would be wasted. In fact, the quality of the product would be irrelevant to the shopper as compared to the ease in which the product can be grabbed from shelf. Without consumers making thoughtful trade-offs between price and value, the price of all brands of toilet paper would converge, rising and falling depending only on how easy it is to grab off the shelf!

As we began the process of writing a sequel to [Passive Negligence](#) we watched a video that masterfully explains the effects of the soaring popularity of passive investing. Therefore, we decided that instead of reinventing the wheel, our readers would be best served by providing them links for the video and chart book from Steven Bregman's presentation at Grant's Fall 2016 Conference.

[Video](#)

[Chart Book](#)

The video is courtesy Steven Bregman and [Horizon Kinetics](#). The chart book is courtesy Steven Bregman and [Horizon Kinetics](#) as well as [Grants Financial Publishing](#).

Summary

This topic is important if one is to understand why valuations continue to rise despite a fundamental backdrop that has historically been poor for stocks. Watching money flows to and from passive managers may very well help provide valuable insight into how much higher valuations can rise and may offer hints as to when they might begin to normalize.

Based upon the prevailing money flows, it appears few investors realize the benefit that value/active investing provides. When their role is diminished by indiscriminate buying based only on the market cap or float of a security, as is the case in passive investing, value/active investors have less influence over the price discovery process and asset valuations become broadly exaggerated.

The outperformance of passive investing strategies over active ones is a major reason for the shift in interest and money flows, but there are other reasons as well. By comparison, fees on passive strategy funds are lower than those of active strategy funds and anticipation of the Department of Justice's Fiduciary Rule is also having an impact on retirement accounts and those who manage them. That said, active managers tend to earn their fees when it matters most to investors – by protecting wealth when it is jeopardized by collapsing markets. Passive investing has no such conscience and will offer no sympathy when the day of reckoning arrives.

Finally, Jesse Felder of The [Felder Report](#) clarified the "logic" of such decision-making in simple terms: ***“Embracing passive investing is exactly this sort of ‘cover your eyes and buy’ sort of attitude. Would you embrace the very same price-insensitive approach in buying a car? A house? Your groceries? Your clothes? Of course not. We are all very price-sensitive when it comes to these things. So why should investing be any different?”***

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