



Under the Hood: What's in *Your* Index?

(An Ongoing Series)

Diversification and the Active Manager: Part II

How Could Indexation Ever Be Invalidated?

Financial bubbles are based upon a forecast that cannot be achieved. Ultimately, this becomes obvious to all, and the bubble deflates. Indexation is unique inasmuch as there is no forecasted return associated with indexation. If the S&P 500 were to decline by 50%, this does not necessarily invalidate indexation. It's merely the return that the index produced.

This is because indexation makes an assertion, as opposed to a forecast. Moreover, it is an assertion that is, in the main, provable in advance. The indexation argument simply asserts that the average manager will underperform the index. Since the active managers collectively comprise the index, and the active managers must charge a higher fee than an index which, in principle, has no fee, since it is an abstraction, the active managers must, by definition, underperform.

Hence, the only way that the indexation argument can be invalidated is if the active managers outperform. Yet, by definition, the active managers cannot outperform. The problem appears to have no solution.

Many active managers who compare their performance to the S&P 500 select securities from the Index, which trades at 21.89x earnings for the latest available fiscal year. This P/E ratio calculation excludes all negative P/Es, so that a bona fide inclusive P/E calculation would result in a higher valuation multiple. An active manager is not likely to find very many reasonably priced securities in such a collection. Those that the manager does find will probably number too few to form a diversified portfolio.

However, as long as there is at least one security with above-average prospects, it will always be possible to build an *undiversified* portfolio. Such securities, when they actually exist, generally are not part of an index or, if they are part of an index, have a very small weight.

These managers are effectively constrained from accepting large quantities of money (if such sums were on offer), due to the danger of exceeding the supply of good ideas. Such a manager might one day come to have a great amount of money under management, but only if these few ideas appreciate mightily.

If one reflects upon the matter, one would see that, in a universe where these active managers were able to build and hold undiversified portfolios of only their best ideas, the indexation strategy would eventually become untenable. A relatively small number of managers would discover an extraordinary company very early in its expansion phase. Thus, a company like an early-phase Wal-Mart, Intel, or Microsoft would be publicly traded, but owned by management and a relatively small number of active managers. In further exploration of this notion, let us assume that in late October 1987, a small group of managers purchased the lion's share of the then-float of Microsoft at \$0.33 per share (the split-adjusted price at the time), with roughly a \$2 billion market capitalization. In this imaginary circumstance, the managers in question would hold Microsoft until the technology bubble of 1999-2000.



One might debate, even in this scenario, whether or not Microsoft would have been in the S&P 500 (it was, in fact, added in 1994), since it would be arguable that the float should not include long-term investors known to have no intention to sell. Of course, at that time, float adjustment was not the methodology of indexation—the S&P indexes did not transition to float adjustment until 2005—but let's imagine that it were. Moreover, whatever the result of such an argument, it would not be easy to purchase shares of Microsoft without paying a truly extraordinary price, since the potential sellers would be interested in holding the shares. Accordingly, it would be very difficult for the index to hold the proper number of Microsoft shares. In turn, that absence would lessen the index return.

Of course, as we know, managers did not hold Microsoft shares. From October 1987 to December 1999, the stock appreciated about 173x. Thus, if a 3% position in 1987 were held in a portfolio and not traded away, it would have become a dominant portfolio position by 1999. In truth, the position would have become so disproportionately large that no active manager would have been permitted to maintain it. In fact, Intel would be a much better example. Between October 1987 and December 1999, Intel shares appreciated approximately 2,680x. Obviously, a 3% position in 1987 would, as a practical matter, become the entire portfolio by December 1999, irrespective of what performance the other portfolio elements accomplished.

If one contemplates these facts, the implications can be interesting. It should be self-evident that any portfolio manager who simply held Microsoft and Intel shares would have dramatically outperformed the S&P 500. Again, of course, this would not have been permissible. Nevertheless, in hindsight, this would have been the correct action.

The equity market is presumed to be efficient. Yet, the correct return optimization strategy is not tolerated by board members, marketers, or investors. The correct return optimization strategy would have been to not sell shares of Microsoft and Intel. But, selling was all that was being done, as anyone could clearly see by the enormous trading volumes of Microsoft and Intel. They were being unceasingly traded.

It should be observed that adhering to the correct return optimization strategy is not permitted, even for those managers willing to accept the increased volatility attendant upon such a concentrated portfolio. Surely, the risk can be no greater than the risk of participating in a venture capital fund or a leveraged buyout fund. Institutional investors regularly participate in such funds. Yet, there is not to be found a single active manager that purchased a position in Microsoft and Intel in 1987 and held the shares in the portfolio, selling none, and permitting no dilution to the position size by the addition of client inflow and the purchase of other positions with new money.

If the market were truly efficient, there should exist investors willing to accept the volatility risk of allowing a portfolio to become legitimately highly concentrated via a policy of buy-and-hold, if such a portfolio indeed produces an extraordinary rate of return. One cannot maintain that there exists a societal or legal constraint upon the existence of such a portfolio; the legal risks are mitigated by a policy of adequate disclosure.

Such a portfolio does not exist, because the market for such a portfolio is limited at best. It would be very difficult to raise incremental assets, which is the primary objective of the money management business. The irony, though, is that such a manager would still greatly grow AUM. For example, a 1987 portfolio



with a 3% position in Intel and a \$100 million starting value would have been worth, by December 1999, about \$8.7 billion, even if the remaining 97% of the portfolio had underperformed the S&P 500 by 200 basis points per annum. Of course, if there were also a 3% position in Microsoft, the portfolio would have been worth about \$9.2 billion by December 1999.

It is interesting that an investment world that is almost universally considered to be an efficient market will not even consider producing a portfolio with an optimal buy-and-hold strategy that realizes returns far in excess of the S&P 500. In fact, if our imaginary \$100 million portfolio had contained a \$1 million contribution from the portfolio manager, which is not at all uncommon, then the manager's stake would have been worth \$92 million within 12 years, to be eventually taxed at the lower capital gains rate. This, of course, ignores the fees that the manager would have earned from the portfolio during the course of the 12 years.

This invites another interpretation of the concept of diversification: at its inception, a portfolio should be sufficiently diversified to have a reasonable chance of capturing, as a constituent, a truly extraordinary firm. However, once such an investment exists within the portfolio, all turnover in that investment should cease, whatever happens to the remainder of the portfolio. The extraordinary investment will ultimately govern, through its ever larger weighting, the return of the portfolio.

Of course, such behavior among investors en masse is extremely unlikely, to say the least. In any case, what if investors did behave in this manner? In other words, what if the market is efficient to the degree that investors recognize a truly extraordinary enterprise? Let us assume that in late 2003, when Apple traded at the split-adjusted equivalent of \$1.48 per share, the investors who happened to own Apple declined to sell any of it. This might be justifiably considered to be bizarre behavior.

However, it is simply an accident of history that most investors came to believe that the optimal rate of return can be earned by consistent trading. Modern scholarship has proven that this view is erroneous. The former trading type of active management has been displaced by indexation, which is ultimately a strategy of buy-and-hold. Thus, indexation has bested active management because indexation has essentially embraced buy-and-hold—at least to a greater degree than active managers—whereas, active management rejects buy-and-hold.

Ultimately, though, a buy-and-hold active manager can outperform the index, since the index will never maintain the strategy to the extreme of allowing a share like Intel to appreciate 2,680x without either diluting the investment by the addition of new firms or placing a restriction upon the maximum percentage to be invested in any one security. One will note the very many indexes and accompanying ETFs that have the term "Capped" in the title, indicating a ceiling on the index weight of any single or specified group of holdings.

If the only assertion about indexation is that the index will outperform the active managers, then the only way to invalidate indexation is to outperform the index. The index can be made to do anything except compound into heavy concentration. This is an approach that the active manager might do well to explore.



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