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On the ETF divide

A golden age of active investment management awaits only one signal event, Steven Bregman, president and co-founder of Horizon Kinetics, told the *Grant's* conference-comers on Oct. 4. A collapse of the index-ETF bubble is that intervening disaster. To hear Bregman tell it, no crash would be so well-deserved.

He called the exchange-traded fund excrescence the world's biggest bubble. "It has distorted clearing prices in every sort of financial asset in every corner of the globe. . . ," asserted Bregman. "[I]t has created a massive systemic risk to which everyone who believes they are well diversified in the conventional sense are now exposed."

The audience was a silent participant in a provocative, Bregman-administered "valuation-sobriety" test. "You can argue stock valuations until you're blue in the face," our speaker said. "Not so much room for debate on bond pricing." Using mid-September prices, he quoted the 10-year U.S. Treasury at 1.7% and a 10-year, AA-minus-rated IBM note at 2.5%. He quoted a 10-year, CCC-plus-rated Wendy's note at 6.9% (as a check, he added, the iShares High-Yield Corporate Bond ETF yields 5.6%).

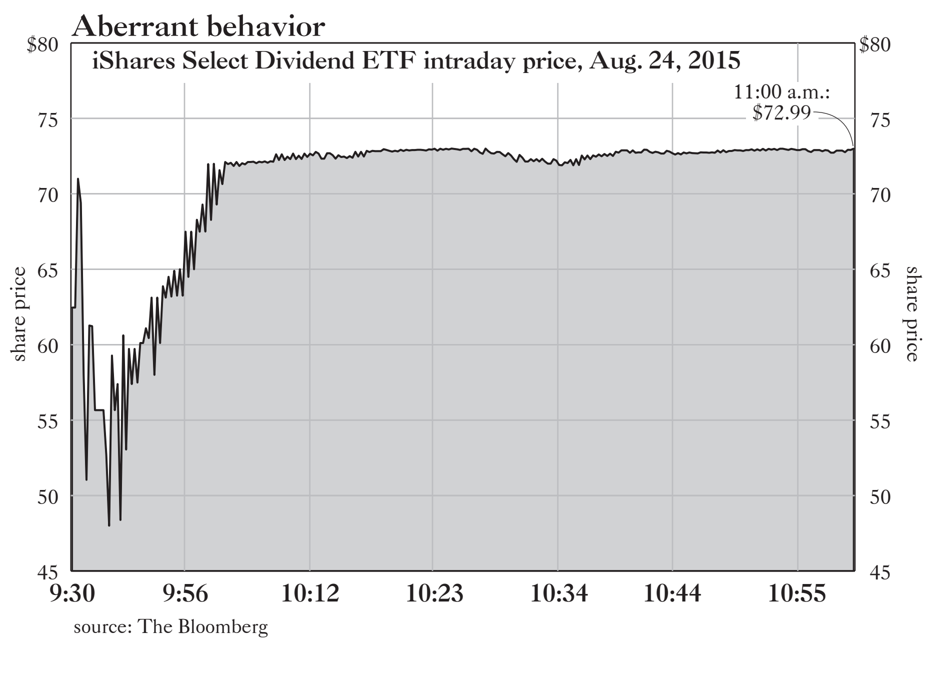
"The sobriety test," explained Bregman, "will consist of top-10 holdings in the iShares Emerging Markets High-Yield Bond ETF (ticker EMHY), and the question for each is: What price for the extra risk? As a frame of reference, the weighted average maturity of EMHY is 9.2 years, comparable enough to the examples above, with a weighted average yield to maturity of 6.3%.

"First up, the 7.5% Russian Federation bonds due 2030. Along with the sharp decline in oil and gas prices, which account for half of [Russian] government revenue and which the government needs to balance its budget (which it cannot do), it's firing one in 10 civil servants and officials this year to save money. Next, the Lebanese Republic 8.25% bonds due 2021. In fairness, the last year for which GDP information is posted on the website of Lebanon's U.S. embassy is 2008; by the way, that comes straight from the CIA *World Factbook*. Hezbollah, which functions as a state within a state in the south, is a participant in the Syrian civil war. Lebanon itself could be in civil war at any moment."

After which came a four-year, BB-rated note of the notorious Brazilian oil giant: "Petrobras? Just count up the number of senior executives and directors now in prison."

"Some additional data," Bregman proceeded: "Russian Federation bonds have the second-largest weight in EMHY, at 6.9%, and Russian credits are closer to 11% of the fund. Petrobras is a 6.4% weight. Lebanon: 3.5%. And this ETF is one of your bogeys if you're a bond manager: It returned 16.3% through August."

Bregman observed that the Russian Federation 7.5s traded at a yield discount to the 10-year IBMs and that the Lebanons traded through the Wendy's. He asked: "Would anyone seriously



argue that these yields are adequate compensation for the risk? If you buy them through the ETF at those prices, could you sell them privately at those prices? If not, do the prices result from some other factor?

"By operation of law," Bregman went on, "new money in EMHY is allocated based on float. In other words, the more debt a nation issues, the greater the allocation to its bonds because it has a greater capitalization. Petrobras issues more bonds: greater index weight. Yes. The allocations must be done promptly and according to their precise index weights.

"There is no factor in the algorithm for valuation," our speaker noted. "No analyst at the ETF organizer—or at the Pension Fund that might be investing—who is concerned about it; it's not in the job description. There is, really, no price discovery. And if there's no price discovery, is there really a market? In which case, what is EMHY really worth?

"This is about artificial supply-and-demand pressures. Now, take this exercise and apply it to the equity indexes. That's what's going on. It's just tougher to debate."

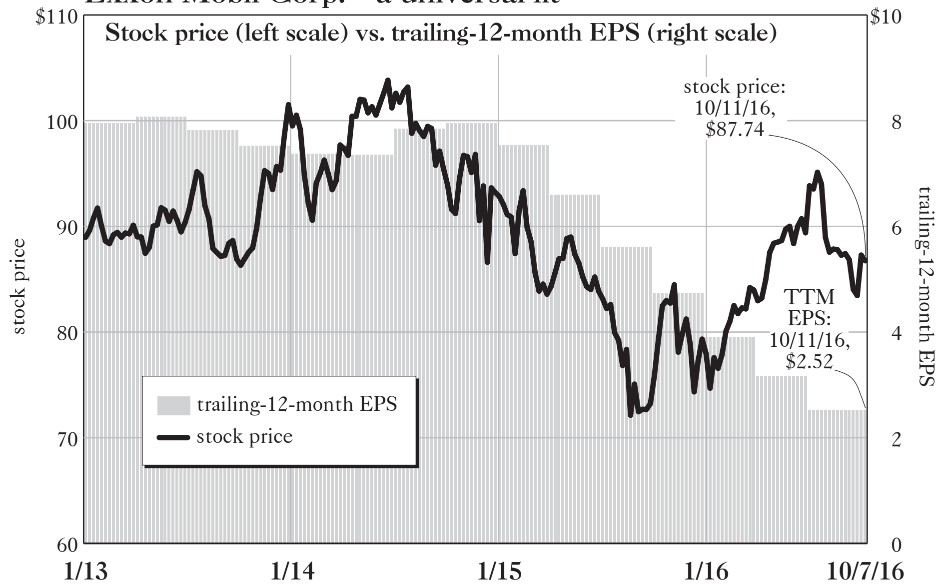
Bregman said he has no objection to the concept of indexation—it is "entirely sensible, and may fortune continue to bless John Bogle." ETFs are the problem, he said, not index funds as a class.

Liquidity constitutes another tripwire, as the events of August 24, 2015 underscored: "Among other interesting features," said Bregman, "ETFs set an all-time record share, 37%, of trading volume. That morning, prices of more than a few ETFs departed markedly—meaning up to 30% or more—from their NAVs. This is not supposed to happen in supposedly liquid investments."

Still more problematic than ETFs, Bregman pointed out, is the "business of ETFs." It's hard to build a scalable business when the least liquid constituent of an index sets the practical ceiling on the size of one's fund.

And then there's Vanguard. A not-for-profit, it unsportingly reduces its prices in line with its falling costs. As fees fall, product differentiation increases: "Ergo, the proliferation of subsets of the market, for which a higher fee could be charged: country funds, industry sector funds, style funds, and so forth.

Exxon Mobil Corp.—a universal fit



source: The Bloomberg

"However," Bregman continued, "devising subsets of the index accentuates a structural flaw of the market-cap weighting system: the top-heaviness problem. With time an index tends to get concentrated. Investors in the iShares U.S. Energy ETF presume to be buying a diversified portfolio. They fled idiosyncratic risk. Do they know that 50% of the fund is in just four companies, that they've actually fled right back to buying idiosyncratic risk? What happened to British Petroleum could happen to Exxon. In fact, it once did."

Bregman lingered for a while on Exxon, a kind of ETF Swiss Army knife: "Aside from being 25% of the iShares U.S. Energy ETF, 22% of the Vanguard Energy ETF, and so forth, Exxon is simultaneously a Dividend Growth stock and a Deep Value stock. It is in the USA Quality Factor ETF and in the Weak Dollar U.S. Equity ETF. Get this: It's both a Momentum Tilt stock and a Low Volatility stock. It sounds like a vaudeville act."

Bregman proposed a mind experiment: "Say in 2013, on a bench in a train station, you came upon a page torn from an ExxonMobil financial statement that a time traveler from 2016 had inadvertently left behind. There it is before you: detailed, factual knowledge of Exxon's results three years into the future. You'd know everything except, like a morality fable, the stock price: oil prices down 50%, revenue down 46%, earnings down 75%, the dividend-payout ratio almost 3x earnings. If you shorted, you would have lost money"—because the financial statement didn't mention the coming bifurcation of the stock market that Bregman called the "ETF divide."

On one side of the line are the anointed ETF constituent securities; on the other side is everything else. McDonald's, like ExxonMobil, finds itself correctly placed: "Sales growth from the 2008 crisis year to 2015 was 1.1% a year. The fastest growing element of its financial profile is its debt. The fastest growing elements of its market profile are its share price and its P/E ratio.

"Not so long ago," Bregman went on, "valuations would have contracted as growth slowed—investors voted with their feet. But McDonald's is bought as part of a basket. Since investors didn't buy the shares individually, they can't sell them individually. Where's the price discovery?"

In response to the oft-heard contention that low interest rates justify blue-chip valuations on the order of 22 or 25 times earnings, Bregman acknowledged that that argument might have held up historically: "It's also true, historically, that these were growth companies."

"An ETF ruleset is, obviously, a security-selection system," our speaker proceeded. "But it is simultaneously an exclusion system," as correlation data well illustrate: "Compared with 1995, the correlation of the largest members of the S&P 500 with the index itself has about doubled. Even Mexico and Japan are now more correlated with the S&P 500 than the top S&P 500 companies were 20 years ago!"

Now came a question: "So how do they—the big 'they'—address this risk?"

And an answer: "In the financial realm, risk has come to be measured by historical price volatility. Consequently, enormous effort is devoted to finding low-volatility sectors with sufficient liquidity. The most prominent statistic for volatility is beta. Go to Yahoo Finance, type in 'IBM,' and there, front and center alongside price, market cap and dividend yield, is beta.

"Let's examine this," Bregman went on. "The iShares REIT ETF, with a 2.8% yield—which I personally see as 35x earnings—has a beta of 0.72. That is low-risk by definition. But which beta should be used for that definition? The beta for the three years through August 2016? Why not the beta for the three years to March 2007?

"Because the beta at the end of March 2007 was even better—an incredibly low 0.3—only 30% of the volatility of the S&P 500. By February 2009, two years later, the ETF fell 90%, and even Simon Property Group shares fell almost 70%, while the S&P fell about 46%.

"All that beta can actually assert is that a stock declined by less than other equities during the measurement period. The Simon Property Group beta (5-year) today is 0.54. Ipso facto, as among the safest of securities, it is included in the most popular of the low-volatility ETFs, which is the iShares Minimum Volatility ETF (USMV)."

Low-volatility ETFs are today's favorite flavor, Bregman observed—that is, funds that have exhibited low volatility in the recent past are the market's favorites. The iShares Emerging Markets Minimum Volatility ETF is one such. In it, Bregman noted, "Taiwan has an 18% weight and South Korea has an 11% weight. Consider that from a risk point of view. Could something big and geopolitical and unfortunate happen to either of these nations? And the ETF has a beta of 0.85. Call me picky, but is it weird that an emerging-markets index has a lower beta than the S&P 500? How do they do that?"

So much for life on the sunlit side of the ETF divide. What about life in the darkness? "In the past two years," said Bregman, "the most outstanding mutual fund and holding-company managers of the past couple of decades, each with different styles, with limited overlap in their portfolios, collectively and simultaneously underperformed the S&P 500. We're talking 10 to 20 percentage points in a given year. There is no precedent for this. It's never happened before.

"It is important to understand why," he stated. "Is it really because they invested poorly? In other words, were they the anomaly for underperforming—and is it reasonable to believe that they all lost their touch at the same time, they all got stupid together? Or was it the S&P 500 that was the anomaly for outperforming? One part of the answer we know. Investors like Mario Gabelli and David Einhorn and Bruce Berkowitz, are simply not going to buy Amazon or Facebook or Netflix. And . . . those companies really do represent all of the market return and then some."

Whom to hold accountable? Bregman had a suggestion: "[I]f active managers behave in a dysfunctional manner, it will eventually be reflected in underperformance relative to their benchmark, and they can be dismissed. If the passive investors behave dysfunctionally, by definition this cannot be reflected in underperformance, since the indices are the benchmark."

Well, the indices would make a rather colorless defendant in the dock of a criminal court. Better, the central banks? Bregman noted in this vein the heightened stock-buying presence of the Bank of Japan, the Swiss National Bank and Buttonwood Ltd., an affiliate of SAFE, China's State Administration of Foreign Exchange. It's hard to compete against the institutions that print their own money.

"Can one say that there is any price discovery?" our speaker asked. "Without price discovery unimpeded by intervention, there can be no rational allocation of capital. But that's the very premise—that securities prices reflect fair value—of modern portfolio theory and indexation."

Pending the overdue comeuppance of the ETF industry, what might an active manager do? "If," said Bregman in closing, "you're willing to take a bit of illiquidity risk—in those securities that have been discarded by the indexes—your degrees of freedom and optionality expand enormously."

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