RICHARDSON GMP

TOUCHSTONE STRATEGY

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The Next Move

Chess master Garry Kasparov spoke in Toronto earlier this spring. He was asked about his widely publicized loss to IBM's Deep Blue computer. Without hesitation he replied that his biggest mistake was not reading the contract that IBM and he agreed to, more closely. He maintained that each time he got an edge in the match, the technology crew was allowed to re-boot Deep Blue (a timely process that exceeded the normal limits of a timed chess match) – and that is why he ultimately lost. Under normal time constraints he believed he would have won.

The theme of man versus machine has occupied our thoughts recently. Barron's Magazine ran a cover article earlier this month entitled: *Man vs. Machine: How Has Indexing Changed the Market? The active/passive debate has obscured a major concern: Will increased indexing impact the market?*

According to JP Morgan analysts, only 10% of stock market trading these days is based on fundamental research, and price sensitive judgment that we believe to be critical to success. The remaining 90% is done by computer and quantitative strategies that generally consider **valuation as irrelevant** which puts them in the same camp as the passive strategies and this **collective price insensitivity** is one of the things that concerns us greatly as fundamental investors.

Collective price insensitivity is what has effectively occurred prior to almost every investment crisis in history (Tulip mania, South Sea Bubble, Dot-com Bubble, US Housing Bubble). When investors stop conducting their own due diligence and start relying on rumour and trendy methodology, it opens the door for capital misallocation, and ultimately culminates in a sharp, painful realization that "this time it's not really different".

For a concrete example of price insensitivity, simply refer to the Toronto housing market and what happens when 10 individuals get into a bidding war over a house – with offers to purchase that contain no conditions and therefore no method to determine the true value of what they are purchasing (new roof, furnace, wiring needed?). The risk is all on the purchaser, with caution thrown to the wind. They get the good features of the house…and the bad.

Investing in stocks and bonds via **passive indexing** is akin to buying a house without any conditions. It is a "strategy" that relies on hope, blind faith, and the greater fool strategy. From the google dictionary, we get the following definition for the word 'passive':

"accepting or allowing what happens or what others do, without active response or resistance"
Synonyms: malleable, pliable, submissive

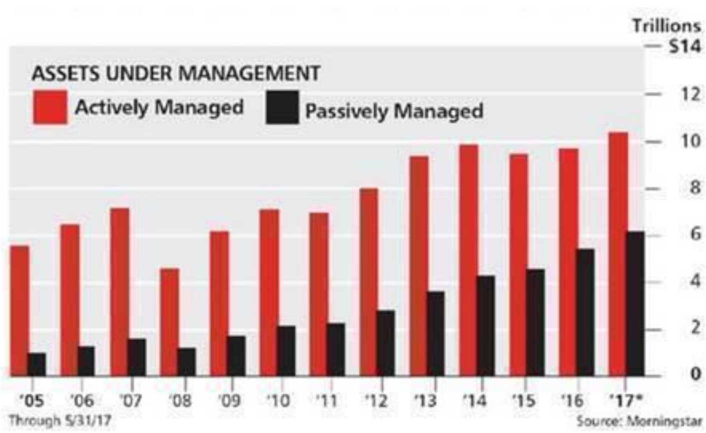
While we cannot speak for others, we certainly would never want to be described in such a manner – especially if it concerned the management of your retirement assets.

We are reminded of guest on BNN who commented on passive ETF's: *if I went into a restaurant I can order a chicken breast, or chicken wings or any other part of the chicken I want to. With ETF's they put the whole chicken in a blender and serve it to you. I wouldn't want to eat that – would you?*

In other words, why would any prudent investor want to be invested in everything the market index has to offer? There are great companies and some not-so-great companies – why invest in the latter? Yet that is what indexing does. It matters not one bit whether the companies are worthy from a valuation standpoint. The only thing that matters is size. Day after day, dollar after dollar, the biggest companies get the lion's share of the money. As a result, their stock prices may rise not based on merit, but because of a collective deposit of money by investors into the overall market. But here's the catch – this same process is RELIANT on a constant flow of new money. If that flow stops or subsides, the laws of supply and demand take over and those same investment darlings may drop precipitously.

Passive investing pioneer and Vanguard founder Jack Bogle, who launched the world's first index fund in 1976, warns that the impact of ETFs on stock trading "has reached mammoth proportions". He further warns that the implications of this rapid trading in ETFs "have yet to be fully examined."

We have written recently about our [concerns regarding passive investment strategies]() – mainly ETF's and quantitative computer driven models using ETF's gathering steam in the marketplace. With the benefit of hindsight and other perspectives we would revise the phrase *gathering steam* to 'are clearly a meaningful component'. The chart below shows that although actively managed investments still lead the way, passively managed investments are gaining fast.



We are certainly not 'thought leaders'. We do however, apply our 27 years of experience to the news of the day, and identify red flags fairly well along the way. Perhaps our 'Rolling Stone' Prime Minister appearing in a photo op with Wealth Simple employees (a 'price insensitive ETF 'fintech' operation) was one of those red flags. With all due respect, our PM knows politics & power, and public relations and drama… He does not have a fiduciary duty to investment clients.

We whole heartedly agree with fellow active Portfolio Manager, Alex Lane, who wrote –"In my experience, when flows completely overwhelm fundamentals and everyone is doing the same thing, often doing the opposite is the wisest course of action. Time will tell but some insurance never hurt anyone."

He further suggests…*One way to insure against the next downturn is to start increasing allocations to active strategies that look different than the indexes and are not blindly following the output from a quantitative strategy. Active managers can raise cash … choose securities based on fundamentals factors that allow them to outperform in a falling market and can move in the opposite direction from the crowd.* This insurance would not include closet-indexing asset managers as they would be subject to many of the same downside forces as the index/quant strategies.

Having Mercer Consulting validate and analyze our investment strategies each quarter is very helpful. It identifies that we are clearly positioned in the *Insurance never hurts anyone camp*. We are certainly price sensitive, we can raise cash, and can move in the opposite direction from the crowd, when it is appropriate.

Over the last 5 years we have beaten the Index handily, and with considerably less risk than the index. Mercer data indicates that we are very different from the crowd – which suits us just fine.