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Why passive investment strategies are past their use-by date



Montgomery Investment's Andrew Macken says the outlook for returns on equities is grim. Daniel Munoz



by Christopher Joye

To understand the historical performance of global equities, the rise of passive investment strategies and the market's future prospects, you can telescope the analysis down to two key variables: profit margins and interest rates.

The problem for many passive portfolios is that corporate profit margins in the United States are at all-time highs, while interest rates are at record lows. And the likelihood of a mean reversion in profit margins and rates could present headwinds for equities returns in the years ahead.

This will be particularly bad news for passive products that are entirely valuation-agnostic and which have of late been popularised through exchange-traded funds (ETFs). These are solutions that mindlessly track the market and provide what is known as "beta", irrespective of whether that asset class is over- or undervalued. This price-independent investment style looks terrific when markets appreciate. But if future returns are weaker, passive beta could be a poor trade relative to "active" strategies that seek to generate positive absolute returns through all cycles via bottom-up and/or top-down asset selection.

To advance this thinking, consider where beta is heading. Market-wide equity returns

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can be decomposed into two factors. The first is changes in corporate earnings, which at the index level are driven by economic growth and profit margins. The second variable is changes in what investors are prepared to pay for equities – as reflected in prices – relative to underlying earnings. This is typically expressed as a price-earnings (P/E) multiple. If earnings are principally a function of margins and GDP growth, the final factor that affects prices (or the numerator in the P/E multiple) is the "discount rate" investors use to value the cash flows they expect equities to produce in present-day terms. This discount rate is itself made up of a "risk-free" rate one can capture in a bank deposit (or via a government bond yield) and the extra return you require from uncertain investments as compensation for their risks.

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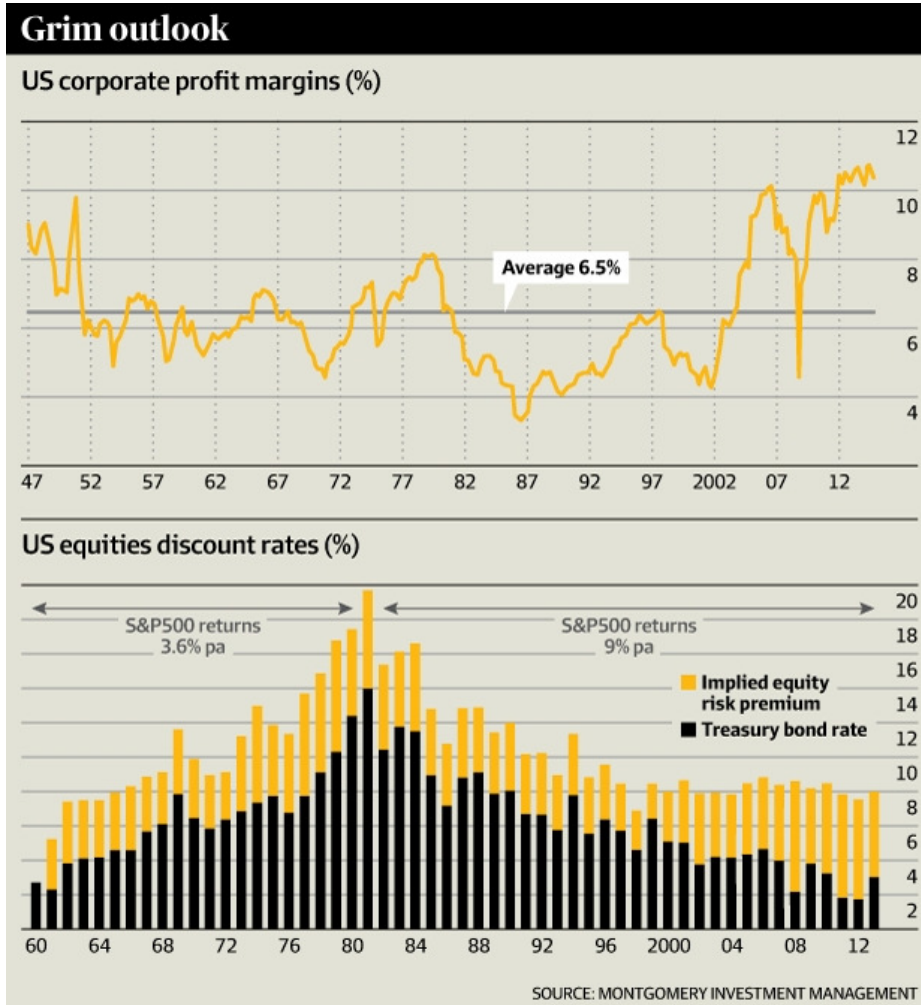


Passive investment past its use-by date

12 mins ago |



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You can therefore form a view on equities returns by understanding where corporate earnings (growth and margins) and valuation multiples (discount rates) are going. This intellectual framework is advocated by Andrew Macken and Chris Demasi, who work with Montgomery Investment Management.

Macken joined Roger Montgomery's eponymous shop after years helping the world's most famous "short-seller", Jim Chanos of Kynikos Associates, run \$2 billion in New York. Chanos is the legendary grave-digger who hunts down overvalued firms and profits from their demise (or forces them back to fair value, depending on which way you look at it). Demasi is another bright, 30-something Aussie who previously spent six years on the buy-side in New York, most recently as a senior member of the Lowy Family Group's portfolio management team.

In July, they will start jointly managing two new global equities strategies: the long-

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only Montgomery Global Fund, which can hold up to 50 per cent of its money in cash; and a long-short version called Montaka, which will more directly profit from downside risk by short-selling individual stocks.

EARNINGS GROWTH HEADED SOUTH

Before the internet, it was rare for Aussie fund managers to successfully run global equities portfolios (one exception was Platinum's Kerr Neilson). But as technology has destroyed the tyranny of distance, we've seen a new generation of outstanding global equities guys emerge from the Antipodes, including Magellan, VGI Partners and Morphic.

Macken and Demasi argue that the outlook for equities' returns is grim for several reasons. The first is that despite sluggish global growth, corporate profit margins in the world's most important economy, the US, are loftier than they've ever been since World War II (see first chart). This reflects the fact that nominal wages growth has been anaemic since the global financial crisis and the commercial focus on cost-cutting and productivity. The worry is that profit margins tend to be mean reverting. "It appears sensible to conclude that the risk for margins is to the downside over the coming years," Macken says.

Another headwind is the structural decline in the share of working-age taxpayers relative to retirees – alongside slower population growth – in both the developed and developing world. Working-age population growth is a crucial determinant of aggregate demand. As the proportion of non-taxpaying retirees rises, productivity and growth fall, while the burden on public finances intensifies as revenues slump and pension and healthcare costs increase.

The bottom line is that future global earnings growth may be much slower than the rates experienced in the post-war period, which were boosted by deregulation and demographic dividends. The outlook for multiples and discount rates is also dim if history is any guide.

The second chart shows that as interest rates and equity risk premiums – the sum of which is the discount rate – climbed off a low base in the 1960s to their peak in the 1980s, the S&P 500 returned a miserly 3.6 per cent annually (before fees and taxes). The equities market has since benefited from three decades of declining interest rates, risk premiums, discount rates and leveraging-up that underpinned the S&P 500's stunning 9 per cent annual return. Blindly buying beta – or going long this index – furnished terrific results that have been hard for active, alpha-generating managers that carry no beta to beat.

"Traditional '2-and-20' hedge funds had to produce returns of circa 13.2 per cent annually just to break even with the market during this period," Demasi notes.

Aussie equities had a second jetstream, which was the establishment of compulsory superannuation in 1992 that shifted hundreds of billions of dollars of savings out of deposits and into equities. The risk is that this process reverses somewhat as asset allocations search for more income stability via cash and fixed income.

If, as many experts warn, the future entails higher inflation and interest rates, total equity returns (including dividends) could be less than 4 per cent annually. In this environment, investing in beta is not going to meet your retirement needs. And the relative appeal of alpha, or strategies that are sensitive to the value of the assets they

acquire, will likely increase.

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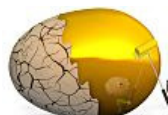
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