WILLIS INVESTMENT COUNSEL
Principled Investing

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THE RISING RISKS OF THE WAY MONEY IS MANAGED TODAY

Addressing an Increasingly Indexed Investment Landscape with WIC's Small Cap Value Strategy

EXECUTIVE SUMMARY

Since its founding in 1979, Willis Investment Counsel has constructed our clients' portfolios by researching and selecting individual companies that we believe will perform well over long periods of time. Across the firm, we believe in a value-oriented, bottoms-up, active management approach. Our belief in the efficacy of this approach has been confirmed and strengthened in recent years as the use of passive investing continues to become a more commonly used tool and company research is renounced.

Throughout this paper, we discuss the rapid growth of passive investing and the resultant impact on individual companies and the market as a whole. We then provide an overview of the WIC Small Cap Value Strategy; with particular focus on the lower correlation attributes of the Strategy and how this could mitigate two risks we see associated with the popularity of passive investing: 1) market dislocation, or systematic selling risk, and 2) valuation risk. We further suggest the WIC Small Cap Value Strategy could be a beneficial component of our clients' portfolios to strengthen diversification and dampen certain risks associated with the popularity of passive investing, including *exodus risk* (defined later herein).

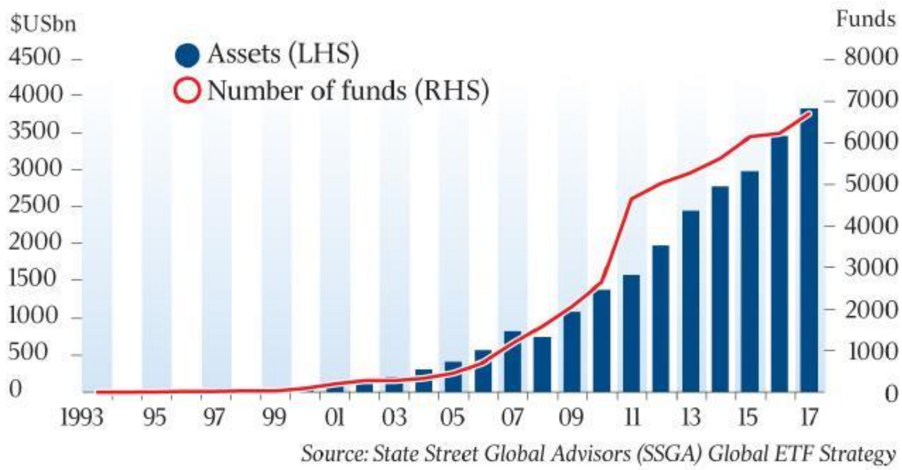
BACKGROUND ON THE RISE OF PASSIVE INVESTING AND USE OF ETFs

Perhaps the most significant trend in the investment world over the past several decades has been the rise of passive investing. Passive investing refers to an investment method that is essentially computerized (little human judgement or involvement) that seeks to replicate the return of a pre-determined market index (e.g., the S&P 500 Index).[1] Depending on the study one references, passive investing now represents approximately 20% of the entire U.S. stock market (i.e., of total traded securities). On many days, ETFs represent up to 40% of the daily trading volume. Almost everyone agrees that passive investing is growing at a very fast rate.

[1] More technically, one could argue there is a lot of human judgment that enters into the design of the computer programs and algorithms. But compared to researching and examining companies one-by-one, passive indexing is more about owning a basket of securities that share certain characteristics.

The most popular way to facilitate passive investing is through the use of exchange-traded funds, or ETFs. These ETF securities first appeared in 1993 and have become wildly popular. The chart below highlights the staggering proliferation of ETFs since 1993:

Global ETF Growth Over the Past 25 Years



Responding to the popularity of ETFs, the creation and marketing of ETFs has become big business on Wall Street. It has been estimated that the largest managers of ETFs (Vanguard, Blackrock and State Street) have recently generated over $6 billion per year in management fees from ETFs. That fact alone is a huge incentive for Wall Street to promote ETFs. ETFs now represent approximately $4 trillion in traded securities comprised of nearly 7,000 distinct funds. ETFs now span virtually every asset class, industry sector, country, and investment attribute (e.g., growth, value, dividend-oriented). In fact, <u>there are more ETFs in existence today than there are actual underlying stocks</u>.

ETFs were originally designed as a vehicle to facilitate long-term passive investing that employs a "buy and hold" technique which benefits from its lower cost and tax efficiency. However, the data describing daily ETF trading suggests that ETFs are being used as short-term trading vehicles, not to facilitate a buy and hold approach. <u>For example, ETF trading accounted for 30% of all volume on U.S. exchanges in 2016</u>; 14 of the 15 most heavily traded securities in the U.S. stock market were ETFs, not individual stocks. The SPDR S&P 500 Trust ETF, which is the largest ETF in the world, turned over completely every 6 days and had annualized turnover of over 4,000%. Some commentators, including *Bloomberg Intelligence*, estimate that when there is heavy selling pressure, ETF trading volume represents a significant portion of such day's total trading volume.

<u>Why do we care about ETFs and what percentage of trading volume they might represent?</u>

It is not our position that passive indexing or ETFs are inherently "bad" or ineffectual. Like so many investment strategies, it is largely a matter of how a strategy (or strategies) is used and how much return leakage results from excessive trading, including tactical reallocation.

In our white paper titled *More Than You Probably Want to Know* dated July 31, 2017 (which can be found on our website under Commentary), we introduced our concerns about ETFs:

> Perhaps an exaggeration, but there is an undeniable trend away from conventional bottoms-up company research where seeking to understand companies is becoming passé. For years, but now with accelerating momentum, it is increasingly considered unnecessary to think about or research the companies owned in a client's portfolio. It is almost like <u>the company</u> is irrelevant; and irrelevant to risk management. Now, many, if not most, portfolio managers believe the way to construct and manage portfolios is to allocate their clients' capital among many ETFs and/or index funds and bet on getting the allocation right. Each ETF or index fund owns many stocks that have particular characteristics or factors – the phrase "factor bet" is the widely-used buzzword. The new norm is to rely on factor bets which tilt the portfolio toward certain factors or characteristics or sectors, and essentially eschew company-by-company examination. Is there herding risk here? Is there a fundamental problem, a fundamental risk, with caring less and less about the companies in which one is invested? Is the company's management irrelevant too?
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> <u>We believe the studies that question the efficacy of constantly changing allocations among various funds/strategies</u>.[2] Given the nature of tactical asset allocation, we suspect the average ETF investor holds a given ETF for a short period of time before moving on to another slice of the portfolio pie (studies indicate the average holding period is only ~200 days). Short holding periods with the widespread ETF allocation strategy; plus the fact this tactical allocation is simply another form of market timing; plus that which *everyone* embraces usually ends badly; plus common sense dictates one cannot manage risk if one does not know what he/she owns[3], all lead WIC to believe <u>this ETF allocation trend has increased risk</u> in the marketplace and insidiously increased risk for many investors. WIC does not follow the crowd. Hopefully, by now, you know that.

This paper continues that theme and expands on the ETF risks we are concerned about. WIC believes that the surge in popularity of, <u>and herding into</u>, ETFs have created significant risks, including:

- Market dislocation potential
- Herding out of ETFs risk (i.e., exodus or lemming risk)[4]
- Disregard of valuation risk.

[2] Davis, Kinniry, and Sheay; *Vanguard's* "The Asset Allocation Debate: Provocative Questions, Enduring Realities".
[3] Howard Marks; *There They Go Again …Again; July 2017.*
[4] The tendency of many investors to move in the same direction together or en masse.

SELECTED PASSIVE INVESTING RISKS WIC IS CONCERNED ABOUT

Market dislocation risk. Given the popularity and enormous amount of money that has flowed into ETFs in the past decade, along with isolated evidence in the past few years of market dislocation, we are concerned that ETFs have not been adequately tested in a protracted market decline environment. For example, in August 2015, several prominent ETFs experienced severe price declines and resulting trading halts due to a sudden surge in sales. In one instance, the Blackrock iShares Select Dividend ETF, an instrument with $13 billion of assets at the time consisting of large, well-known companies such as McDonald's and General Electric, declined 35% in less than 15 minutes. However, the net asset value (NAV)[5] of the ETF declined by less than 2.5%. A similar episode occurred in 2012 but received less attention due to the smaller size of the ETF industry at the time.

Exodus Risk. It is important to note that ETFs were not in existence during the stock market crash of 1987 and were a fraction of their size in previous market sell-offs such as the bursting of the dot-com bubble. More recently, ETFs had less than $1 trillion in assets during the 2008 financial crisis compared to the nearly $4 trillion they hold today. With the number of ETF securities now surpassing the number of individual stocks, it is unclear if ETFs are equipped to handle a sizable stock or bond market decline. This raises concern that ETFs could be hit with a systematic selling type of event similar to what occurred in 2012 and 2015, but perhaps on a much larger scale. WIC believes that by owning companies – versus ETFs – we can better manage this type of systematic risk during normal stock market declines. Investors often move en masse making decisions in herd-like fashion. This herding into or out of stocks, or into or out of a popular sector (e.g., tech stocks), can reach exodus proportions where investors behave like the proverbial lemmings going over the cliff. When one owns such an ETF, one's investment is connected to the ETF and to its selling pressure, not with an investment in a given company.

Because WIC invests in *companies* – not in ticker symbols or ETFs – we believe our clients have less exodus risk. Exodus risk is reduced because only WIC decides whether to sell a company in our clients' portfolios. Owning an ETF is akin to owning a preset portfolio; a packaged arrangement. If thousands of investors decide it is time to get out of a wildly popular social media ETF, the ETF manager may have no choice but to sell stocks inside the ETF; and that selling pressure often compounds the over-reaction tendency and it begins to feed on itself – the exodus risk. The crowd, the herd, the emotion exacerbates this risk. WIC does not have this risk because others do not make decisions for our clients – only WIC makes the sale decision.[6]

Valuation risk. One direct result of the continued shift of money into passive investing strategies is that stocks are increasingly purchased as part of a "basket," assigning little weight to company fundamentals (balance sheet, earnings, and valuation). Most of the largest U.S.-listed ETFs are benchmarked to traditional market capitalization-weighted indices, and include larger capitalization companies with ample trading liquidity. However, there is a limited supply of

[5] The net asset value is based on the summation of the market prices of each security owned within the ETF.

[6] But WIC and its clients do have illiquidity risk with some of its small cap value holdings. Some of the small cap stocks WIC owns have such low trading volume that they could drop significantly during a market downturn when there are far more sellers than buyers. A mitigating factor should be the fact WIC is not forced to sell during any such selling pressure. Another point is that on "normal" trading days transactions in ETFs may be accomplished by transactions in the ETF shares and may not involve the underlying stocks to a material extent.

these large companies, which effectively means that the most widely held and well-known companies are generally owned across many ETFs. When an ETF receives inflows of new investor cash, the fund essentially has no choice but to invest in stocks in the index it is passively tracking, without any consideration for company fundamentals or valuation. This creates an increased amount of purchases of larger companies as money continues to flow to ETFs. We think the enormous flow of funds into ETFs has inflated the valuations of many of the largest publicly-traded companies.

WIC believes investing is about owning *companies* on behalf of our clients; accordingly, we believe it is important to understand (i) the business the company is engaged in, (ii) how the company makes money, (iii) the company's financials, (iv) the company's industry dynamics, along with a host of risk factors that can affect the company's operations and profitability; and then compare all of that to a company's valuation. While this is the foundation of WIC's philosophy, we are concerned that a growing percentage of investment management firms, wealth advisors, mutual fund and ETF firms are moving away from valuation and company analysis in favor of a liquidity-driven, automated approach. **WIC is not among that herd.**

WIC SMALL CAP VALUE STRATEGY

The WIC Small Cap Value Strategy is a *value*-oriented, bottoms-up approach that owns companies, not ETFs. The Strategy seeks to generate annualized net returns of 9 - 12%[7] over a full market cycle[8] by primarily investing in companies with market capitalizations below $2 billion. We offer this Strategy to our clients to provide an additional layer of asset diversification and to provide higher return potential albeit with a higher level of assumed volatility. Because of the long-term historical performance of small cap stocks (as an asset class), WIC believes there is a higher long-term return opportunity in owning smaller companies within an investment portfolio. Increasingly, we believe there is now a potential additional benefit with small cap value stocks – a potential hedge against the ETF risks described above.

The aforementioned significant increase in money being allocated to passive investment strategies and ETFs has brought about an increase in the studies around active management, with a focus on the factors that drive outperformance among active managers. The correlation coefficient[9] is often used to measure the similarity of a portfolio's returns to those of its benchmark index. The higher the correlation coefficient, the more similar a portfolio's returns are to its related index. For example, an index fund designed to mimic the S&P 500 Index would be expected to have a correlation coefficient close to 1.00 (the fund vs. the S&P 500).

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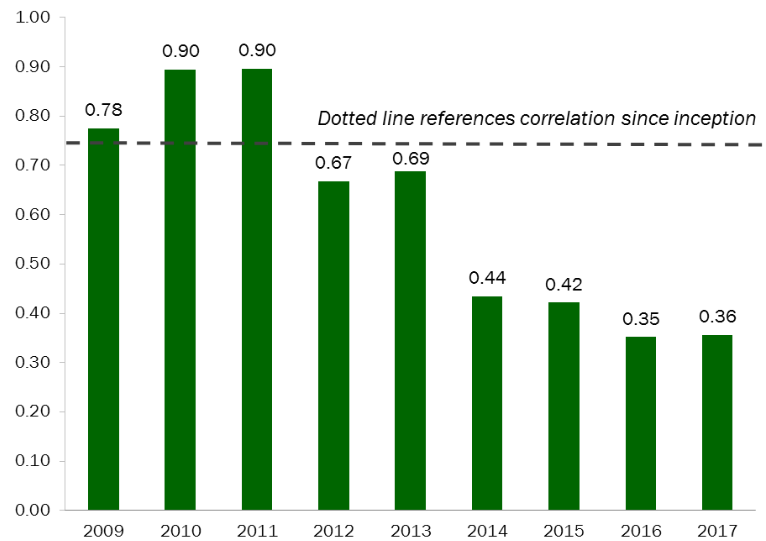
[7] This 9-12% return is simply a target; it is not WIC's historical performance. Small cap stocks, as an asset class, over long periods of time, have generated an annualized return of approximately 12%. It is important to note this relatively high return carries greater risk, and greater year-to-year variation of returns, than the S&P 500. See *Ibbotson Associates* and *Dimensional's* annual Matrix Book.

[8] A full market cycle typically spans seven to ten years and includes both a bull and bear market.

[9] In statistics, the coefficient of determination, or R-squared, measures the strength and direction of a linear relationship between two variables on a scatterplot.

The following graph indicates WIC's Small Cap Value Strategy has experienced a declining correlation with its small cap index benchmark. This is by design.

WIC Small Cap Value Strategy
Correlation Coefficient with the Russell 2000 Value Index



This graph displays a clear trend of declining correlation with the Russell 2000 Value Index. Again, this is by design. Since 2012, WIC has added significant bench strength (one new portfolio manager and five new analysts). Along the way, WIC has dedicated more resources to the research of smaller companies, including micro capitalization companies[10]. These types of companies are often excluded from ETFs, due to lesser daily trading liquidity. This can create additional valuation anomalies, as they are often considered to be *orphan stocks* due to their lack of inclusion in ETFs. These inefficiencies, coupled with a well-documented illiquidity premium, create opportunities for attractive returns over long periods of time. Data has consistently shown that many smaller companies are not closely followed by analysts. While the lack of analyst coverage of a company doesn't ensure that a mispricing exists, it does increase the odds.

Less than half of the stocks in WIC's Small Cap Value Strategy have significant representation in ETFs.[11] Our representation is even lower in the small cap focused ETFs. The Strategy's purposeful relatively low level of representation amongst the leading ETFs suggests we should have less systematic exposure in the event of an ETF exodus. Said another way, if asset allocators or wealth managers wake up one morning and decide to reduce their small cap exposure, and do so by selling their small cap ETFs, many of the ETF holdings could be indiscriminately impacted. Because few of WIC's holdings are part of the small cap ETF basket, we would expect to be impacted less by this specific risk.[12] As a result of the Strategy's minimal ETF representation, we often see less correlation to the small cap ETFs. While a lower

[10] Micro capitalization companies are those with market capitalizations below $300 million.
[11] This WIC data is as of January 30, 2018. We define significant representation as being in the top 15 holdings of an ETF.
[12] See footnote 6.

correlation does not guarantee superior investment results relative to passive investing, it does suggest that our Strategy's returns should be different from a small cap passive index fund (which can be a form of diversification).

Because small cap stocks can be more volatile, many of our clients limit WIC's Small Cap Value Strategy allocation to 10 - 30 percent of their investable assets. The remainder of our clients' capital is usually allocated across our other in-house managed strategies:

- WIC's Core Equity Strategy – a large cap, value oriented equity strategy
- WIC's Value Fund – a core, value oriented stock/bond balanced strategy
- WIC's Managed Volatility and Income Strategy – a defensive, hedged equity strategy
- WIC's Fixed Income Strategy – a core investment grade bond strategy

CONCLUSION

We are risk managers first, investment managers second. Risk management begins with protecting capital. If the popularity of passive investing and the resulting proliferation of ETFs has made small and large cap stocks more similar in pattern, this makes it harder for ETF-driven asset allocation models to manage downside risk with stocks (i.e., if stocks go down, both large cap and small cap ETFs will likely go down in relatively similar magnitude). This fact alone suggests the lower correlation nature of the WIC Small Cap Value Strategy could be an important risk management tool. By owning fewer *companies* whose shares are packaged within ETFs and bought or sold without regard to fundamental analysis or valuation, we believe we are shielding our clients from some of the risks associated with the rapid growth of passive investing (including the proliferation of ETFs).

For more information on Willis Investment Counsel's *Small Cap Value Strategy* contact Jay Kilroy at 770-718-0706 or at jkilroy@wicinvest.com.

For more commentary, we invite you to visit our website at www.wicinvest.com.

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