

# Two Perils Luring Today's Investors

*The current rush to indexing and dividends is not likely to end well.*

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In the three years since the 2008/2009 financial crisis investors have reconsidered many of their *o n c e - c o n f i d e n t* assumptions about how to reduce risk and add value. Two trends that have emerged from such contemplations are the rising popularity of indexing, funded by money flowing from active management, and an enthusiasm for dividend yield strategies, which some see as an appealing alternative to traditional stock and bond allocations. Both trends appear to be gathering momentum as we near the end of 2012. However, if we take a close look at each, we see a future filled more with peril than opportunity.

## An Ill-Timed Shift

To be sure, indexed strategies play an important role in many institutional portfolios. They help lower management fees and can make sense when several different equity styles are used for diversification. A review of holdings across three or four independent equity portfolios typically reveals some degree of overlap with the constituents of an underlying primary benchmark. When the overlap is significant, there is little sense paying active management fees for assets that are essentially indexed. A better approach is to invest a portion of

assets in an indexed portfolio while ensuring that active strategies take meaningful bets relative to their respective benchmarks. When implemented well, this approach should result in lower overall costs with comparable equity returns.

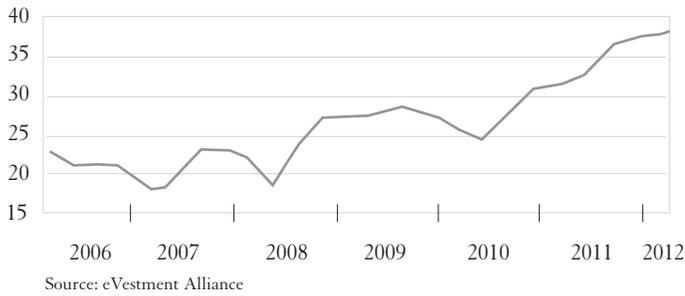
Investors sometimes shift assets from active management to indexed programs out of frustration with their active managers' performance. However, an investor should first understand the reasons for the shortfall before making a potentially ill-timed shift. In fact, market trends periodically favor capitalization-weighted indices due to the force of money flows alone. The late 1990s is a good example, as investors flocked to technology, media and telecom stocks — precipitating the “tech bubble” — chasing the momentum of rising prices while ignoring signs of speculative fever. Many active managers who were painfully cognizant of underlying company fundamentals saw widespread evidence of irrational valuations and cut back exposure to these sectors, only to lag their benchmarks by large margins for several years running. More recently, the sudden shifts from periods of “risk-on” to “risk-off” since the 2008/2009 financial crisis have frustrated the near-term performance of many fundamental equity managers — a trend amplified by the rising valuation mismatch between richly priced defen-

sive sectors and undervalued cyclical sectors. These performance shortfalls are evident in equity manager universe data. Typically, at least two-thirds of active equity managers exceed their benchmarks (before fees) over multi-year periods. In other words, the indices plot in the bottom third or quartile of the active manager peer universes. In recent years, equity benchmarks have ranked in the top third or higher of these same universes.

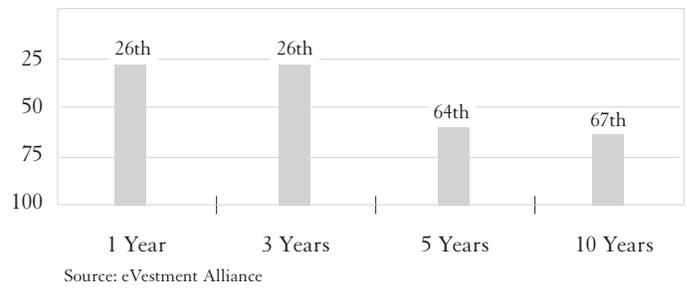
Investors should recognize that the recent strength in index performance reflects several factors unlikely to be sustained. One is simply the momentum of the movement of capital from active to passive equity management, which has undermined stocks favored by active managers as these must be liquidated to meet redemptions. Conversely, allocation of money within passive portfolios is based on capitalization alone, with no recognition of the relative value offered by individual companies. The proliferation of exchange traded funds (ETFs) — which offer passive exposure to many market sectors — has only augmented the amount of money flowing to capitalization-weighted investments that ignore company fundamentals. Assets invested in ETFs have grown from zero when the structure was developed in 1993 to \$1.3 trillion today.

In our view, the push for indexing is a cyclical phenomenon that will lead to disappointment. Active managers often

I. U.S. Institutional Equity Assets in Indexed Portfolios (%)



II. S&P 500 Rank vs. U.S. Large-Cap Managers (6/30/12)



experience their strongest relative performance following peaks of strength in passive results. All of CBIS' sub-advisers now note the valuation discrepancy between many of their portfolio holdings, which generally emphasize economically sensitive cyclicals, and the stocks that have been strong since 2008, largely the defensive consumer staples, big pharmaceuticals, telecoms and utilities. Valuations in these sectors are now at multi-decade extremes. It seems likely that indexing's run of success is nearing an end, and that substantially stronger relative returns will be evident from fundamentals-focused active managers over the next year or so (albeit with occasional setbacks if macro-economic events derail the equity market in any given quarter). Rather than giving up on active management, now is the time to focus on reaping the benefits.

Wait for a Better Opportunity

Investors have bid up stocks with high dividends due to the low yields available from bonds and cash and to the hedge dividend-paying equities offer against inflation. Higher-yielding stocks with strong dividends have also helped cushion portfolios during the equity downturns of mid-2011 and the second quarter of 2012, offering valuable relative performance benefits in a trendless and choppy market.

Yet a significant drawback now to relying on dividends as an engine of

overall portfolio performance is the stock market's current high valuation level and its modest overall dividend yield. Equity investors since the 1980s have acclimated to low stock dividend yields under the theory that companies should have freedom to remain flexible with their cash — possibly using it for stock buybacks or acquisitions instead of distributions to shareholders. It is true that, if dividend and bond yields are equal at the start, long-term investors should favor a dividend strategy as it offers the prospect of gradual growth and substantially higher payout over future years. This indeed can offset inflation, while the volatility risk of stocks relative to bonds diminishes as the investment horizon lengthens. Moreover, conditions today seem to favor dividend increases, since investors now recognize that managements often destroyed shareholder value through over-priced acquisitions and poorly timed buybacks, while aging baby boomers increasingly prefer cash in hand over the hope for future portfolio gains (which come with the risk of unexpected and potentially devastating losses).

Critical to exploiting a dividend-focused strategy, however, is the starting dividend yield — currently a miserly 2.1% for the S&P 500 as a whole. When viewed across decades, total stock market returns have been modest when the starting dividend yield was 3.5% or

less (with the exception of the 1990s, which saw price/earnings multiples expand by more than 7% annualized). With the market's current price/earnings multiple in the mid-teens, significant multiple expansion seems unlikely.

Given all the risks overhanging the stock market, the value offered by bonds (even with yields as low as they are) comes in part from the protection they offer in an equity market sell-off. A diversified portfolio of U.S. high quality corporate bonds, comprised of companies with substantial cash balances and strong interest coverage, can yield from 3% to 4% or more and would likely rise in value if stocks declined due to fears of slowing economic growth or deflation. Indeed, there is a reasonable chance the equity market will weaken as the realities of excessive global debt loads, high and persistent unemployment, and excess capacity overwhelm the tools that governments can use in response, and a correction in stock prices will present a more opportune entry point for dividend-yield focused strategies. Should the overall stock market yield 3.5% or more, it will be possible to implement a diversified approach to dividend growth investing at much more reasonable valuations and with less downside equity risk. This will provide a logical transition out of bonds, which will ultimately weaken in a future secular increase in interest rates. ■