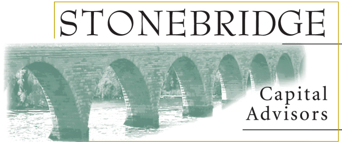

The Bridge Research Article:

Investing With or Without People

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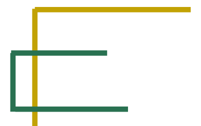
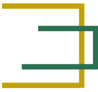




Introduction

The investment management world seems to be reducing the role of people due to index or passive investing, quantitative and algorithmic investing, and AI and machine learning. Is that a good thing? Below is one man's opinion.

Index and ETF's

Index and Exchange Traded Funds (ETF's) have gained popularity as the "Efficient Market Hypothesis" – cannot beat the market's performance – and lower volatility markets help drive the momentum in low volatility passive investing. According to data from Morningstar, roughly similar amounts went into active (more people) and passive (less) funds from 2005-2011, but flows have since accelerated into passive with passive products accounting for nearly 25% plus of total stock assets.

The merits of index/passive investing seem obvious, lower expense structure / potentially less trading costs and, of course, you get index returns. Today we have index Funds/ ETF's / smart beta index's / factor models, all of which have some human setting the selection rules but below the level required to run an actively managed, consultative product. Is passive investing prudent? Remember no individual is analyzing the companies or thinking about whether individual stocks are under or overvalued or what percentage they should be in an individual's portfolio. Passive only works on the backs of active investors who are performing those functions. The belief in passive is cemented in the efforts of active investors and that the efficient market efforts of those active investors cause assets to be "fairly priced." So, in a world moving more passive (less people), the humorous part is that active managers perform the price setting that passive indexes pay for stocks which also determines their index weights. What happens if and when the majority of equity management becomes passively managed or when the next economic downturn causes passive funds to unwind ALL index holdings at one time? My belief is that illiquidity in the market will create many more mis-priced stocks that active managers will be able to exploit.

In addition, with an ETF, the price you get when selling is only what a buyer is willing to pay. There have been several occasions over this Bull market when, in a correcting phase, the price of an ETF at sale was below the value of the underlying securities backing the ETF. That is called illiquidity. I think I would want an active manager at that problematic time.

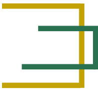
Quantitative and Algorithmic Investing

These funds use programmers using rules/formulas/ factor allocations (growth, value, momentum) and large data sets in a search to generate higher risk adjusted returns.

These funds have, in this Bull market, generated some of the best returns and have increased their assets under management. The question becomes when a low volatility/passive, if you will, stock market transitions to a normal or excessive volatility period, will these programmable formative models be as effective? My guess is a big no – especially during the phased transition period between low and high volatility. I would rather have an experienced investment manager who has gone through these cycles than a changing rule-based programmer to appropriately allocate my capital.

AI and Machine Learning

This is where computers sift through massive amounts of data on historical market performance and how



stocks / sectors / factors perform in different investment environments searching for patterns that lead to investment success. Think how computers are now beating chess masters by assessing historical consequences of every move made in past matches (IBM Watson). The problem as I see it is global macro/currency/central bank activity and behavioral finance is a higher-level game to successfully program.

Conclusion

In conclusion, what do these rapid changes mean for the role of humans in the investment management process and you as investors?

1. I believe passive will continue to grow untill it breaks or the market breaks.
2. Quantitative investing makes good use of what humans do well – communicate, manage the "art and science of the markets" – and enhance the investment process by processing data from which people make the individual decisions.
3. I think we are still years away from "Skynet" running people less investment networks. That does not mean good "marketers" will not try to sell their investment skills that way.

So, until computers/programmers create human interaction, judgement and distinguish between investment signals versus existing everyday noise, I think people will have a role to play. I hope you do, also.

Sources:
All data and charts sourced through Bloomberg.

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