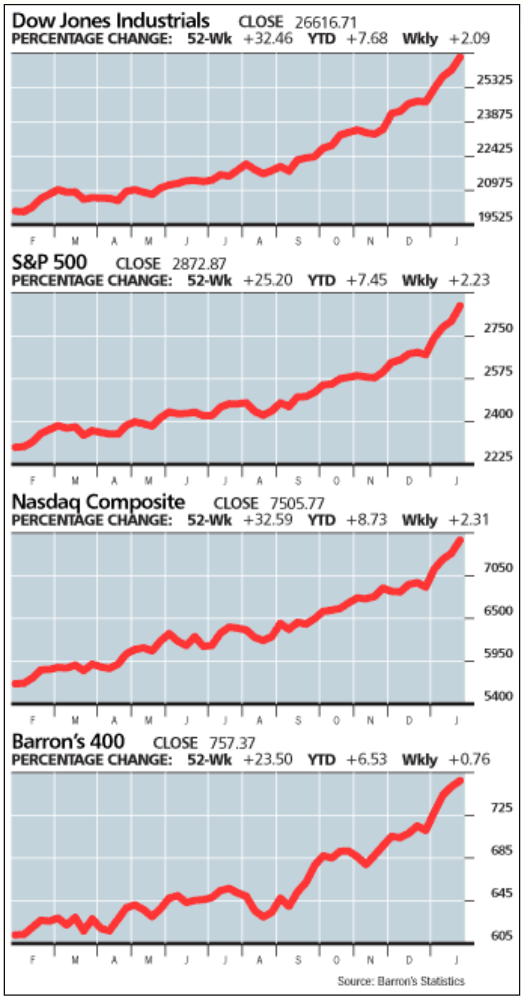
COMMENTARY®
by SULLIVAN & SERWITZ

ISSUE
342

The Market Place: Analysis & Commentary

February 2018

A common refrain among Wall Street stockbrokers is, "No one rings a bell to warn investors when a calamity is about to strike." I disagree. The bells have been ringing all too loudly of late. What may be more accurate to say is that "No one can know *when* the ringing bells will extract their toll on those who are deaf to their reverberations." You see, the sound of the Wall Street warning bell does not have the resonance or character of that which typically resides in a bell-tower. Rather, it is a "sound" that must be "observed."



Source: Barron's Statistics January 27, 2018

A Sound Concept Gone Awry

Index investing is a sound concept. The ambition of index investors is to capture the average growth of the economy as this growth is reflected in the stock market. Indexing appeals to investors who recognize that they do not have the expertise necessary, or the interest, to manage their own portfolios. Nor do they have the knowledge to sort through the many thousands of investment managers and mutual funds to select ethical agents capable of adding value. Indexing, when seen in this light, is completely rational.

Manifesting an unfailing pattern endemic to Wall Street, a sound concept has morphed into a caricature of the original model due to the distortions perpetrated by misguided agents, poorly aligned incentives and the inherent flaw of indices constructed by market capitalization.[1]

For months I have been highlighting various trends, each of which has contributed to the unprecedented flight into all manner of passive

Footnotes

[1] See May 2017 edition of *Commentary* (Issue #333) for a review of the inherent flaw of market capitalization indices.

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investment products and strategies. These investment products and strategies span the spectrum from index funds (e.g., the S&P 500) and their kissing cousins, ETFs, to the Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT). Consider that there are approximately 6,000 indices today. 10 years ago there were about 1,000. At the same time, according to the Center for Research in Security Prices at the University of Chicago's Booth School of Business, the number of U.S. stocks has withered from 7,355 in 1997 to about 3,600 today. In other words, today, there are more indices than stocks! This does not even account for the number of ETFs. This stampede into index fund products and ETFs can only be described as breathtaking.

Distortions are Extreme and Disquieting

As I explained in the May 2017 edition of *Commentary*, the market capitalization construction of the vast majority of index funds and ETFs has created an inherent mechanism provoking distortions. Most naïve investors believe the S&P 500 is well diversified because it is composed of approximately 500 stocks.[2] Due the market capitalization nature of the index, however, the effective – sought after – diversification is rendered moot. *10% of the S&P 500's total value is a function of only three stocks*: Apple, Alphabet (formally Google) and Microsoft. Add in the next seven largest stocks by market capitalization and the ten largest stocks within the S&P 500 determine 20% of its value. In other words, one-fifth of the S&P 500's value is determined by just 10 out of approximately 500 stocks!

If you believe the degree of concentration of the S&P 500 is an anomaly, then please reconsider. The NASDAQ 100 is supposed to be the 100 largest firms of the approximately 3,300 firms that comprise the NASDAQ. The NASDAQ 100 may be purchased via the PowerShares NASDAQ 100 ETF (ticker QQQ). The PowerShares NASDAQ 100 ETF has amassed just under $50 billion of assets, making it one of the largest ETFs. The five largest holdings of The PowerShares NASDAQ 100 ETF are Apple, Alphabet, Microsoft, Amazon and Facebook. These five companies, collectively, as of this writing, represent just over 41% of the total value! How one could conclude that either the S&P 500 or the NASDAQ 100 is well diversified is a mystery to me.

The concept of diversification was further turned upside down with the advent of sector indices and sector ETFs. A sector index or sector ETF is a basket of stocks that is restricted to a specific market sector, e.g., technology, health care, a country or industry group, etc. In an extreme, if not audacious attempt to garner client assets, there are now ETFs that target gender-diverse senior management (SPDR SSGA Gender Diversity Index ETF)[3], those who want to practice "biblically responsible investing,"[4] those who seek solutions to obesity,[5] and those who would like to invest in the whiskey and spirits business.[6]

Footnotes

[2] The number of companies that comprise the S&P 500 is continually changing due to mergers, acquisitions, bankruptcies, changes in composition initiated by the committee that determines the composition of the S&P 500, etc.

[3] Here's the marketing pitch: "The SSGA Gender Diversity Index is designed to measure the performance of U.S. large capitalization companies that are 'gender diverse,' which are defined as companies that exhibit gender diversity in their senior leadership positions. https://us.spdrs.com/en/etf/spdr-ssga-gender-diversity-index-etf-SHE?fundSeoName=spdr-ssga-gender-diversity-index-etf-SHE (Ticker: SHE)

[4] Here's the marketing pitch: "Inspire Global Hope Large Cap ETF is an exchange traded fund incorporated in the USA. The fund tracks the Inspire Global Hope Large Cap Index. The ETF invests in foreign (including emerging markets) and domestic large capitalization equity securities using the index provider's Inspire Impact Score, a proprietary selection methodology based on biblical values and ESG score criterion. https://www.bloomberg.com/quote/BLES:US (Ticker: BLES)

[5] https://en-us.janushenderson.com/advisor/product/slim-the-obesity-etf/

[6] Here's the marketing pitch: "The Spirited Funds/ ETFMG Whiskey and Spirits Exchange Traded Fund (WSKY) was created to provide investors access complete exposure to the world's publicly-traded companies involved in the production and sale of whiskey and spirits. The Spirited Funds/ ETFMG Whiskey and Spirits ETF (Ticker: WSKY)

The creation of sector ETFs is limited only by the creativity (machinations?) of one's marketing department.

By narrowing the focus of the index or ETF, one has created an investment product that is *highly concentrated* which is the polar opposite of the principle of diversification. Then the Wall Street mathematicians, by divine inspiration (and perspiration), created a pseudo-scientific methodology to bless their increasingly outrageous creations. To explain why I say "outrageous creations," let's consider an example that illustrates the abuse of the mathematical contrivance, "Beta."

Beta

Beta is a measure of the volatility of a security or portfolio[7] in comparison to the market as a whole. Because Modern Portfolio Theory asserts that risk = volatility (a notion we think is absurd), Beta has become an important test to measure the "riskiness" of a security. Beta is calculated using regression analysis and represents the tendency of a security to respond to the broad swings of the market. A beta of 1 indicates that the security's price moves in lock-step with the market (which is usually defined as the S&P 500). A beta of less than 1 means that the security's price is less volatile – or less "risky" – than the market. A beta of greater than 1 indicates that the security is more volatile ("risky") than the market.

Observe how the Wall Street marketing machine employs Beta to create fool's gold from irrelevant, nonsensical data. According to the iShares fact sheet, as of 31 March 2017, the iShares Frontier Markets ETF is described as 91% lower risk than the S&P 500 because it has a Beta of 0.09. "The 91% lower risk assertion," explains outstanding investor Murray Stahl, "says you can ignore the 10% weighting in Pakistan, which is now contemplating the greater wisdom of a nuclear first-strike strategy against India, as well as the 20% in Kuwait, smaller than New Jersey and surrounded by Saudi Arabia, Iraq and, 5 miles off its Persian Gulf coast, Iran. Or that almost 50% is in financial stocks." Mr. Stahl further highlights the absurdity of these sector ETFs by observing that the "iShares Italy ETF [is] fascinating for the fact that seven of the top 10 holdings get an average 72% of their sales from outside Italy."

I would like to underscore this fact: there is *no* attempt to assess the underlying component holdings comprising the aforementioned ETFs, nor is there any attempt to *value* these underling holdings. It is almost as if someone threw a fistful of darts at a list of companies that have been designated "Frontier Markets" and then did a little math to create the result described as "91% lower risk than the S&P 500." I could not make this up. Abstractions based on flawed assumptions, and models based on false propositions, will create their own reality. In other words, if one were to simply look at the underlying holdings of the iShares Frontier Markets ETF, that this ETF could be described as "91% lower risk" than the S&P 500 is beyond absurd.

The Wall Street marketing machine does not rest here: stock brokers – who now refer to themselves as "financial advisors" – then dial up the volume to create the illusion of competency and sophistication by recommending to the overwhelmed investor that they assemble a "well diversified portfolio" comprised of these sector ETFs to reduce risk by following the statistical allocation principles of Modern Portfolio Theory (MPT) and the Efficient Market Hypothesis (EMH). For example, an investment product/strategy which is gaining popularity is the "Hub and Spoke" portfolio. A hub and spoke portfolio is composed of several investment vehicles (usually a number of index products and/or ETFs). These discrete products are combined to create a portfolio. The central investment vehicle – usually the largest investment product (e.g., the S&P 500) – is referred to as the "hub." Smaller investment vehicles, the "spokes," are added to the

Footnotes

[7] For the sake of brevity, the term "security" will encompass both "security and portfolio."

portfolio; these smaller vehicles are usually sector products. The Mad Hatter[8] would be totally at home among those who champion MPT, EMH, ETFs and all manner of market capitalization index products.

When one can observe such extreme foolishness in a market – a foolishness born of a marketing department's sole ambition to amass greater amounts of assets into the fold – one can "hear" the deafening sound the Wall Street Bell tolling. Salesmanship long ago replaced stewardship on Wall Street.

Valuations

In the October 2016 edition of *Commentary*, I introduced the reader to Robert Shiller's broad stock market valuation model, the "Cyclically Adjusted Price-to-Earnings Ratio," or CAPE. CAPE is a measure of valuation that is usually applied to an index like the S&P 500. It is a relationship expressed as a fraction: its numerator is the price of the S&P 500 at a given time and its denominator is the month-by-month ten-year moving average of the Consumer Price Index (CPI) adjusted earnings of the corporations that comprise the S&P 500. The higher or lower the CAPE ratio, the dearer or cheaper are the stocks that comprise the index.

Historical CAPE Valuations

- According to Mr. Shiller, the CAPE from January 1881 through June 2015 had an average value of 16.6.
- The average for the 20th century was 15.5.
- The average from 2001 through June 2015 was 24.
- In June of 2015 the CAPE weighed in at 27.2.
- As of this writing the CAPE has advanced to 31.3.
- At the top of the bull market in 2000, the CAPE recorded an all-time high of 43.0.

The S&P 500 exceeded 30X earnings only once in the past 130+ years, in June 2000 (when the dot.com bubble peaked). At 31.3 the CAPE is now effectively tied with the peak recorded in 1929. *It is important to underscore that the CAPE is not a short-term warning indicator of a market about to decline*. But it should give pause to anyone with serious money dedicated to formulaic passive products.

In that same edition of *Commentary* I also discussed what has come to be known as the "Buffett Indicator" which is the Ratio of Market Capitalization to GDP. "The ratio has certain limitations in telling you what you need to know"[9] explains Warren Buffett. "Still," explains Mr. Buffett, "it is probably the best single measure of where valuations stand at any given moment."[10]

Historical Buffett Indicator Valuations:

- In January of year 2000, just before the dot.com mania bubble burst, the Buffett Indicator was 155% and advancing.
- In July 2007, just before the housing bubble popped it was 116%.

Footnotes

[8] See the April 2017 edition of *Commentary* (Issue #332) for additional information about ETFs and our *Alice in Wonderland* stock market.

[9] What are the limitations to which Buffett is referring? In Chris Casey's article *How GDP Metrics Distort Our View of the Economy*, as reported in the *Ludwig von Mises Institute Daily Article* of 15 May 2015, Casey provides a succinct explanation of GDP's shortcomings. Mr. Casey writes, "GDP purports to measure economic activity while divorcing itself from the quality, profitability, depth, breadth, improvement, advancement, and rationalization of goods and services provided. For example, even if a ship – built at great expense – cruised without passengers, fished without success, or ferried without cargo; it nevertheless contributed to GDP. Profitable for investors or stranded in the sand; it added to GDP. Plying the seas or rusting into an orange honeycomb shell; the nation's GDP grew. Stated alternatively, GDP fails to accurately assess the value of goods and services provided or estimate a society's standard of living. It is a ruler with irregular hash marks and a clock with erratic ticks. As proof, observe this absurdity: in 1990, Soviet GDP equaled half of US GDP, according to the 1991 CIA Factbook. No one visiting the Soviet Union in 1990 would believe their economy came close to 50 percent of the quality and quantity of the goods and services produced in America. GDP-defined production may have been strong, but laying roads to nowhere, smelting unusable steel, and baking barely edible breads stretches the definition of 'production.'"

[10] As quoted from the 10 December 2001 edition of Fortune Magazine.

- From 2015 thru July 2017 it has fluctuated at about 129%.
- As of this writing, the Buffett indicator weighs in at 138%

Based on these historical valuations, GuruFocus[11] created the following chart to put the Buffett Indicator within a historical context:

Ratio = Total Market Cap / GDP	Valuation
Ratio < 50%	Significantly Undervalued
Ratio 51% to < 75%	Modestly Undervalued
Ratio 76% < 90%	Fairly Valued
Ratio 91% < 115%	Modestly Overvalued
Ratio > 115%	Significantly Overvalued

Again, neither the CAPE Ratio nor the Ratio of Market Capitalization to GDP is a short-term warning indicator of a market about to decline. If nothing else, such lofty valuations should encourage caution. Notwithstanding, the rush into all manner of passive investment products shows no signs of letting up.

To be continued next month at which time I will draw the distinction between "value investing" and "rational investing" and how this distinction relates to the risks inherent in today's worldwide publicly traded markets.

Working hard for you,

Marshall Serwitz

P.S. Thank you for your support.

Footnotes

[11] According to the GuruFocus website, "GuruFocus.com is engaged in the business of financial news, commentaries, research and publishing."

Thank You

We hope that in the course of conducting our business we might meet prospective clients with whom we share common values and investment philosophy. If you know of someone for whom the fit appears mutually beneficial, please pass along our name or provide us with contact information.

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