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What Ted's Thinking

Active Management Today is a Single Decision

About twenty years ago, I sat down with a leading long-short hedge fund in Korea. The portfolio manager spent forty minutes offering an articulate bull case for Samsung, in which he had a 20% long position. When he finished his impassioned presentation, I responded with a single question: “That sounds great, but why are you net short Samsung?”

The manager had a long book comprised of individual stocks and a short book comprised of KOSPI index options and futures. Samsung comprised 40% of the KOSPI index. His fund was 100% long and 60% short, so despite the seemingly large 20% long position, he effectively had a 24% short position through the index and was 4% net short his favorite stock. The concentration of the KOSPI index was wreaking havoc on his bottom-up stock approach to security selection and position sizing.

Since the GFC, the underperformance of active managers has been a repeated refrain. Index funds have been the beneficiaries, with Vanguard leading the pack and overseeing $7 trillion in assets. The flow of funds to indexes has also been the correct market call; the S&P 500 compounded at 12.2% for the last five years and 13.8% over the last fourteen, far surpassing most markets around the world and its long-term returns of 10.9% over the last fifty years[1].

The driver of this soaring index performance has been the magnificent seven.[2] These technology-enabled businesses emerged as the winners of the internet, capturing the lion’s share of all the economics created from the technological revolution. Their business success translated into stock performance as well. In an extreme example, in the first half of 2023, the mag seven comprised 95% of the performance of the S&P 500 and 70% of the MSCI ACWI.

After this incredible run, the mag seven comprises 25% of the S&P 500 and 18% of the MSCI ACWI. To put the dominance in perspective, the market cap of Apple today is larger than that of

[1] MSCI ACWI ex-US 5.4% and MSCI EM 4.0% over fourteen years ending 7/31/23. Data: FactSet via AJO Vista.
[2] Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, Meta Platforms

the entire Russell 2000 Index, and the mag seven weighting in the NASDAQ is so high (51%) that the index had to rebalance away from the stocks.[3] The S&P 500 and MSCI ACWI have experienced similar concentrations in the past, but never has the concentration been in the hands of stocks with roughly the same risk factors – in this case large cap, high beta, growth, and technology.

As a result, active management today comes down to a single decision – how much do you own of the mag seven.

Many managers have a large position in one or more of the gang, but few have 25% of their portfolio invested. All the work of active managers that goes into creating an investment philosophy, searching for uncovered gems, conducting deep fundamental research, exercising sound decision making, and constructing rigorous portfolios is dwarfed at the end of the day by a single decision.

This set up has me thinking about first principles of an allocation to equities. Stated as a question, what are investors trying to capture by owning U.S. stocks? The purpose of the allocation is to benefit from diversified exposure to the U.S. or global economy, which raises another question: Is such a significant concentration in large, growth-oriented, technology companies achieving that objective?

Jack Bogle said the beauty of a cap-weighted index fund is it provides the purest representation of an economy as measured by the market. The mag seven certainly dominates the U.S. economy today, so he might conclude that it is what it is.

In recent weeks, I've had several conversations with CIOs who inquired how others are managing the underperformance of their U.S. equity managers. I don't think diversified portfolios benefit much from having 25% of their U.S. equity exposure invested in a highly correlated basket of names. Most others agree. These CIOs are shrugging their shoulders and thinking about equal-weighted indexes, recognizing that their desired high active share is synonymous with a significant underweighting in the mag seven in a cap-weighted index. At the same time, that active share is resulting in significant underperformance.

Those seeking analogs to the dilemma can consort with their peers abroad. Raff Arndt from Australia Future Fund and Tom Joy from Church Commissioners Pension Fund in the U.K. both shared on the Capital Allocators podcast that the biggest driver of their returns each year is the decision of how much to hedge their home currency, as their global assets have lots of USD and EU exposure, but their liabilities are denominated in the AUD and GBP, respectively. They know they can't get this right all the time but recognize that it still has the biggest impact on their results.

[3] https://www.forbes.com/sites/bethkindig/2023/07/28/nasdaq-rebalance-what-you-need-to-know/

Active management in the U.S. today is the same.[4] The winners will make the right call on their allocation to the mag seven, and that's about it. The entire investment process and the typical importance of behavioral, analytical, informational, or technical edge will be swamped by that one decision when assessing returns for the foreseeable future.

Few profess to have an edge on these types of decisions. Rather than diving in to develop a false sense of security, the lessons from peers abroad and stock pickers in emerging markets with concentrated indexes is one of communication. It's less about what to do and more about how to educate your constituents on the choices at hand and expected outcomes to come.

Proper communication is necessary because the one decision will in fact determine relative performance in equities. It's a very different dynamic than any I remember in this country, but it's the same one that the manager in Korea faced twenty years ago.

One thing is for sure – communication and understanding is what gets us to the other side. The naivete that led that Korean manager to get net short his favorite name was not a good look irrespective of what happened with Samsung stock.

[4] And to a lesser extent globally as well.