

Beware the Dumb Money: Why Endowment Style Investing Matters Even More Today

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HighVista Strategies

HighVista Strategies was founded in 2004 by an experienced team with diverse backgrounds in endowment management, hedge fund and principal investing, wealth management and academia.

We focus singularly on achieving attractive risk-adjusted portfolio returns through investing across public and private markets. We utilize the time-tested principles of endowment investing and a forward-thinking application of risk management to manage globally diversified investment strategies and solutions tailored for our clients' varying needs. The priority placed on capital preservation and avoiding major drawdowns fosters the patient and rigorous pursuit of excess returns, and is itself a critical driver of long-term performance.

Executive Summary

Public market investing is a zero-sum game, and understanding who is on the other side of any trade is important when seeking to outperform. This paper lays out perspectives on alpha generation in a world where unsophisticated investors ("dumb money") seek to become less exploitable. Indexing is one manifestation of such behavior; small order share executions is another. Both exemplify how capital market innovation can change the landscape of players—and their requisite skills—and consequently affect the opportunity set for generating alpha.

Private market investing is less burdened by the zero-sum constraint and by free riding by others. While much costlier to pursue and no less subject to overheating than any market segment, it is an area in which skilled investors should be able to extract a disproportionate share of the gains for their efforts.

Endowment style investing is well suited for the pursuit of alpha in today's capital markets. It is a good match given the greater need for flexible, patient and opportunistic capital, as well as for the opportunity set provided by less liquid investments. The approach matters more today for alpha generation even as the bar is higher on the skills required to execute on this model successfully.

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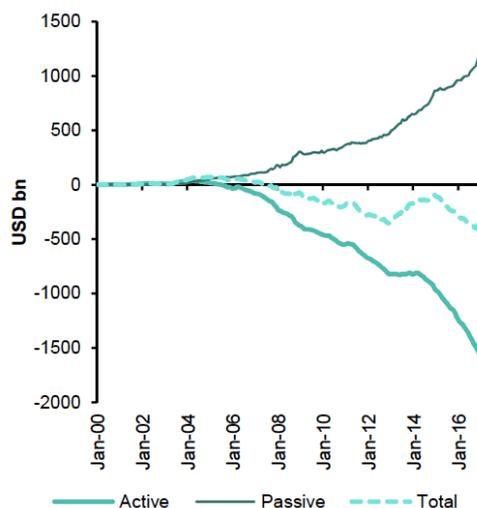
Endowment style investing is primarily about the unfettered search for outperformance (“alpha”) while maintaining broad asset class diversification.

In the endowment approach, the search for alpha extends across geographies, asset classes and strategies, and across the liquidity spectrum and security types. Executing on this search critically entails identifying and accessing truly talented investment managers, and, by their nature, hedge fund and private investment firms play significant roles in endowment portfolios.

To be able to generate alpha is always valuable, but especially so today. Equity market valuations are high and bond yields are low. The 60/40 global equities/bonds portfolio is priced to deliver a real return of 1-2% below its historical average of 5% per annum.¹ Many not-for-profits and other investors have spending needs in the range of 5% per annum and they are relying on alpha generation to meaningfully close that projected gap. The question is whether the prospects for earning excess returns are also diminished in the current environment and whether a heavy reliance on alternatives investing will continue to be effective. This question is the focus of this paper.

Beyond valuation levels and interest rates, the market is different today in important respects. One big difference is the flood of money from active into passive investing along with the proliferation and use of exchange traded funds (ETFs). Alliance Bernstein estimates that index/passive mandates will soon constitute 50% of U.S. assets under management and that the net flow out of active U.S. equity funds has exceeded \$1.5 trillion since 2005 (**Figure 1**). Not unrelated to these phenomena is the rise of machine-driven strategies and the use of algorithms to execute even simple trades. Perhaps also not unrelated is the dramatic reduction in the number of actively traded companies in the U.S. Today, only 3,600 firms trade frequently enough to be included in the major indexes versus 7,600 in the 1990s and over 5,000 in 2005.

Figure 1: U.S. Equity Funds: Cumulative Flows (\$billion)²



Source: EPFR Global, Bernstein analysis

¹ Source: HighVista Strategies analysis.

² Source: Alliance Bernstein, “Nearing the 50% Passive Milestone”, April 27, 2017. 50% of AUM being passively managed equates to about 15% share ownership of U.S. firms being held via passive mandates. The report estimates that in Europe and Japan, AUM managed passively is approximately 35% and 70% of total AUM of the respective regions.

These changes represent structural shifts that could importantly affect the opportunity set for earning alpha. They are being blamed for the lackluster performance of traditional active strategies, although it is increasingly being asked whether there will come a tipping point where research-based approaches to security selection will again “have their day.” It’s a question whose answer greatly affects what kinds of firms and strategies will be best suited to generate attractive returns going forward.

Intuitively, outperforming should be easier in inefficient markets. Inefficient markets include ones in which prices do not reflect full information and/or in which there are impediments to capital formation. However, the evidence on the ability to perform well in such markets is mixed. Good examples are small capitalization equities and emerging markets equities, which are not nearly as efficiently valued as large capitalization U.S. equities. Mutual fund data shows that the dispersion among active manager long-term returns is high in those areas—which is consistent with the better firms being able to add significant value—yet the average performance of funds over long periods is no better than the indexes. It requires skill to outperform even in inefficient markets.

Outperforming in inefficient markets is made difficult for two fundamental reasons: 1) it is costly and 2) security selection is mathematically a zero-sum activity between buyers and sellers. It is costly because the low-hanging fruit is usually picked fairly quickly, leaving the higher hanging fruit for those willing to invest the requisite resources and patience. Whatever is causing a market to be inefficient in the first place usually also makes it more challenging to exploit.

The zero-sum aspect—making money only at someone else’s expense—requires that the other side of the trade be wrong or have a particular need (such as for liquidity) that creates an opportunity to earn an excess return. When alpha depends on someone else being “wrong”, it requires an informational, valuation or other advantage. It is a game ideally played against unsophisticated or other investors who are doing things they should not.

The problem is that “dumb” money is not stationary. It learns over time when a market is inefficient and tends to find ways to become less exploitable. Warren Buffett said it well (1983 Berkshire Hathaway Annual Letter) when he noted that “when ‘dumb’ money acknowledges its limitations, it ceases to be dumb.” Understanding what happens when dumb money becomes smart is essential for being successful at alpha generation.

For the purposes of this paper, the term “dumb money” refers to investors who have little knowledge of, or insight into, the specific company shares in which they may be trading—and conversely for “smart money.” Dumb money may well be sophisticated in other matters relating to finance and/or investing.

The Survival of Dumb Money

In a game played by smart against dumb money, there are inherent limits to how much the dumb money can lose. If smart money could trade in unlimited quantities without moving prices, the dumb money would be unlikely to survive for very long. Something therefore limits trading in large amounts at favorable prices. Either 1) the smart money is constrained—for example by limited capital or the size of the opportunity—and/or 2) prices move when volumes get large—a friction called market impact.

Market impact is the amount by which one needs to move a stock’s price to get an order filled. Market impact combines the bid-ask spread and the amount by which prices move while one is executing a trade. It can be relatively insignificant for small quantities and much bigger for large quantities; it can be significant when rapidly filling an order but much less so when executing an order slowly over time.

Market impact is not something decided externally like a brokerage commission. It’s an outcome of the game being played between buyers and sellers and is an inherent part of the price discovery process.

Market impact gates the profits of the smart money and is an important lens through which to think about how index investing may affect the opportunity set.

It is useful to illustrate with a specific example.

Illustrative Example:³ Suppose that the fortunes of a given firm, Company A, will be determined entirely by the flip of an unbiased coin. If the outcome is heads, Company A will be worth \$2 a share, and if it is tails, Company A will be worth zero. If this is well understood and there are no market frictions nor risk aversion, Company A should trade for \$1/share prior to the coin being flipped.

Imagine next that an astute Investor HF has figured out (legally) how to perfectly predict the outcome of the coin flip. Investor HF moreover wants to trade in the shares of Company A prior to the flip. If able to trade at \$1 per share, Investor HF will profit handsomely by buying if she knows the outcome will be heads and by selling short if she knows the outcome will be tails. Investor HF ought to be able to do precisely that if the market has no inkling that someone could possess such valuable insight into the future of Company A.

But what if the market thinks that the next trade order is likely to be placed by an investor who knows the outcome in advance of the toss? At what price should the shares be quoted (prior to the coin flip)? Should there be a bid-ask spread? How wide? The answers are yes and very wide. In fact, the shares should be bid at \$0 and offered at \$2. At any tighter spread, say bid \$0.80 and offered at \$1.20, Investor HF will hit the offer at \$1.20 if she determines that the outcome will be heads—and make a sure \$0.80 profit, or sell short at \$0.80 if she determines that the outcome will be tails—and again make a sure \$0.80 profit. The ultra-wide [\$0 - \$2] spread fully protects the dumb money from losing to the smart money. Importantly in this instance, the dumb money does not know the outcome in advance, just that someone else does and is about to trade on it.

A very wide spread is a way of screening out the smart money. It unfortunately also makes the market illiquid and it takes away the incentive for the smart money to do research. Markets with high costs of trading are not well-functioning.

So why is it that many markets can and do function well? It's when the vast predominance of trading is by dumb money. The dumb money still loses to the smart money, but those losses are shared by many which permits bid-ask spreads to be narrowed and market impact to be lower. Lower trading costs benefit all investors—the market is more liquid and there is price discovery because low frictions incentivize the smart money to do research and trade on it. There is also more competition, which in and of itself provides protections for the dumb money. This is an ecosystem in which the dumb and smart money can healthily coexist. Everyone is better off provided that the smart money is neither dominant, nor absent.

Index Investing as a Refuge for Dumb Money

The creation of index instruments (e.g., ETFs and index futures) changes the ecosystem.⁴ To see how, let's take the perspective of the dumb money. Even if they are experiencing only modest impact when trading, the dumb money would prefer to execute with minimal friction. They understand that they are often paying a spread or moving the market because the other side of the trade does not know if they are dumb or smart. If a dumb buyer and a dumb seller could credibly convince each other of their lack of smarts, they should be comfortable trading with one another at the midpoint of the spread. But that's hard to do given that smart money can masquerade as dumb.

³ This example is based on Lawrence Glosten and Paul Milgrom, "Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders," *Journal of Financial Economics* 14 (1985).

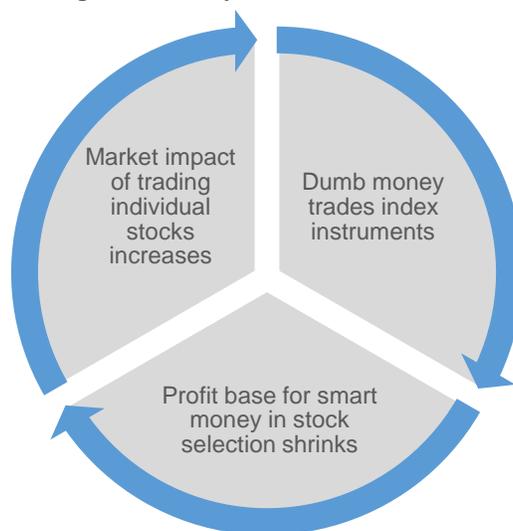
⁴ The basic idea of this section of the paper was first advanced by Jim Gammill and André Perold, "The Changing Character of Stock Market Liquidity," *The Journal of Portfolio Management*, 1989.

Enter index instruments. If you are trading an index of many securities rather than just one security, it's extremely unlikely that you're doing so to benefit from research you have done in a single stock. Trading indexes therefore should be much less costly. Factually, and not surprisingly, the market impact of trading in index instruments tends to be much lower than in their constituent stocks. It is no surprise therefore that the dollar volume transacted in index instruments tied to a broad index like the S&P 500 is routinely far in excess of that of the shares of the firms that comprise the index.

Trading index instruments is like belonging to a dumb money "refuge." When inside the refuge, you're credibly signaling that you are dumb and smart money is screened out by definition. Refuge "members" therefore can more easily trade with one another in relatively large amounts without having much impact on prices.

This way of owning equity market exposure is all well and good but not necessarily for the smart money. When the dumb money chooses to trade in index instruments rather than individually in the component stocks, there is a smaller base to pay for the profits of the smart money and the market impact of trading individual stocks ought to be greater. In the presence of larger trading costs, two things are likely to happen: the profits of the smart money decline and the incentive increases further for dumb money to trade index instruments. This in turn should increase the incidence of smart money being pitted against smart money in the trading of the underlying stocks. It is in principle a vicious cycle, as depicted below (**Figure 2**). The question is how this interplay affects the efficiency of markets and the opportunities to earn alpha.

Figure 2: Index Instruments Change the Ecosystem



Other Innovations Helping Dumb Money

The creation and trading of index instruments is but one example of how financial innovation can alter the balance of smart versus dumb money at a given place and time in the capital markets. Another is the ability today to inexpensively execute trades in individual stocks in small quantities (something that has been enabled by market regulation and technological innovation). It is a development that has helped the dumb money as they seldom need to trade in large quantities in a short space of time. It helps them because institutionally-sized smart money is now more likely to stand out if they desire to trade in a hurry. Factually, the average trade size in listed shares has declined dramatically over the last several decades, from over 2,000 shares and around \$80,000 per trade in 1990 to around 200 shares and \$10,000 per trade today. In today's share markets, traders seldom call in block orders to execute trades of any significant size. They have little choice but to spread them out over time with the use of intelligent algorithms. Those who do otherwise are likely to bear significant costs of market impact.

Implications for Alpha Generation

Index instruments and the ability to trade efficiently in small order sizes offer the dumb money ways to own equity exposure without being as susceptible to being on the other side of smart money trades. These are phenomena that in principle should raise the bar on the skill required for success in active stock selection. Precise implications are always hard to draw, but here are a number of particular thoughts. All have implications for endowment style investing.

Less float but higher quality investment firms. Over time, a higher bar to perform should threaten active managers with marginal capabilities. The large flows out of active management in recent years have most likely come from managers with the worst track records. If true, and if that continues, the average quality of the firms that remain could well be higher. Higher quality firms with less competition should be able to do better. At the same time, however, there is less “float” in the system as the money that has left the active stock selection space is now being managed in a way that is harder to trade against.

Longer time horizons and staying power. In a world with higher trading frictions in individual stocks, it takes longer to accumulate or shed an active position and the focus of alpha generation has to shift to opportunities that take longer to play out. Less liquid “off the run” equities will be less efficiently priced but will provide opportunities only in smaller size. The large active firms will gravitate even more to the larger capitalization areas of the equity market. In either case, the need for longer time horizons in the pursuit of alpha makes staying power more important—for investment firms as well as for their clients.

Times of stress—when smart money can really shine, or become worse than dumb. Staying power affects how firms manage the tradeoff between seeking to make money in the here and now versus waiting for more opportune times in the future. Some firms will tend to stay fully invested, even in the absence of high conviction opportunities, while others will be more patient. The latter tend to have more flexible mandates and will hold significant cash and/or be more hedged so as to be better able to invest at times of dislocation. Their performance will tend to lag in heady times but they could more than make up for that in dislocated environments—provided of course that their clients are equally patient. These firms become the truly smart money in such environments. The “here and now” firms by contrast may perform better even for long stretches, but they will have a greater propensity to attract hot money and will be more prone to becoming forced sellers at times of dislocation. In such instances, they will be anything but smart and serve as good fodder for the patient money. Meanwhile, the buy-and-hold dumb money—if they can really hold—will not be as affected if the dislocations turn out to be temporary.

Activism and short selling. As effectively buy and hold investors, the large index funds have become long-term shareholders and they are becoming more vocal on issues relating to corporate governance. Some are increasingly taking the side of hedge fund investors and are facilitating corporate activism. They are thus facilitating some forms of active investing even as their presence may be raising the bar on other approaches.

Another example relates to short selling. Index funds and ETFs are today among the primary lenders of shares. They ameliorate the borrow costs and risks of being bought in that can be significant impediments to short selling.

Creating value and keeping a larger share of the spoils. In the public equity markets, shareholders generally get to free-ride off of the efforts of the smart money. Activists for example are compensated for their efforts on the positions they own while the vast bulk of shareholders get a free lift. The zero-sum nature of public market investing exacerbates the problem as the activist needs to acquire the shares without the other side of their trade being aware of their motivation.

Finding ways to keep a greater share of the spoils can be very valuable. For example, an investment firm with the mandate to do so could transact with a company on terms not available to the public at large. Providing private financing (such as PIPEs investing—Private Investing in Public Equity) would be one such instance. Another would be to take a company private and thereafter effect positive change. To do

so would require paying a premium price, but the gains from there would all accrue to the new owners and capital providers.

The opportunities to benefit from value creation may be greater in today's environment. The cost of capital for a company is generally higher in a less efficient market. If passive investing is draining dumb money away from trading in individual stocks, it may well be a contributor to firms deciding to go private. It may also explain the increased tendency today of early stage firms to forsake going public in favor of raising additional rounds in the private financing markets. Private markets are much more dependent for their functioning on long-term knowledgeable capital.

Capitalization-based indexing distorts all component equities—or none. Most indexes are constructed based on market capitalization weighting and it is argued that this feature distorts market prices by disproportionately steering passive mandates into larger capitalization equities. This claim seems manifestly false. If investors are overly exuberant about the market as a whole and they choose to express that optimism by purchasing a capitalization-weighted index instrument, they will by definition purchase each component in proportion to its current size. If their buying behavior is distortive, it will do so in a way that puts the same proportional pressure on all of the constituents. An investor who knows that particular stocks are over- or under-valued should be taking active positions in those stocks and not in the index.⁵

The same applies to sector ETFs. ETF turnover can be very high and the proliferation of these instruments has made it easier to move in and out of particular market segments and exacerbate herd behavior. Again, exacerbation would be at the level of the sector rather than disproportionately affecting particular stocks within that sector.

Rules-based strategies. Rules-based approaches include stock selection strategies that emphasize factors such as firm characteristics like “value”, “momentum”, “quality” and “low volatility.” These strategies can be mechanized and be very competitive with the active manager who is doing little more than implicitly investing based on such characteristics. The approaches utilize portfolios of many stocks and benefit from easier execution in a small order-size world. Rules-based approaches are of course as subject to excess demand and distortive behavior as any others.

A Tipping Point?

If the flows from active to passive investing continue, will there be an eventual tipping point where active stock selection suddenly becomes easier? Unlikely, as active management never has been “easy.” If trends like indexing and small order executions are simply manifestations of dumb money seeking to be less so, those now less dumb investors will also be less likely to be the ones to suddenly cause stock-specific price discrepancies. Their exuberance or despair may well cause broad sectors of the market to be over- or undervalued, but that source of alpha is more the domain of investors with flexible mandates and the ability to straddle asset classes and broad sectors.

So Why Does Endowment Style Investing Matter Even More Today?

We are in a world in which investor patterns have been shifting dramatically. The main phenomenon discussed here is the increasing share of public equities that is being held by investors who do little stock specific trading. For the reasons mentioned, this should raise the bar for achieving outperformance through stock selection but could improve the opportunity set for capital with flexible mandates.

⁵ For a fuller discussion of this topic, see “Fundamentally Flawed Indexing” by André Perold, *Financial Analysts Journal*, November/December 2007.

Another phenomenon highlighted here is the increase in supply and sophistication of private capital—to the point where many firms today are forsaking public ownership. The private investment space has grown also as banks have shrunk their lending activities in the face of regulatory tightening. As already mentioned, private market investing is less burdened by the zero-sum constraint and by free riding; it's an area where skilled investors should be able to extract a disproportionate share of the gains for their efforts. As the landscape of capital deployment has changed, the opportunity set for alpha generation is mirroring this evolution.

Endowment style portfolios have long favored more patient public market strategies and flexible mandates, as well as allocations to a broad range of private investments. These will all need to feature even more prominently in the quest for alpha. The biggest alpha opportunities are episodic and they tend to exist in times when the effect of the dumb money is overwhelming and/or a significant portion of the smart money does not have the capacity to take the other side. The subprime mortgage crisis is a good example where clients redeemed from hedge funds and/or placed pressure on private equity firms not to call capital. The firms that were best able to manage risk and their access to capital were able to reap the greatest returns.

Of course, there is no panacea here. Investors have to be able to identify and access skilled firms, and they need to be able to do so on terms favorable for them. They also need governance that is compatible with approaches that inherently require a longer time frame for oversight and evaluation, yet require the ability to act opportunistically, especially in times of dislocation. The large university endowments for the most part have been quite adept in this regard. Endowment style investing matters more today even as the bar is higher on the skills required to execute on this model successfully.

While the structure of markets is indeed different today, alpha will always be alpha and the nature of active management will in a very real sense endure. To outperform, managers need to think hard about 1) where in the capital markets are investors acting to the detriment of their own welfare and 2) where is there capital scarcity that smart money can gravitate towards. This challenge is what active management is about in the first place.

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