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Thoughts for Investors

Big Picture or “Thematic Investing”

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“It has long been an axiom of mine that the little things are infinitely the most important”

-Sherlock Holmes

Years ago the “newspaper” included the “news”, “sports” and somewhere in the middle the “business” section with page after page of stock prices. The “stock pages” often served as the start of an investor’s “research”. Today they have been replaced by page after page of past “performance statistics” on a variety of stock, bond, international, interest rate, borrowing rates/yields and currency and commodity “indexes”. Today many investors leave the detailed research to someone else and invest based on the big picture, or as it is also known, “thematic investing”. Unfortunately, it’s harder than you think to create wealth this way, as I will explain in this newsletter.

“It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts”

-Sherlock Holmes

Many investors are attracted to big picture “themes” and “theories” or investing based on “opinions” on interest rates, politics, the return of value stocks or the end (or not) of COVID. Next they search for index funds/ETFs or actively managed funds/ETFs that complement (and compliment) their views. This has not been lost on Wall Street who can whip up “products” to capitalize on investor’s appetites. Note: when you see the word “product” used to describe an investment, scrutinize it very carefully. For diversification investors then spread their money around in several funds/ETFs or “products”.

Finally, they judge their choices by comparing them to past performance statistics, available online anytime.

“I never guess. It is a shocking habit destructive to the logical faculty”

-Sherlock Holmes

The attraction of this style is that popular themes and theories often have many supporters (derogatorily known as the “herd”) driving up prices. “Opinions” can be sheer guesses, not based on fact or knowledge. It is ironic that with the proliferation of investment “tools”, largely available today for free, many investors don’t believe they are qualified (or don’t want to learn) to make decisions about the investment merits of individual stocks.

“How do you know that?” “I followed you.” “I saw no one.” “That is what you may expect when I follow you.”

-Sherlock Holmes to Dr. Watson

“Indexes” are considered “benchmarks”, fixed standards of performance against which other investments are often judged. That belief has resulted in the immense popularity (that should give you pause) of “index investing” or as it is better known, “passive investing”. This is an investment style that attempts to match, not beat, the performance of indexes. There are now millions of people all investing the same. It is important to remember that investing in index funds/ETFs does not assure a positive return over a given holding period! Not surprising (to me), I’ve encountered investors who believe “passive investing” always gives you a positive return because one is “paying less”.

Much has been written about an “artificial” effect on share price of “passive investing” and stocks being included in an index. The gist is that if the index is going up, so are the stocks in the index. While this seems “obvious”, it should be noted that could be happening to stock(s) regardless of their underlying fundamentals. Does being firmly ensconced in an index make company managements “careless” with shareowners capital, such as through ill-advised mergers? What, are they going to kick us out of the index??? If more money is flowing into index funds via passive investing and thus driving share prices up, who is going to argue with management’s actions even if they might not be fundamentally sound?

Also keep in mind you cannot invest directly in an index. To match the performance of an index one must buy an index fund/ETF. These are meant to “mirror” an index, i.e., own the same stocks as the index. Additionally, the best way for a portfolio manager of these funds/ETFs to keep their job is to just copy the index as closely as possible.

Besides general market risk of index funds/ETFs, “mirroring” creates other risks investors may not fully appreciate. To mirror an index, index funds/ETFs need to buy and sell the same stocks that are about to be added and removed from an index. This needs to be done quickly so performance doesn’t diverge from the index’s performance. Actively managed and thematic funds/ETFs that are “benchmarked” to a particular index must do likewise. That means lots of buying and selling, volatility that can confuse investors.

“Life is infinitely stranger than anything which the mind of man could invent”

-Sherlock Holmes

Take the example of the upcoming December 21 addition of Tesla to the S&P 500 index. The WSJ estimated that the inclusion of Tesla will put it ahead of Berkshire Hathaway but behind Facebook in the S&P 500 ranking. The result, they say, will be over \$100 billion of stocks being moved around, including what needs to be booted (no one knows which stocks) from the index to make

room. Sensing a tsunami of buying and selling, there are traders trying to capitalize on the inevitable volatility. “Leveraged” and “inverse” ETFs will also attempt to magnify any effect for their benefit. A lot of buying and selling will happen without any consideration of the “fundamentals” of these stocks. It is not easy to know exactly when the rumor Tesla might be added to the S&P 500 index started, but year-to-date the stock has risen over 600%. Can that rise all be due to improving business fundamentals for Tesla and declining fundamentals for those stocks being booted?

Nor does the S&P 500 index committee make things easy for investors. One might suspect that as a “benchmark”, there are strict guidelines for including/removing stocks from the index. Yet the committee can, and does, change the rules. In September 2020, according to the rules, Tesla technically “qualified” for the S&P 500 because it had “four quarters of profitability”. The stock rose. But for some reason, the committee decided not to put it in. The stock sold off. In November the committee changed their minds and decided to put it in after all on December 21. Imagine the Tour de France committee changing the route mid-race! It is interesting to note there are currently many unprofitable stocks in the S&P 500.

“Nothing is more deceptive than an obvious fact”

-Sherlock Holmes

In summary, this has been a very “confusing” year for investors. Selling everything in the face of COVID uncertainty seemed the obvious thing to do. On the other hand, buying index or actively managed funds/ETFs based on surefire themes, theories and opinions (even COVID beneficiaries) seemed obvious as well. But as the CFA Institute (Chartered Financial Analyst) explained, “Thematic investing isn’t just performance chasing, it’s performance chasing with a narrative. That can be a seductive combination”. Yet for those who took a deep breath, did some fundamental “ground level” research (or hired someone to do it for them) and invested this year, well what are your “results”?

“You see but you do not observe”

-Sherlock Holmes to Dr. Watson

If it sounds like we are automatically against the big picture as a place to start, that is not true. It helps to start your search in areas you believe in and can remain patiently invested when volatility inevitably occurs. You just can't stop with the big picture. It's hard to see much from up there. Wealth creation (if that's your goal), still requires investors do ground level research. Like Sherlock

Holmes with his magnifying glass, we believe investors must closely observe a company's market opportunity, products & execution, barriers to entry, management and financial condition. Owning “themes” or an S&P 500 Index fund with 500 stocks, with or without Tesla, makes it a little harder.

“Education never ends, Watson. It is a series of lessons, with the greatest for the last”

-Sherlock Holmes

ⁱ <https://www.economist.com/special-report/2020/11/12/stewards-inquiry>

ⁱⁱ <https://www.wsj.com/articles/teslas-s-p-500-debut-is-set-to-put-100-billion-in-trades-in-motion-11606645801?mod=rsswn>

ⁱⁱⁱ <https://blogs.cfainstitute.org/investor/2020/03/23/thematic-investing-thematically-wrong/>

The S&P 500 index is comprised of approximately 500 widely held stocks that is generally considered representative of the U.S. stock market. Investors who attempt to mimic the performance of an index would incur fees and expenses which would reduce returns. Individual investor's results will vary. Past performance does not guarantee future results.

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