HOW "ACTIVE" SHOULD YOUR INDEX BE? A DISCUSSION WITH ALPHA ARCHITECTS

Jeremy Schwartz – Global Chief Investment Officer
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On last week's podcast, Wesley Gray, CEO of Alpha Architects, spent the hour in our Philadelphia studio discussing the financial markets, with a focus on quant-active investment strategies. We also had Professor Jeremy Siegel on the top half of the podcast to talk about some of Gray's previous research pieces—including a discussion on the historical equity premium for stocks in the U.S. and how it compared to international markets.

- Siegel discussed why his forward real return expectations of stocks are a bit lower than the 6.7% historical studies from his book, *Stocks for the Long Run*—now he's looking for 5% real returns from U.S. stocks. He discussed how international markets historically did have a slightly lower equity return compared to the U.S. While Siegel has lowered his forward-looking expectations for stocks, the forward-looking returns for bonds he marks down even further, given that 10-year TIPS yields are at approximately 60 basis points[1]—so the current equity premium is likely even higher than historical averages(Siegel estimates the equity premium to be about 4.4% now compared to 3.2% historically).
- On "open secret" factor investing with value and momentum: The Alpha Architects team employs very concentrated portfolio-value and momentum investment philosophy. We talked about whether these "open secrets" for excess returns will ever get arbitraged away by the markets. Gray believes these two factors work due both to an element of risk in these strategies as well as a mispricing element.
    - Will there be massive amounts of "permanent" capital coming into value strategies to remove the mispricing component? Gray is skeptical that we've seen "armies of Warren Buffetts" coming into the market fully embracing a value discipline. He thinks, by contrast, we may witness more performance chasing flow in exchange-traded fund strategies, as well as standard human behavior, which may serve to *amplify* historical factor returns.
- Are you active or passive? Alpha Architects embraces a self-indexing model that some might describe as passive, but its indexes by design employ almost as significant active risk as possible with a very concentrated 40 stock portfolios—equally weighted with no sector constraints. Gray refers to this model as career suicide but thinks few people are focused on super-concentrated, high-octane "active" portfolios that really are geared to the academic factors that drive returns.

- For those looking for the anti-Amazon portfolio, his quantitative value index today has over 50% in the Consumer Discretionary sector—most of which is right in the crosshairs of Amazon. Deep-value contrarian investors always have to own the most hated part of the market, which today is anything that will be hurt by Amazon's dominance. But perhaps these stocks will not be hurt by as much as being factored into prices.
- On being a reformed stock picker: Gray talks about how he used to be a hard-core stock picker and thought quant investing was "insane," but after "getting his face ripped off" and having to "eat humble pie," he started approaching investing with a systematic discipline and feels that is the most sustainable style of investing.

In the second half of the conversation, we also spoke with Charlie Tian of GuruFocus.com, who has a new book, *Invest Like a Guru*. It was interesting to hear how Tian started his career in fiber optics and got swept up in the tech bubble of the late 1990s. This led Tian to read all of Buffett's shareholder letters, along with writings by other gurus, including Peter Lynch. His website provides a portfolio screener to make it easier to invest like a guru. There is a big emphasis on value investing, but also focusing on good companies, with a quality focus.

I want to thank Alpha Architects' Wes Gray for spending time with us in the studio, as well as Charlie Tian, who shared his knowledge on quality investing.

Listen to the full podcast here.

[1]Bloomberg, 7/10/17.

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DEFINITIONS

Equity premium : the excess return that investors may receive over the risk free rate as compensation for taking on the relatively higher risk associated with equit.

TIPS : Treasury Inflation Protected Securities.

Basis point : 1/100th of 1 percent.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Momentum Factor : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Excess Returns : refers to investment returns on a securities above that of a benchmark or index exhibiting similar risk characteristics.

Arbitrage Mechanism : The ability to compare the price of an ETF and its underlying basket and exchange one for the other utilizing the creation and redemption process.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.