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ROB DAVIES

FUNDAMENTALS

ANYONE who watched the recent exchange on US TV between comedian Jon Stewart and former hedge fund manager Jim Cramer would surely agree with Stewart's opinion that there are two markets out there: the long-term cautious savers (like Stewart's mother) and the short term traders looking for returns over days or weeks rather than decades.

But what is only slowly becoming apparent is that it is the rise of long-term passive (index-tracker) investing that has allowed such frenetic short-term activity to take place. Short-term, fast money, is needed to redress the imbalances created by the long-term passive investment process. The mechanism that relates the two is stock lending, but there are other connections as well.

Unfairly blamed for creating instability in the markets, short-sellers of expensive overvalued stocks are actually now more important than ever to correct the wrong valuations resulting from automated buying of index trackers. And where do short-sellers get their stock from? Index funds, of course.

Index funds can only compete on price, so annual management charges have been driven down and down. Some retail index funds, like Virgin, still charge an eye-watering 1%. More typically, fees are closer to 0.5% for funds the public can buy. However, in the institutional space fees can be as low as 0.1%. In that environment the only way index funds can survive is to lend stock out. Who wants the stock? The short-sellers do; so that they can bring valuations back to the correct level.

So this is the reason for the two-tier market. More and more long-term money is giving up on active management and is being placed in index funds, which allocate capital proportionately according to the size of the stock. That creates valuation distortions, which means an increasing need for short-term traders to correct these distortions by borrowing stock from these self-same funds. And that process can be painful for investors like Jon Stewart's mother. The only way to resolve the conflict is to get long-term money allocated correctly in the first place by using more fundamental measures than simply share price.

The inherent illogicality of just using price to allocate capital reached its apotheosis in the dot-com boom when small technology companies became very popular. As they rose in value they attracted index money. Being small, often illiquid, companies a small amount of index money had a disproportionate effect on the share price. That pushed the shares even higher and the cycle was repeated. Eventually tiny and unprofitable companies became constituents of the FTSE-100 such as Baltimore and ARM. The worst example of all was Vodafone. As a consequence of its hubristic takeover of Mannesmann it grew to represent 15% of the index, yet it actually made very little money at that time.

One might ask why Vodafone made such an expensive acquisition, or why RBS was so keen to buy ABN Amro? Well, if the market is going to value your company purely on size then surely it is the duty of every chief executive and his board to grow his company as much and as fast as he can. It is very much a case of never mind the quality, feel the width. Big companies became bigger just because, well, they were bigger. Advocates of passive, market cap-based, indexing know their process is flawed. But we argue that it is up to active fund managers to bring the market back into line with reality.

Rob Davies is founder of Glasgow-based Fundamental Tracker Investment Management


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