



Under the Hood: What's in *Your* Index?

(An Ongoing Series – April 2016)

How Indexation is Creating New Opportunities for Short-Sellers, And Why This Should Alarm Ordinary Buyers of Stock and Bond ETFs

Part 1: The Short Sellers' Lost Decade

The emergence of indexation as the dominant mode of investing, combined with artificially low interest rates, has made it difficult for classical hedge funds to identify attractive short sale candidates, at least until recently.

Artificially low interest rates enabled otherwise troubled short-sale candidate companies to refinance their high-coupon bonds or to be acquired or restructured by private equity and activist investors financed with ultra-low-cost debt.

Indexation inflated the valuation multiples even of companies with poor business fundamentals. Low-risk-profile (i.e., low beta) indexes gathered huge amounts of assets, driving enormous demand for stocks with desirable characteristics simply as raw material for ETFs: trading liquidity, low-volatility statistics, and certain sector representations – the ETF inclusion rules are pretty much silent on the issue of valuation. (In contrast, a well-managed company's stock might trade at a low valuation for no reason other than that its statistical characteristics do not qualify it for index inclusion.)

As is usually the case when an idea is pushed to the extreme, this dynamic has now led to new investment opportunities, to be explored next time.

Part 2: Spoiler Alert: Low Volatility Indexes ≠ Low Risk Indexes

Index funds and other quantitative strategies have taken the quest for low-volatility investment opportunities to such an extreme that they have inadvertently created a low-risk mechanism to inexpensively hedge portfolios. (This means that short-sellers believe that the risk of these indexes rising significantly – which would hurt them – is low, and that they are more likely to fall sharply than to appreciate.) One of these is the iShares MSCI USA Minimum Volatility ETF (USMV). Its \$10.8 billion of net assets¹ is composed of stocks that have demonstrated low price volatility. They include the well-known “brand companies,” such as McDonald's, General Mills, Coca-Cola, and Procter & Gamble. However, these are now demonstrably mature, with either declining or essentially flat revenues over the past several years.

USMV also includes top 10 positions in AT&T and Verizon, but one can't avoid seeing competitors advertising to have customers switch carriers based on deeply discounted price plans. Cellphone service is a classically high-fixed-cost, low-marginal-cost business: if the incumbent service providers are forced to lower their prices, there will be a virtually undiluted impact on operating income.

Two major sectors in USMV are REITs and electric utilities. Used as bond substitutes in a yield-starved world, they exhibit low price volatility because of both declining interest rates and continuous buying by index funds. They trade at all-time high valuations. The REITs in USMV are trading at an average yield of



only about 3%, or more than 30x earnings. The utilities are trading at a remarkably low 3.5% dividend yield. These different sectors do not represent diversification. They simply represent additional ways to have very long-dated exposures to interest rates at an historic low—or put differently, additional ways to suffer severe losses if long-term rates rise. Moreover, electric utilities are facing a rapidly expanding demand threat from the popularization of rooftop solar panels. For utilities, just a percentage point or two of demand deficit represents tipping point issues relative to the ability to expand earnings at all or to earn sufficient returns on high-cost historical plant and equipment to support dividends.

Part 3: Why a Short Seller Should Love the Low Volatility Indexes

2 views of the iShares MSCI USA Minimum Volatility ETF (USMV):

Here's the market's picture of USMV (via its statistical profile):

Offers an equity beta of 0.66 and a standard deviation of 9.01%², as against a 3-year annualized return of 15.4%³. USMV's return is a somewhat higher return than the S&P 500, which has a return of 15.1% over the same period but, importantly, with lower volatility (S&P beta of 1.00 and standard deviation of 10.95%).

Here's a short-seller's picture of USMV (and similar low-volatility funds):

Consists of mature companies and industries that will or have already experienced slowing or declining revenue and earnings. Relative to that reality, they trade at egregiously high valuations (an average P/E ratio for USMV of 24.1x) and are therefore vulnerable to higher interest rates, competitive pressure, or failure to meet analysts' earnings projections that continue to exceed actual experience. They also present minimal surprise risk to a short seller, because they also lack the positive optionality inherent even in an overvalued biotechnology stock or a technology company.

Part 4: Low Betas Absolutely Will NOT Protect You From Volatility. How's That?

Equity beta, which is the primary statistical measure by which ETFs select low-volatility securities, and by which investors select low-volatility ETFs, is a calculation that rests on precarious ground:

First, there is the matter of the ongoing net flow of funds into such stocks and ETFs over the past half-decade. With this constant-bid phenomenon underpinning these stock prices, are the index organizers measuring the intrinsic properties of these companies or are they simply measuring their own asset allocation behavior, in a great self-reference paradox?

Second, the volatility statistics are based upon 1-year or 3-year or 5-year measurement periods. So, does that capture the volatility behavior of REITs in 2007 to 2009, when even the shares of the best companies (like Simon Property Group) fell by 70%? How can it capture the behavior of newly mature large-cap consumer brand companies (like McDonald's) if their history in the prior 50+ years was one of national and international expansion? And how can it capture the impact of price competition in cellular or from solar power if that's never happened before, although the early stages are quite visible?

Comfortingly low beta and standard deviation statistics will stay low until various companies or sectors in the low-volatility indexes suddenly experience price volatility. Then those companies will demonstrate high betas, after which they will be ejected from the indexes, to be replaced by new low-volatility securities. But low-volatility indexes will decline all the same.



¹ as of March 23, 2016

² as of February 29, 2016

³ as of December 31, 2015

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