QE: quantitative entanglement, “spooky action at a distance”

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An interest in nature, science, history and art have supplemented my interests of being a continuous observer of the capital markets. Over time I often find myself looking for parallels in the other sciences to provide insights into the capital markets. The performance of Q4 2018 was one which amplified my search (and most other investors) for answers wisdom and explanations. While it was no 2008, it’s one thing to see a sharp sell-off in one market or a cluster of markets; it’s quite another thing to see essentially every asset class, all synchronize in unison to the downside. These were the unusual conditions that global investors witnessed during Q4 last year which essentially wiped out the positive returns of the first half of the year.

Earlier this year I was introduced to the physical phenomena called quantum entanglement (the other QE, not quantitative easing) and was fascinated to learn about it. Einstein colorfully dismissed quantum entanglement “as spooky action at a distance”. It remains one of the strangest aspects of quantum physics and essentially recognizes, that “if you observe an atomic particle in one place, another particle, even one light-year away, will instantly change its properties as if the two are connected by a mysterious communication channel.” The two particles become linked. This unusual and mysterious connectivity seemed relevant to the fourth quarter 2018 when global asset classes sold off in a rare and “spooky action”. I started to wonder was there a “quantum entanglement” of financial assets and some mysterious communication network linking them? Of course not, I concluded. There was nothing mysterious at all, but I hypothesized that the ubiquitous information and the universal interpretation of it, is probably the root of rising financial asset class covariance. Of course, technology and social networks have heighted the speed in the linkage of the worlds’ capital markets (this is not a new observation), but an additional thought was that especially in the public markets, large capital has become concentrated in perhaps fewer and different hands than in the past. Whether it is the global central banks acting in accordance with the same playbook (new linkage) or whether it’s the passive indices and ETF’s that buy and or sell in formulaic mixes based on matching the weightings of indices, these are some changes to the capital markets today and sources of new “entanglement” and systemic risk. In the past it was the concentration of leveraged exposure in the global banking sector, today the concentration is occurring in other areas that are increasing conditions of a *crowded trade* which might explain the rising covariance of returns across asset classes. Furthermore, because no major asset class offered satisfying protection, I resumed my questioning of whether the traditional 60%/40% “plain vanilla” equity/fixed income asset allocation model will be effective prospectively to deliver balanced policy returns for investors trained under this 60/40 paradigm. There is no doubt that global pension funds, and others with finite liability streams, have continuous pressure for absolute returns and the quest for alternatives to all simplified equity and fixed income are being aggressively sought around the world.

Much has been written about the synchronized central bank policies and the beta trade of being long risk, after the financial crisis so I won't dive too deeply on this matter now. It's sufficient to say that quantitative easing can largely explain the public and private equity market recoveries, the strengthening of the credit markets and the return directionally to broad global economic stability since 2009. Adhering to the maxim of "don't fight the Fed" has been a great wealth accumulation strategy over the last 10 years or more; but today buying ahead of what the Fed buys, is now in reverse. The Fed is the first to apply braking which means that it's probably imprudent to be long what the Fed is in effect selling during its QE unwind/pausing phase. Central bank policy stances (relative tightening/loosening speed) still underpins and preoccupies the fixed income, equities and currency markets globally. Headlines and explanations of last quarter's market behavior are predominantly ascribed to pivots in Fed policy and its leading indication of economic momentum and global interest rate policy but the media, loving to create stories for the insatiable appetite of global investors contiguously throws out its litany of reasons for market behavior.

The other structural change has been the market share impact of the passive industry relative to the active industry. In the last ten years the ETF concentration of markets have gone from $700 billion to somewhere around $5 trillion today. Some critics assert that this concentration of ownership, while it has been a cheap way to own "diversified" equity exposure, that it will be the next origin of synchronized financial hardship. The argument goes that ETF's and their indiscriminate buying, has led to a divorce of fundamentals and judgment and in effect all of the ETF money goes into the same companies based on market capitalizations. Hence larger companies receive increasing valuations whereas smaller companies not included in an index become illiquid, and a fundamentally forgotten because there is no promotion of the company and little real comprehensible transparency. Hence the ETF industry has in some respect weakened the premise of the public markets as a way to allocate capital to merited smaller businesses. Materially reduced commissions on equity trading, scarcity of fundamental research, fewer IPO opportunities for lower middle market companies, mean that unless your company has unicorn characteristics like Uber etc. it is becoming less likely to envision going public or maintaining that status.

These conditions have been in part a source of a continued driver of growth in private equity which is premised on largely conducting knowledgeable buy-side research, adding value through acquisitions build-ups, cost cutting, digitalization strategies and prudently managing more leveraged balance sheets etc. There is a growing body of sophisticated institutional investors that construct portfolios using a combination of passive exposure to gain access to the large public industry champions and then utilizing active approaches through PE as the last bastion of merited active approaches to gain true diversification because they understand that buying an index through an ETF's can be just disguised exposure to the largest capitalized companies.

A credible source of validation to the above views on asset allocation are evident in observing the investment strategy and policy of Warren Buffet's company Berkshire Hathaway. What Mr. Buffet gets plenty of media attention on is his philosophy in picking buy-and-hold long-term franchise equity-oriented investments. The emphasis on buying right, allowing for long term compounding, deferring tax leakage are all well-known causes for his extraordinary wealth creation for his shareholders. His preferences for high margins, defensible moats, franchise like characteristics and the strength of a company's brand have become the *ten commandments* for every CFA and MBA student. He spends little to no time publishing his views or acting on the temporal news flow about Fed policy changes, political noises, risk of fears of recessions. Rather Mr. Buffet stays long term focused and is not shaken by the news flow that can magnify anxieties and cause less committed investors to react in fear.

What is not discussed so frequently about Mr. Buffet's strategies is the way he constructs asset allocation in order to achieve his long-term superior results. Upon examination it is evident that Buffet has a few engines of investment success and he refers to these engines as “groves” in this years’ annual letter. Grove number one, that generates the majority of the company’s earnings is his private equity allocation. Here his strategy is more buy-and-hold private companies done in “partnership” with management teams; not necessarily PE General Partners but “partners” as in management teams that are fully aligned with the shareholders and incented accordingly. He holds control positions almost all of the time and generally aims to hold in perpetuity. Grove number two is his allocation to public equities; usually positions in market leaders that also meet his well published buy-and-hold criteria. What is not that commonly discussed is the way this portfolio is actually constructed. At the moment it is predominantly allocated (46% of public equities grove) to systemically relevant US financials including the likes of Bank of America, Wells Fargo, American Express etc. It is quite telling to see the expression of views on the strength of the US banking sector and that this public equity grove is definitely not a replicant of a broadly diversified US financials equity ETF. Even though Mr. Buffet is often quoted as saying just buy the S&P 500, his own asset allocation is overweight Private Equity (subsidiaries) and allocated to public equities in a sector concentrated manner. The maxim “actions speak louder than words” applies.

The third largest grove and earnings producer is the control exposure to insurance companies. Insurance is a particularly interesting asset allocation premise for Mr. Buffet. He looks at it as a capital sourcing machine meaning that if one can write insurance and maintain a combined ratio below 100% (The sum of loss ratios and operational expenses associated with insurance operations), then the business generates excess capital. When that capital is invested successfully it in effect delivers positive float on investment earnings. Because insurance operations are regulated to insure claims paying capacity, a good portion of this surplus capital is held in US Treasuries and is designated as a grove in its own right. While Mr. Buffet makes no particular reference to active management of this portion of the portfolio, he has said that to the extent that this cash not trapped for insurance reserve purposes, it is cash that is idling warm and ready to be deployed into a private equity control acquisition in or into public company franchise entities.

All of the above dynamics of the ETF industry, the weakened premise of the “plain vanilla” fixed income allocation, the public equity market volatility and the reviews of Mr. Buffet’s own particular asset allocation are all encouraging validation to the private market focused and proactive investment strategies we are advising on for our clients.

We all thank you for your trust and confidence in allowing us to share the stewardship journey to achieve your financial and other goals.

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