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Vexing Today's Convex Pricing Behavior

Dear fellow investors,

After getting into our offices around 8:30am Eastern on Monday morning, I was lucky enough to catch an interview with famed short seller Carson Block of Muddy Waters. As expected, CNBC anchor Andrew Ross Sorkin asked about GameStop and short sellers. Block provided his answer, but then went on to say:

> *...But the bigger issue really is that when you get down to what actually causes this. I'm going to throw something out there that I suspect a vast majority of your listeners have not heard, but a lot of this disfunction is being driven by the prevalence of passive investing. I want to say one thing before questions come my way. Yes, I knew about the robo-bid and I knew that fundamentals are irrelevant to the robo-bid or passive investors. What I didn't appreciate is that as passive grows in a float that It actually creates convex pricing behavior. It basically becomes the driver of growth and it is in my mind, based on my understanding now, it's the single biggest explanation for why growth as a style has massively outperformed value. Again, it's not tied to fundamentals. It's tied to supply and demand.*

His use of the word convex is interesting because convexity is typically only discussed with bonds. As bond yields fall, convexity explains the underestimation of bond prices from a linear view. The inverse is true as well, causing a curvature of bond pricing relative to a linear relationship of bond prices and bond yields. To simplify this, convexity explains how bond prices increase in a more rapid fashion as yields fall. In fact, zero-coupon bonds that only pay interest upon maturity exhibit the most rapid increases (high convexity) in price as bond yields fall.

However, Carson was not trying to teach us about bond yields and pricing in his use of the word convex. He was explaining that the planned buying among passive participants is causing a similar curvature. Planned buying would happen among 401(k) plans, high income savers and wealthy business owners automatically investing into the equity markets. These types of investors have continued to gravitate their investments from a price-sensitive investment vehicle (active) to a price inelastic vehicle (passive). Passive was a small part of the stock market 20 years ago, with only folks like Vanguard, Motley Fool and William Sharpe peddling the idea. The lack of size allowed these early adopters to benefit as they were a small part of the total float of the stock market and individual securities, to Block's point.

Today, it might represent 60% of U.S. large cap stocks alone. This may be underrepresented because of what the closet-indexing active management community is doing to try to keep up with the convexity. They may only charge your mutual fund 50 basis points for this type of closet-indexing, but good luck. Either way, the 50 basis points is statistically not likely to help you as the investor, but the board of that mutual fund will still get paid.

To move on to William Sharpe's original idea of passive investing, he said:

> *Should everyone index everything? The answer is resoundingly no. In fact, if everyone indexed, capital markets would cease to provide the relatively efficient security prices that make indexing an attractive strategy for some investors. All the research undertaken by active managers keeps prices closer to values, enabling indexed investors to catch a free ride without paying the costs. Thus there is a fragile equilibrium in which some investors choose to index some or all of their money, while the rest continue to search for mispriced securities.*

Sharpe's statement is prima facie to us at Smead Capital Management. We have crossed the Rubicon to the point where Sharpe says that the "capital market would cease to provide relatively efficient security prices." Sharpe foreshadowed the problems of today in his statement. Professionals like Carson Block are just now realizing the problem that passive has created in the convex pricing structure. Much like zero coupon bonds, low bond yield and cash flows way out into the future for many of these companies only exacerbate the convexity.

Unlike Block, we find this environment to be the opportunity of a lifetime. Humans do one thing extremely well: they buy high and sell low. The majority of investors suffer stock market failure. In a Charlie Munger approach, you would invert today's circumstances to recognize that there is a myriad of businesses that don't require you to look into the future like the zero-coupon bond or the company that will someday produce free cash flow. In fact, you can buy many businesses for less than the value of their assets and not have to worry about the cash flow in the near-term or long-term.

We believe this may vex the institutional and individual stock market participants over the next decade. The way to begin taking advantage of today's convex price behavior would be to look into sectors/industries like energy and mall REITS. These companies have gained an insignificant amount of benefit from the convex price behavior of the passive investor. As of the date of writing, energy is only 2.53% of the passive S&P 500 Index. This means the automatic buyers don't buy much. Our two mall REITS together represent 0.10% of the S&P 500. To say we own quite a bit more would be an understatement!

Fortunately, human behavior has a history of repeating itself at extremes. The worst buying decisions are made at the top. Just like bonds, the convexity is true when yields rise going forward. It's a slippery slope and could be vexing.

Fear stock market failure my friends,

Cole Smead, CFA

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