Read Time: 5 minutes

The Nub. The nub of this note is telegraphed by its title, with passive surrounded by quotes to underscore the fact that **all** investment strategies, even and indeed especially ultra-diversified ones, entail the exercise of human judgment. How so? Because no one has assembled or indeed **could** assemble a portfolio comprising fractional interests in **all** investable assets — not without making crucial judgments about which assets to include, in what weights, and not without somehow compelling pre-existing owners of non-marketable assets to sell slices of them to complete the exercise. Of course, no sensible investor would **want** to hold a truly comprehensive basket of investable assets, especially one constructed in accordance with the most widely followed rule for "passive" portfolio construction *circa* 2019, namely capitalization weighting. As foolish as that rule is when applied in multi-asset contexts — do you really want to add incrementally to your Tesla or Venezuelan bond positions merely because the powers-that-be at Tesla or Venezuela borrow more dough? — it also tends to be sub-optimal when applied within the original and still-largest arena for indexed strategies, namely marketable stocks. To be sure, cap-weighting is often the least-worst approach for investors seeking to minimize costs or benchmark risk or both. Alas, given the large and growing universe of benchmarks or indexes and in turn index funds to choose among, "going passive" in a truly thoughtful manner with all or even part of an institution's or wealthy family's investable capital is much trickier than many fiduciaries believe.

Obvious Truths. Imagine one were tasked with assembling the broadest possible portfolio of investable assets — a sensible endeavor for investors who've concluded that incremental gains from more selective approaches are unlikely to offset the incremental costs and hassles of same. (For what it is worth, we believe most investors spend far too much time and money trying to outperform the markets in which they invest.) Would a capitalization-weighted basket of the stocks that certain employees of Standard & Poor's have blessed in constructing that firm's eponymous 500 stock index make the cut for at least a portion of our hypothetical all-asset portfolio? It almost certainly would if one polled the typical US-based fiduciary using passive strategies, notwithstanding the S&P 500's somewhat peculiar ~~defects~~ attributes: (1) considerable turnover if held over the multi-decade time horizons over which stocks reliably outperform bonds and cash (today's S&P 500 looks nothing like that of 1998, to say nothing of '88 … or '78, etc.); (2) the ongoing exercise of human judgment respecting constituent stocks (when firms merge, go belly up, or morph in certain other ways, the aforementioned S&P employees necessarily rejigger the Index, minimally on most occasions but materially over time); and (3) big opportunity costs for all but the largest and least nimble investors. Determined as we are to limit this note to an eminently digestible length, we won't furnish here evidence proving that the S&P 500 if not also other cap-weighted constructs are guilty as just charged, but rather will point readers to such evidence in an endnote.[1] In doing so, we'll remind readers of an obvious truth about investing that we try to keep top of mind when vetting potential strategies and managers: just as there is no otherwise sound investment strategy capable of generating attractive returns if the costs of using it are raised high enough, there's no otherwise unsound investment strategy capable of generating attractive returns even if the costs of using it are lowered to zero.

Deceptively Difficult. Turning back to the imaginary but nonetheless instructive task of constructing the broadest possible portfolio of investable assets, what government bonds would make the cut and in what proportions? Surely US treasuries (USTs) would get included, comprising as they do the world's largest pool of any single sovereign's debt obligations. What about Japanese government bonds? If size truly matters, JGBs would surely make the cut, comprising as **they** do the world's second largest pool of such obligations — approaching $10 trillion as against roughly twice that for Uncle Sam. Wait: you're vexed by the fact that Japan's GDP is just one-fourth as large as America's, thus theoretically if not actually making JGBs much riskier than USTs for dollar-based investors even before taking currency risks into account? Geez: this is getting complicated. What if we ditch the idea of constructing a hyper-diversified multi-asset portfolio and focus on the narrower task of building a fully diversified and hence globalized **stock** portfolio? As noted above, for most US-based investors, the S&P 500 or something like it would surely comprise a substantial part of such a construct — a logical choice given that stocks comprising the S&P 500 have an aggregate capitalization equaling roughly one-third of the planet's 13,000-odd publicly-traded stocks (about $25 trillion for the S&P 500 as compared to roughly $75 trillion for all listed stocks worldwide).

Cheesecake Anyone? What about Canadian stocks? Quite apart from the happy fact that Canadians are invariably courteous and kind (certain pro hockey players excepted), Canadian stocks have delivered perfectly satisfactory returns; indeed, on a cap-weighted basis, they’ve actually outperformed US stocks over the last 20 years — the longest time period for which we have wholly reliable apples-to-apples data (i.e., total returns in US dollar terms net of applicable withholding taxes) for a truly wide range of investable assets. Interestingly and importantly, the same fact — ugly or not, depending on one’s perspective — rears its head when one compares the S&P 500’s returns over the last 20 years to those of emerging market stocks … or US-focused real estate investment trusts … or long-dated US treasury bonds, all of which have outpaced the S&P 500 over the last two decades and all of which are available for purchase via index funds, albeit at annualized costs typically exceeding the vanishingly low costs of their “passive” counterparts tracking the S&P 500.[2] In short, even if investors limit their menu of potential investment choices to “passive” strategies only, the resulting bill of fare resembles a Cheesecake Factory menu: bulky and varied enough to raise doubts that most items on it are truly worthy of consumption.

Einstein Had It Right. Paraphrasing Samuel Putnam’s famed dictum in the judicial opinion establishing the so-called prudent man rule — “Do what you will; the capital is at hazard” — do what you will as an investor, all investment choices are exactly that: judgments whose soundness depend on the knowledge, experience, temperament, and especially incentives of the human beings making them, be they principals acting on their own behalves or agents acting on behalf of others.[3] Dedicated as we at New Providence are to helping clients achieve their investment goals, we’re certainly able and necessarily willing to employ whatever strategies are best suited to such pursuits, including those commonly described as passive. That said, we’re under no illusion that the rapidly expanding universe of low cost index funds is making it easier for thoughtful allocators to deploy capital; if anything, the burgeoning popularity of indexed approaches to capital deployment is making it harder for conscientious stewards of multi-generation investment programs to fashion and **stick with** strategies conducive to achievement of such programs’ stated aims. **That** said, we relish the challenges that indexation’s growing popularity and complexity are spawning, mindful that, as Einstein said, “In the middle of difficulty lies opportunity.” [4]

Endnotes

[1] To its credit, S&P acknowledges that its vaunted 500 stock index is in essence an actively-managed portfolio; see *inter alia* S&P honcho David Blitzer’s arrestingly candid essay entitled “Inside the S&P 500: An Active Committee”. The sub-optimality of cap-weighted portfolios is discussed thoroughly and persuasively (in our view) in an essay by Jason Hsu entitled “Cap-Weighted Portfolios Are Sub-Optimal Portfolios” in Vol. 4, No. 3 (2006) of the *Journal of Investment Management*. While there are literally thousands of other articles about the use and abuse of indexed strategies, in an effort to help readers seeking greater understanding of the topic obtain it as efficiently as possible, we’ll point them to the fine series of articles on indexing published by Jason’s former employer, Research Affiliates, with emphasis on the essay by Arnott, Kalesnik and Wu entitled “Buy High and Sell Low with Index Funds!”. We commend that essay to readers not only because it’s relatively fresh (June 2018 initial publication) but also because it contains an excellent bibliography of choiceworthy books and articles on indexing. No need for the New Prov team to reinvent that particular wheel, not when the hard-working and discerning folks at RA have already fashioned it!

[2] Over this same 20-year interval, the corresponding annualized total returns for the other asset classes mentioned in the linked text were +8.1% for emerging market stocks (as measured by the MSCI Emerging Markets IMI), +9.8% for real estate investment trusts (as measured by the S&P US REIT Index), and +6.1% for long-dated US treasuries (as measured by the Bloomberg Barclays US Aggregate Government Treasury Long Index).

[3] The quoted words are excerpted from Justice Putnam’s opinion for the Supreme Judicial Court of Massachusetts in *Harvard College v. Amory* (1830).

[4] At this writing (early 2019), the New Providence team is especially focused on long-term investment opportunities in Asia — a region in which nearly 60% of the world’s roughly 13,000 publicly-traded companies are domiciled and in which roughly one-third of global GDP gets produced. At present, Asia’s roughly 8,000 public companies as a group account for less than one-fourth of global listed stock market capitalization, with vastly fewer than one-fourth of the world’s concededly oversized population of investment pros focused on the ongoing analysis of such companies’ evolving prospects and valuations. A robust and expanding set of materials prepared by our team on investment opportunities and perils in Asia is available upon request.