John Dessauer Investments, Inc.

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John Dessauer's market review and update as of Wednesday October 5, 2016

For weeks, stocks have been up one day and down the next. There was a relief rally when the Federal Reserve left interest rates unchanged last month. But investors still have plenty to worry about. The economy is still growing very slowly. Second quarter U.S. GDP growth was revised up, from a 1.1% annual rate to 1.4% - still far short of the 3% pace during past recoveries. The U.S. economy remains stalled in a long term, slow growth mode. But there continues to be good news from individual companies. PepsiCo, for example, delivered quarterly results much better than expected. And there has been confirmation of Intel's good news from other technology companies that indeed PC demand, while not earth shattering, is stronger than expected. Overall the U.S. economy is growing slowly. However, there are pockets of prosperity. Likewise, while broad measures of corporate profits are sluggish, there are pockets of growth - enough to provide solid support for the stock market. If widely different companies like Intel and PepsiCo can deliver pleasant surprises then there is hope for many other companies as well.

The news that the Personal Computer (PC) is not as dead as predicted should not be a surprise. Yes, new technology has made cell phones and small portable tablets capable of doing what once required a computer, but there is a point where small isn't good enough and a larger screen and more internal computing power are needed. The technology that has made cell phones so popular is still at work, now making laptop computers lighter, faster, and more efficient. Solid state hard drives have arrived. They have no moving parts, no spinning disks and are incredibly fast. There are new faster ports, Thunderbolt being one example. And there are new processors. All of these developments make laptops far more portable and attractive. You can watch a favorite movie or play a favorite game on your cell phone, but it is more enjoyable on a 13 or 14 inch laptop screen. Research and development is also benefiting desk top PCs. Storage capacity has increased dramatically. Monitors have much better screen resolution and color accuracy. All sorts of devices, including keyboards and the mouse, can connect wirelessly. And the desk top tower is getting smaller. Those who predicted the end of the PC apparently did not consider the possibility that technology would make the PC more efficient and overall more attractive.

Passive investing - using index funds - is becoming very popular. Why pay higher fees to managers of actively managed mutual funds if they can't beat the market? The problem is that, like other investing techniques, passive investing works only as long as it is not too popular. If too many investors turn to passive investing, ownership in large, market dominating, companies becomes concentrated. A handful of fund managers would become controlling shareholders, raising all sorts of issues, regulatory and financial.

Since 2008 American investors have taken $600 billion out of actively managed equity mutual funds and added $1 trillion to index funds. Researchers at the University of Amsterdam track the holdings of the "big three," asset managers, Blackrock, Vanguard and State Street. Treated as a single entity, they would be the largest shareholder in just over 40% of publicly traded American companies. Those companies represent 80% of the U.S. stock market's capitalization. Passive investing has already become so popular that the serious questions about influence - even control - are now being raised.

Harvard University has a huge, $35+ billion endowment fund, actively managed by a team of 200 highly paid investment advisors. Over the last five and ten year periods the fund has underperformed a passive basket of 60% stocks and 40% bonds. The last twelve months have also been bad news for the fund's managers. Pressure is building for Harvard to move to passive investing to save tens of millions of dollars in salaries and get better results. You can be sure Harvard is not the only endowment fund feeling the pressure to switch to passive investing.

One of the serious issues with concentrated ownership is competition. Martin Schmalz of the University of Michigan, along with co-authors, has recently published a series of papers about the anti-competitive aspects of concentrated ownership. They found that institutional investors own 77% of the shares of the companies providing services along the average airline route. And 44% of the shares are controlled by the top five investors. This level of concentrated ownership is far higher than what the Department of Justice considers questionable in anti-trust matters. And the researchers found that airfares are 3%-5% higher than they would be if the ownership were more diverse. If you were the controlling shareholder in a dozen airlines would you want one or more of them to be cutting fares to increase business? That would not be in your best interests. Your investment would be best served by having all the airlines cooperate to keep fares at the most profitable level. This is all theoretical for now. But, academics are correct to be carefully studying what looks to be a market changing trend to passive investing.

Executive paychecks have long been popular political targets. That may increase because the University of Michigan researchers found that managers of large funds often approve large pay packages for executives no matter whether they are preforming well or not.

The great irony is, as analysts at Sanford C Bernstein, a research firm said: “If passive investors took over the market entirely, unexploited opportunities would abound, active strategies would thrive and the passive-fund march would stall.”

Perhaps we don’t have to wait for passive investing to take over the entire market. As the march to index funds proceeds, there are fewer and fewer investors and fund managers looking for unexploited opportunities. One reason so many mutual fund managers have trouble beating the market is that, at any given time, the universe of real unexploited opportunities is limited. It may well be that as passive investing gains popularity, its reason for growth may disappear as the remaining active fund managers exploit opportunities and consistently beat the market.

I will have the next market review and update for you one week from today on Wednesday October 12, 2016.

All the best,

John Dessauer