V 2020

HOW MUCH TIME DO YOU HAVE FOR... ETFs?

two SECONDS

ETFs are warping our capital markets, making them more dangerous, less efficient, and a whole lot dumber.

ONE MINUTE

To examine the distortive effects of ETFs, Real Vision spoke to Horizon Kinetics founder, Steven Bregman, about market darling Amazon – whose stock has marched relentlessly higher since 2008.

Amazon's climb from around $50 to over $1,000 would be impressive for any company. But for a business with hardly any net profits to show for its gigantic market share – it's downright incredible. Some would say nonsensical.

Here's where the ETFs come in.

Amazon is the fourth largest stock in the S&P 500 and therefore the fourth largest holding of SPY, the hugely popular ETF that tracks the S&P 500.

This is because, like the S&P 500, SPY weights its holdings by size. And because Amazon is a huge company, SPY owns a huge $4.5 billion chunk of Amazon – or approximately 1% of Amazon's market cap.

This makes for perfectly circular logic:

Q: Why is Amazon so large?

A: Because hundreds of ETFs own Amazon stock and buy more every week.

Q: Why do ETFs continue to buy billions worth of Amazon stock?

A: Because Amazon is large.

Indeed, according to research website ETFdb.com, 181 ETFs own chunks of Amazon. This means that ETFs have funneled tens of billions of dollars into Amazon stock.

Remember... index ETFs are passive vehicles. They allocate money based on pre-set rules. Index ETF managers don't care if a company is grossly overvalued... or consistently loses money... or is saddled with incompetent management.

Most of them care only about the size of a company. The bigger it is, the more stock they buy.

Multiply this effect across the markets and you'll find that ETFs have diverted hundreds of billions of dollars into certain favored stocks... regardless of their performance.

This is deeply worrying of course, but the distortion of valuations also means some stocks are relatively cheap and there are great opportunities out there too...

---

5 MINUTES

"The Dark Side of ETFs" is the title we chose for a series of recent discussions between our own Grant Williams and Horizon Kinetics founder Steven Bregman. Bregman has dedicated a good part of his career to studying ETFs.

The series – which explores how ETFs are disrupting the very way capital markets function – struck a chord with Real Vision subscribers. It's one of the highest-rated and most-viewed pieces of content we've produced since launching Real Vision three years ago.

As anyone who follows investment news knows, the proliferation of ETFs has come at the expense of Active Managers like hedge funds and mutual funds. Over the past several years, had you bought and held a U.S. index ETF, you would've outperformed 9.5 out of 10 active managers. This has led millions of investors to conclude that paying for active management is a waste of money.

If you are familiar with the role capital markets are supposed to play in society, you will understand why this may be a problem.

Capital markets exist to efficiently allocate capital to where it will do the most good, i.e. where profit opportunities are best. The job of an asset manager is to find these opportunities. On Wall Street, armies of Ivy League grads tweak financial models, study balance sheets, and discount cash flows in an attempt to best decide where to invest precious capital.

This does not mean asset managers always make the right decisions. But at least there is experience, instinct and a thought process involved. Contrast this to our Amazon example earlier, and recall that most index ETFs buy companies simply because they are... large.

It's important to recognize that the distortive effects of ETFs extend beyond the stock market. Consider the curious case of Lebanon's 10 year bond...

Lebanon is about the size of New Jersey and is located in the war-torn Middle East. Southern Lebanon is the home base of militant group Hezbollah and Lebanon's government has not published GDP statistics since 2008.

Given these "challenges," you'd expect to earn a premium for investing in Lebanon's bonds. Well, you may be disappointed to learn that Lebanon's 10 year bond yields is just 5.1%... less than U.S. burger chain Wendy's, which yields 6.3%.

The reason, according to Steven Bregman, is the wild popularity of certain ETFs that offer investors exposure to emerging market (EM) bonds. Many investors, drawn to high dividend yields, have plowed billions of dollars into these ETFs. So obviously, this has brought an influx of cash into the underlying EM bonds.

From there, the laws of supply and demand take over. A flood of cash chasing a scarce security – like Lebanese bonds – will always result in a low yield (high price). As Bregman pithily notes:

"Wendy's, if they were to reincorporate Lebanon, could save themselves 1.2 percentage points..."

Or consider this brief story of screwed up incentives...

As we mentioned earlier, many ETFs own stocks in proportion to the market capitalization of the stock. When a company conducts a share buyback, its market capitalization declines, because the purchased shares no longer trade on the open market.

So, despite the fact that a share buyback is theoretically bullish (management believes shares are undervalued), a buyback causes many index funds to sell shares and reduce their exposure to the company.

In other words, the exact opposite of what logic would dictate.

Finally, we come to ExxonMobil. ETF sponsors love large, liquid stocks and ExxonMobil is one of the largest, most liquid trading securities in the world. So, it's no surprise that, according to ETFdb.com, ExxonMobil stock is present in 211 different ETFs including...

...the iShares Core High Dividend ETF... the Russell 1000 Value ETF...the PowerShares 500 BuyWrite ETF... the First Trust Low Beta Income ETF... and the SPDR S&P 1500 Momentum ETF.

That's right, Exxon Mobil is a value stock and a momentum stock. And its widespread ownership among ETFs has done wonders for its stock price.

Between 2013 and 2016, ExxonMobil's revenue declined 45%... its earnings per share declined 74%... and its debt roughly doubled.

Yet its stock price went up during that period.

How's that for efficient markets?

Of course, at this point, one could argue that where there is inefficiency, there is opportunity.
And Bregman concluded our illuminating discussion by calling attention to forgotten securities – those stocks and bonds that, for one reason or another, are shunned by indexes and ETFs.

Here's Bregman:

"Look outside the 'ETF divide' and you will find some extremely well-run companies. Companies that are profitable, have strong balance sheets, and could be trading at half of book value. Companies that might have a 7% or 8% or 9% dividend yield. Companies that are actually growing."

He continued:

"Value investors used to have to look for companies with something wrong with them... then evaluate the reason why the stock price was down. Is it management? Is it process? Is the reason permanent or transitory?"

"Now there are stocks with low stock prices simply because they're not in an index..."

See you next week.

IF YOU ONLY LOOK AT ONE CHART

Emerging Markets have been star performers in 2017 and Brazil has been one of the leaders. Brazil appears to be recovering from a serious economic slump and political crisis.

Is this Brazil's time to shine?

The signs are promising.

6 DEGREES OF CONNECTION

1 US DOLLAR WEAKNESS

Since achieving a 14-year high in early January, the U.S. Dollar has dropped 11% - catching many traders and investors by surprise.

For most of 2017, the dominant narrative has been that a series of interest rate hikes by the Federal Reserve will continue to push the dollar higher. Instead, markets have punished the consensus – as they often do – and inflicted pain on dollar bulls.

The dollar now sits at multi-year lows, and is the worst performing major currency of 2017 by a significant margin. It has lost 12% against the Euro, 9% against the Canadian Dollar, and 6% vs. both the yen and Swiss Franc.

GOLD BREAKS OUT 2

It is no coincidence that as the only tangible currency (along with silver) that governments cannot create from thin air, gold typically rises when the U.S. dollar falls. Indeed, the recent correlation between the two is -0.91. So, it's no surprise that with the dollar struggling, gold has broken out to new 2017 highs.

In fact, gold has finally blasted through $1,300/oz. – an important level which it had challenged but failed to breach earlier this year. Many traders and chartists view $1,300 as a key boundary that, once breached, would signal that gold's rally is "for real."

3 GOLD MINERS REMAIN CHEAP

Despite gold's rally, gold mining stocks remain extremely cheap relative to the broad stock market. This is due, in part, to the strength of the S&P 500, which continues to levitate near all-time highs.

We can observe the cheapness of gold miners by comparing the S&P 500 to the popular gold mining ETF GDX. Today, one "share" of the S&P costs approximately 100X more than one unit of GDX. Since GDX's creation in 2006, this ratio has averaged just 55X.

From current levels, gold mining stocks would have to nearly double - or the S&P would have to be cut approximately in half - for the ratio to return to its historic average.

4 INVESTOR OVERCONFIDENCE

These S&P 500 all-time highs mean investors are brimming with confidence. According to Gallup, investor optimism has surged to a 17-year high – eclipsing even the euphoria seen during the raging bull market in US housing in the early-to-mid-2000s.

Investor overconfidence has been a key ingredient in some of the largest stock market bubbles and subsequent crashes in history. In fact, the last time investor confidence reached these levels was the year 2000. That euphoric peak preceded the dot-com crash, and led to peak-to-trough losses of 78% in the Nasdaq.

From today's levels, a 78% decline would knock the S&P down to about 550. Impossible? Maybe. But given the tendency of bear markets to overshoot to the downside, it's something to think about.

LACK OF CONFIDENCE IN POLITICIANS

5

In stark contrast to the extreme confidence of investors, Americans seem to have no confidence at all in their politicians. Pew Research reports that public trust in government is running at just 20%. Meanwhile, the latest Gallup polls show Americans' confidence in Congress is a pathetic 12%.

President Donald Trump's abysmal numbers have not helped matters. Just 38.8% of Americans approve of the job he's done so far as President, which sets a new all-time record for worst approval rating for a U.S. President in his second quarter on the job.

What's all the more amazing is that Presidential approval ratings are usually heavily influenced by how well the economy is performing. We can only imagine what Trump's approval rating would be if the stock market weren't at all-time highs or the headline unemployment rate weren't at decade lows...

6

TRUMP WANTS A WEAK DOLLAR

To combat his weakening popularity, Trump seems to believe a weaker dollar will help his cause. After largely supporting a strong dollar policy during his campaign, President Trump has now changed his tune. He's repeatedly called the dollar "too strong," and has said "lots of bad things happen with a strong dollar."

It's well within Trump's power to weaken the dollar further – possibly a great deal further. Especially as he'll have the opportunity to load the Fed with doves, as he's responsible for appointing 4 of the 7 members of the Fed's Board of Governors by February 2018.

As of yet, Trump hasn't taken action to weaken the dollar but with the dollar down big against every major world currency this year, markets are clearly taking Trump's anti-dollar shift seriously.

THE SNIPPET

JAMAICA HAS BEEN THE WORLD'S BEST PERFORMING STOCK MARKET OVER THE LAST 4 YEARS. THE MARKET WAS UP 200% ALONE IN THE PAST 2 YEARS IN US$ TERMS.

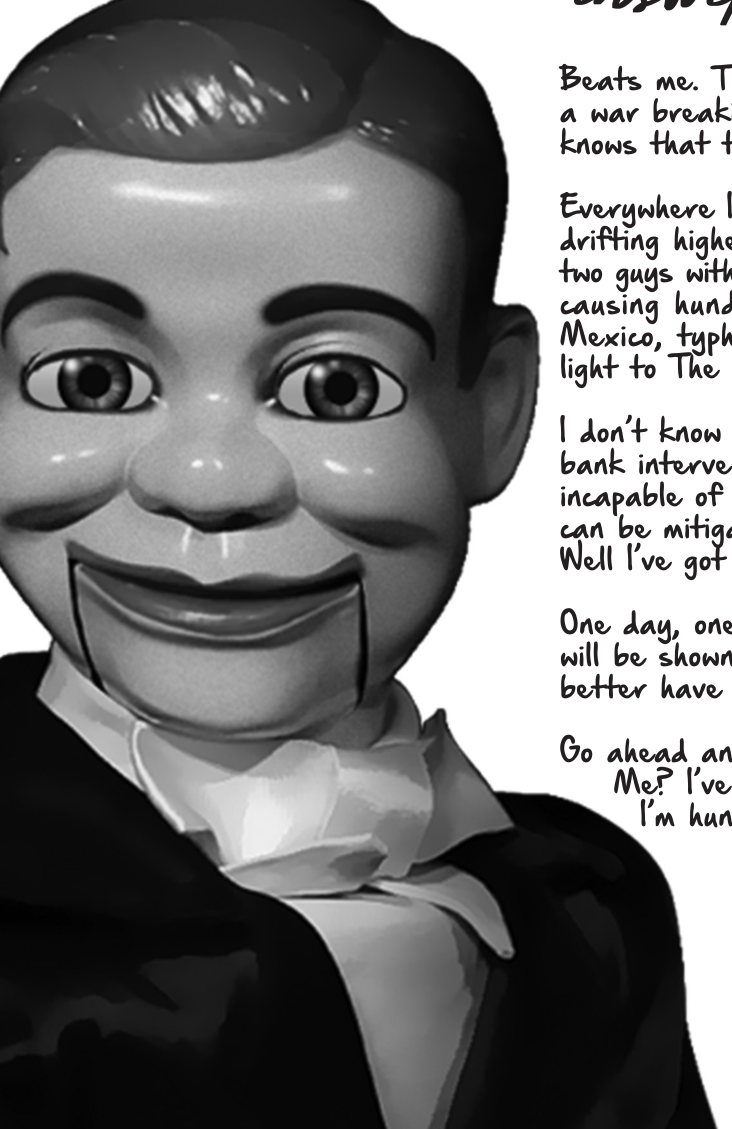
HOW DID THAT HAPPEN?
WHAT ARE THEY SMOKING?

Ask Milton

question

Milton,

Why does the market seem to be completely ignoring a potential nuclear war on the Korean Peninsula?



answer

Beats me. The market seems to be assigning a possibility of 0% to a war breaking out but even a wooden dummy with a hand up his a** knows that the chance is higher than that.

Everywhere I look, I see complacency; low volatility, low volume, markets drifting higher with no meaningful corrections. Meanwhile, we have two guys with bad haircuts in a nuclear stand-off, hurricanes potentialy causing hundreds of billions of dollars of damage, earthquakes in Mexico, typhoons in Hong Kong and somebody even gave the green light to The Emoji Movie.

I don't know how any of this ends, but I'll tell you this; since central bank intervention became the foundation of the market, it has been incapable of effectively pricing risk and acts as if (any and all) risk can be mitigated by the injection of more liquidity by central bankers. Well I've got news for those dummies – it can't.

One day, one of these risks is going to erupt and the central bankers will be shown to be powerless to 'fix' things. When that happens, you'd better have a tail hedge in place.

Go ahead and pick up nickels in front of the steamroller if you want. Me? I've got my bags packed, I've stockpiled furniture polish and I'm hunkering down.

Milton

5xW + 1H

What's hot on Real Vision this week...

WHO

Kyle Bass, the Investment Titan and Founder of Hayman Capital Management

WHAT

The largest global imbalance he's ever seen in his life - The sort of credit expansion that can only lead to a financial crisis.

WHERE

China

WHEN

Kyle thinks there will be a signifiucant correction sometime between November 2017 and June 2018.

WHY

Total credit in the system is $40 trillion which has grown 1000% in a decade. This is supported by just $2 trillion of equity and $1 trillion of liquid reserves.

HOW

China is going to have to recap their banking system and the exchange rate is going to suffer accordingly.

SEND COMMENTS TO
2020@REALVISION.COM

REAL VISION TELEVISION

REAL VISION PUBLISHING

REAL VISION PODCAST

FOLLOW US