

SENTIMENT UPDATE

S&P 500 = 2344.02

REFERENCED CHARTS

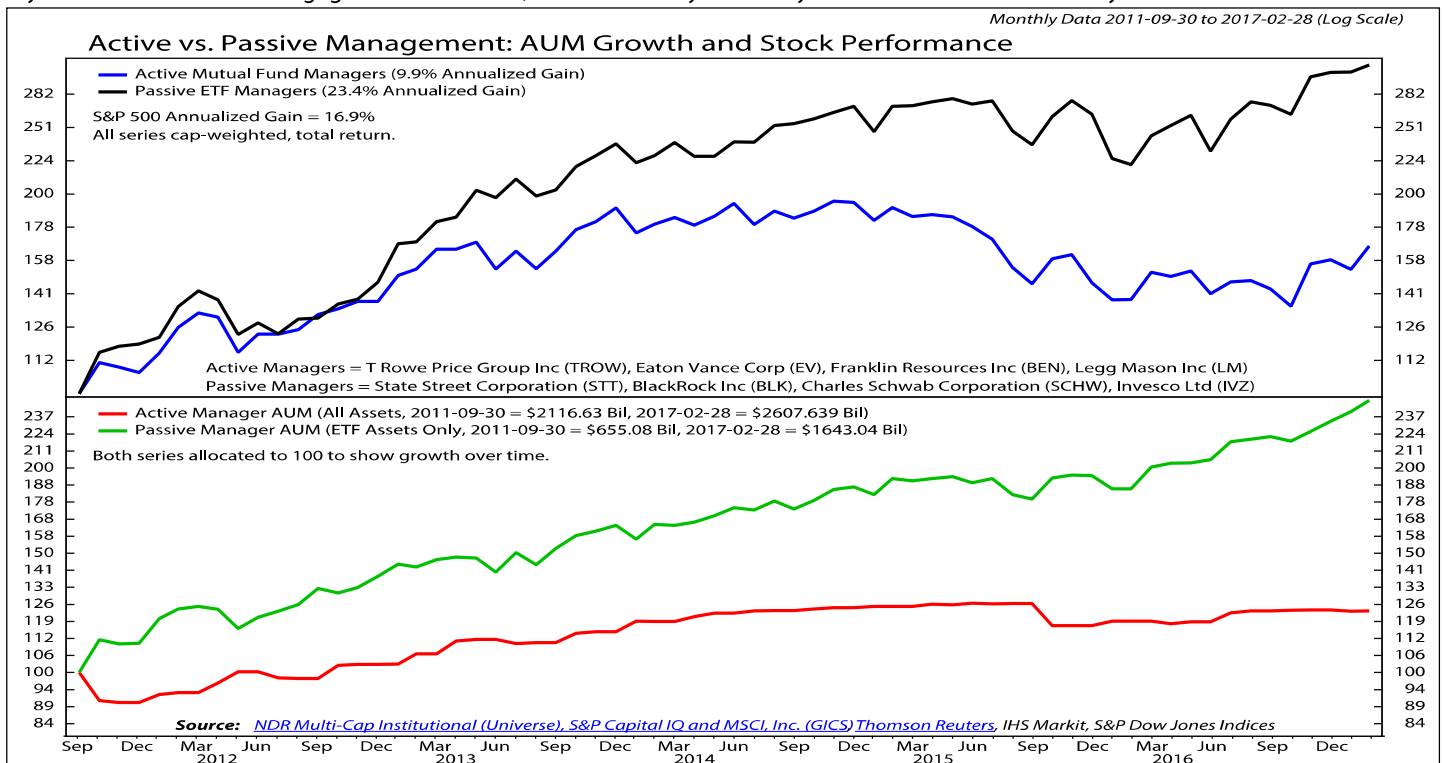
The Passive Investing Bubble

In each market cycle, there is usually a new narrative to rationalize excesses in the late stages of a bull market. "Don't worry about overvaluation in 1987," it was said, because institutions had no need to sell due to a new concept called "portfolio insurance." The concept was well thought out, tested, and sold. I thought it had great validity. Nevertheless, when something becomes too popular, and has a large crowd using it, it can malfunction, and that likely played a large role in "the crash."

Again, in 1972-1973, it was, "Don't worry about overvaluation" if one just bought the "Nifty-Fifty" group of growth stocks that history had proven grew in both good times and bad. Some of these companies are no longer around! There was a similar story in 2000. We were in a "new era" of internet growth. "Don't worry if stocks had no earnings." It was "internet clicks" that were important to measure. The internet was indeed a new era, but most dot-com stocks went bust. In 2007, it was "Yes, housing is pricey," and nearly anyone could obtain a mortgage loan. However, real estate only

went in one direction – upward! Also, don't worry about mortgage debt – no major bank/broker had gone broke in decades. Besides, as everyone knows, real estate is "local." In 2017, I fear the bubble is mainly in passive investing. It has done so well for so long that John Bogle's great idea has been bought by nearly everyone.

Low fee passive funds that just buy and hold an index fund have largely creamed the high fee active funds the last few years. We developed the [chart](#) below that illustrates this. Not only have index funds outperformed, but the crowd has noticed. Most all the positive flows are going into passive funds as seen by comparing the flows into mostly active equity mutual funds with passive ETFs. The [chart](#) on page 2 shows 52-week flows into largely active mutual funds, and mostly passive ETFs. "Don't worry about fundamentals, or values; don't worry about market timing; just buy the market and hold!" Even if there is a small correction, **the market** has always come back! Sounds "bubbly" to me.

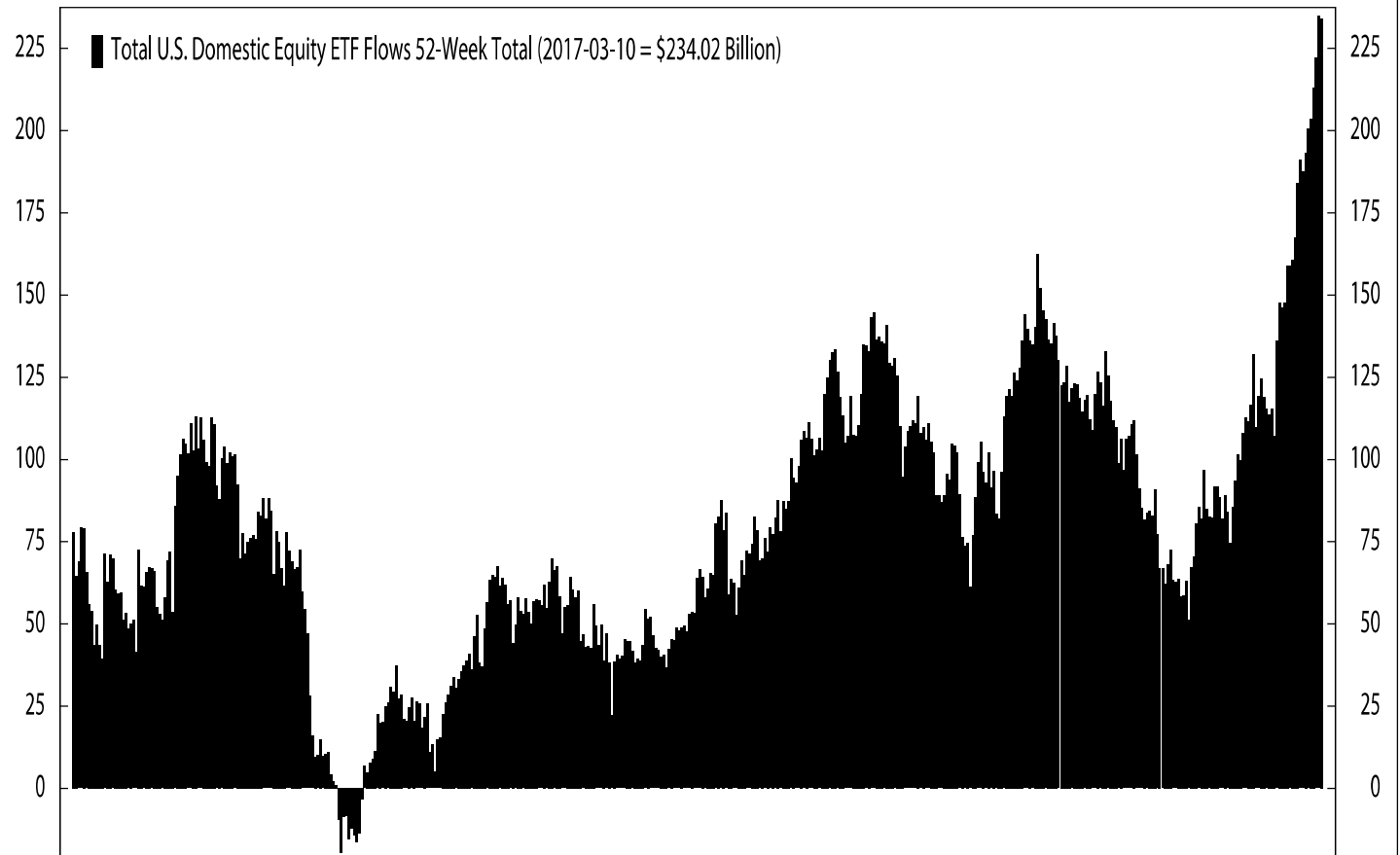
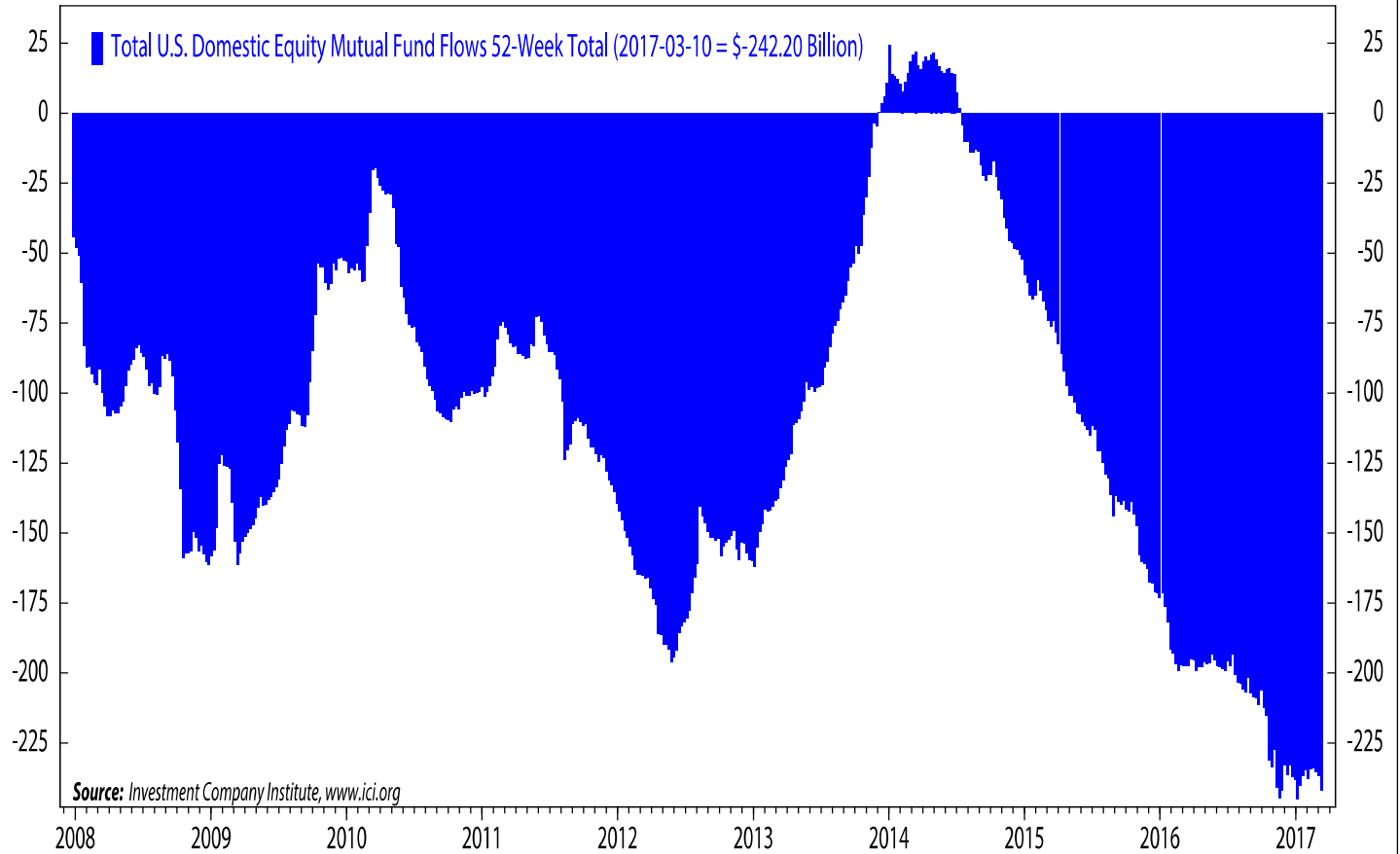


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Total U.S. Domestic Equity Fund Flows (Mutual Funds And ETFs)

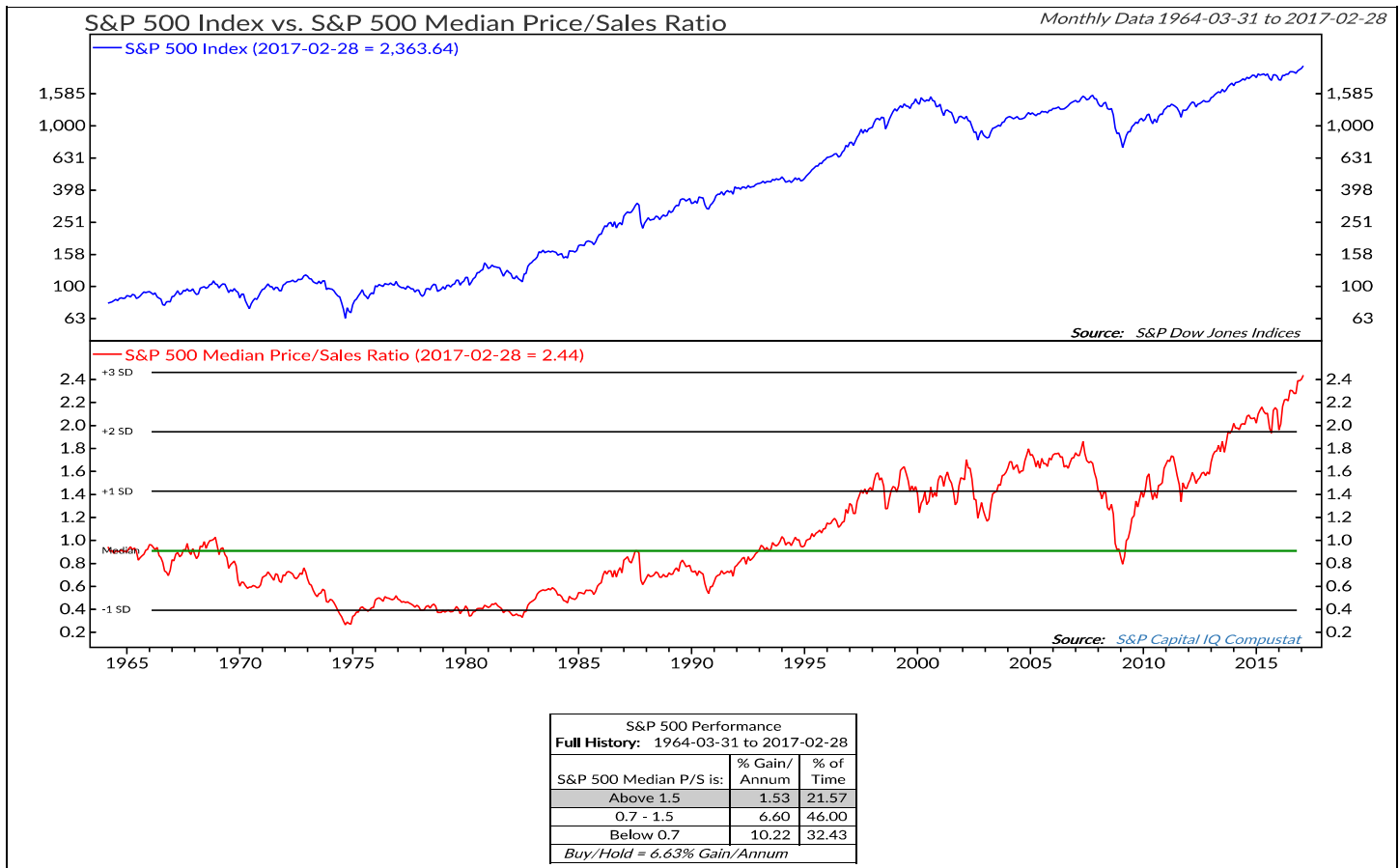
Weekly Data 2007-12-28 to 2017-03-10



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One of my favorite charts of a bubble is featured on [DAVIS37](#) to the right. Note that in 2000, well over 90% of all the assets in mutual funds were in growth funds. Look what happened to growth versus value funds from 2000 to 2007 in the top clip!

One of the differences between now and 2000 was that in that case, most of the overvaluation was in growth stocks. Value stocks were cheap! However, when one buys an S&P 500 Index fund, one buys **all** the stocks in the Index, whether cheap or expensive, and whether growth or value. So, [DAVIS208](#) now shows the **average** (median) stock as much more overvalued than it was in 2000 and 2007. In my opinion, this is clearly bubble territory.

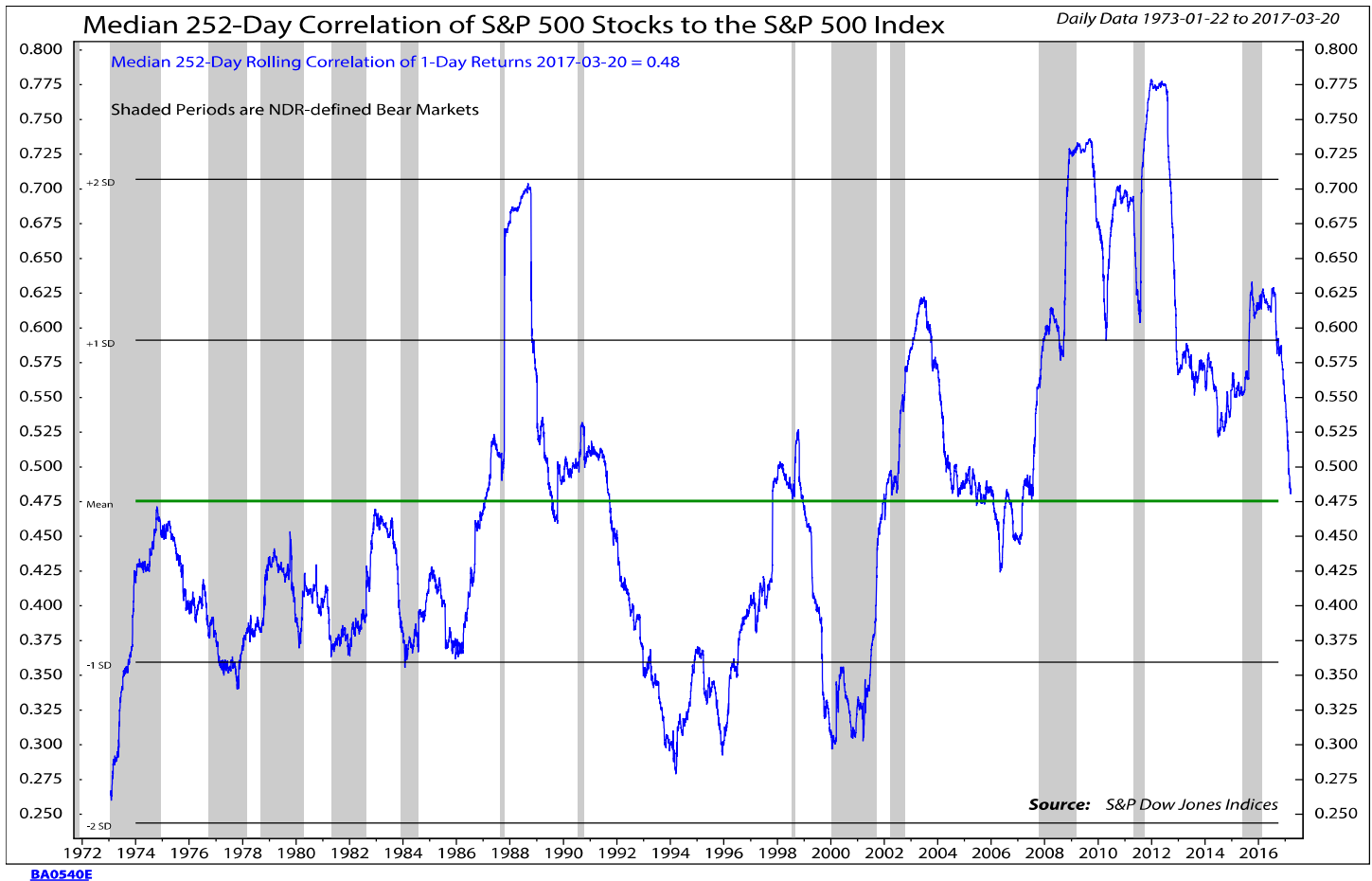
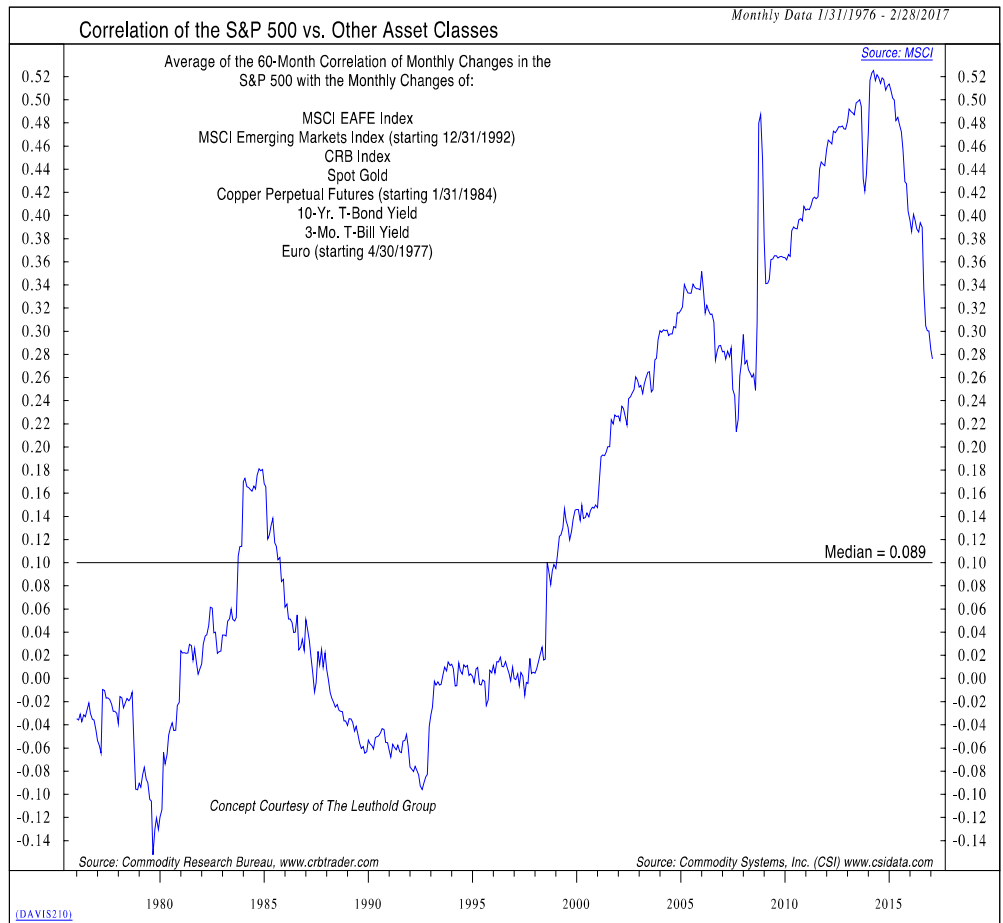


[DAVIS208](#)

Even if one agrees that Indexes are overvalued, and the flows toward passive funds have been excessive, how does one know that the trend has gone too far?

One of the things about passive investing, plus the global Central Banks' policy of "making cash trash" by making it yield near zero (or even negative yields) is that everything else looks attractive **relative** to cash, so all things tend to go up together. This can be illustrated by very high correlations between most assets. One can see that clearly on [DAVIS210](#). But, note as the Fed quit QE and its' zero interest rate policy, slowly but surely correlations have dropped.

Another sign of a less passive index correlation can be shown just looking at the S&P 500 stocks themselves on [BA0540E](#). The correlations are breaking down, and that may mean the trend toward passive investing is overextended.

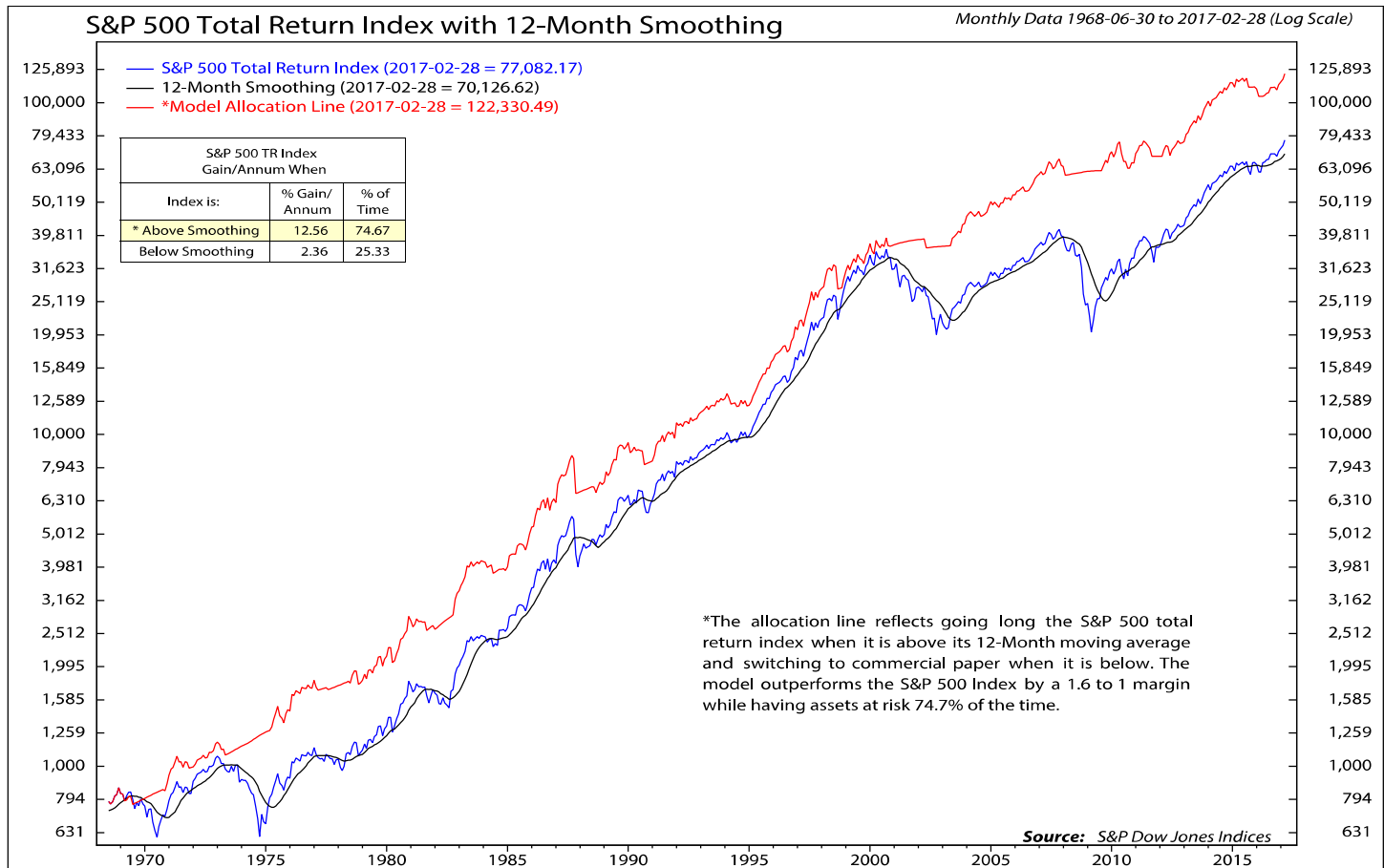
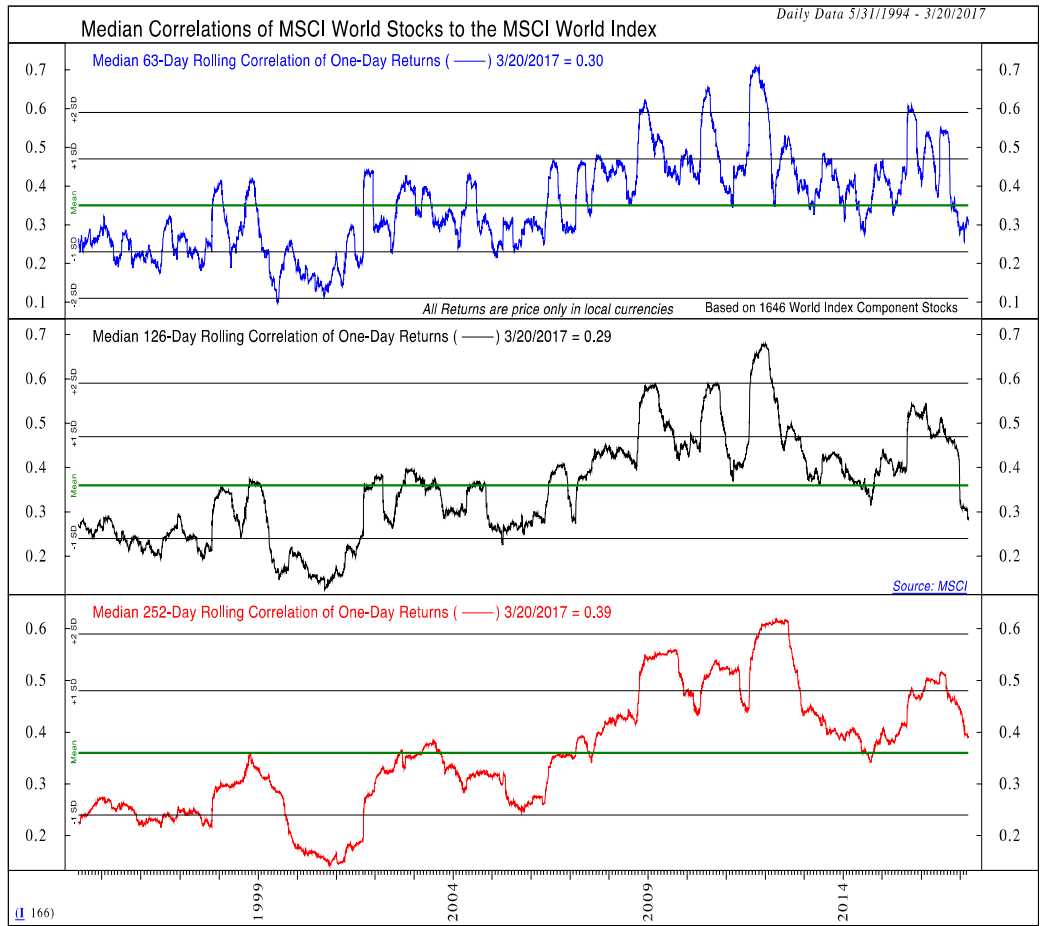


[BA0540E](#)

This is also true for global stocks. The returns are becoming more diverse, which could greatly help active fund managers, as featured at the bottom of [I166](#).

Finally, as for timing this market, it is often said that "genius is a bull market." In other words, it is very hard for timing to outperform in a roaring bull market, as featured on the [chart](#) below. We show the S&P 500, and one simplified timing indicator. Timing seemed to underperform in 1968, and again in the late 1990s, but it was potentially very useful over a full cycle, as seen in 1974 and 2009.

In conclusion, I feel we are in the late phases of a passive index bubble. I think over the next five years, there will be great opportunity for active managers to outperform passive managers.



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