Morningstar's 'Secret Sauce'

By Kerry Pechter *Tue, Mar 8, 2011*

Speaking at the 2011 Morningstar/Ibbotson Conference in Orlando, Roger Ibbotson (above) described low-liquidity as a largely unrecognized source of alpha in stocks and mutual funds.

When London pedestrians swarmed onto the Millennium Bridge soon after it opened in 2000, a 'Black Swan' event occurred. The elegant steel-and-aluminum footbridge spanning the River Thames started to wobble.

Engineers hadn't foreseen the effect of so many people doing the same thing at the same time. Oddly, the bridge stayed perfectly stable until the number of pedestrians hit a critical mass. Then their "synchronized footfall" caused the bridge to yaw by up to seven centimeters.

Like bridges, financial markets have a tendency to buckle suddenly when too many people do the same thing at the same time, said Rodney Sullivan, CFA, during a presentation at the 2011 Morningstar/Ibbotson Conference in Orlando last week.

Sullivan, who is editor-in-chief of the *Financial Analysts Journal*, asserted that investors are more prone to herding, more susceptible to moral hazard, and more instinctively shark-like than economists traditionally assume. And that has made markets riskier.

"Markets work best when we're all doing different things. Markets break down when we all do the same thing," Sullivan said. "Las Vegas is much more rational than the stock market. If only market was as rational as Las Vegas."

This annual conference, now in its 10th year, gives money managers a chance to hear the retrospective and predictive insights that analysts at Morningstar and Ibbotson Associates, along with eminent guest speakers, have culled from recent research into the behavior of stocks, mutual funds and markets.

This year the lineup included Roger Ibbotson, founder of Ibbotson Associates and CEO of Zebra Capital Management, along with James Xiong, Tom Idzorek and others from Morningstar Investment Management Services. Guest experts included Sullivan, Martijn Cremers of Yale, John P. Hussman of Hussman Funds, John W. Rogers Jr. of Ariel Investments, and ERISA attorney Marla Kreindler of Winston and Strawn LLP.

How to outperform

If you want to find mutual funds that will outperform, said Idzorek, Ibbotson's chief investment officer, look for those that contain—by chance or by design—stocks that are both illiquid and show recent gains.

Expanding on research that he, Ibbotson and Xiong first published last August, Idzorek offered data showing that if you categorize mutual funds or stocks by turnover rates and momentum—as measured by recent performance—you find that those with the lowest turnover and most momentum will, if regularly rebalanced, produce consistently higher returns.

"Composites of mutual funds that hold low liquidity, high momentum stocks dramatically outperform those that hold high liquidity, low momentum stocks," the analysts said in their paper. The effect is achieved, he said, by capturing more gains during bull markets than losses during bear markets.

This advantage, though no secret, hasn't been arbitraged away yet, Idzorek said. As Roger Ibbotson put it during his presentation, "Someday this will be beta, but right now it's alpha." His firm, Zebra Capital Management, is building funds that capitalize on this advantage.

If low liquidity and high momentum offer sure-fire outperformance, then investment in "closet" index funds offer sure-fire underperformance, said Martijn Cremers, a professor of finance at Yale University.

Many funds that call themselves "active" actually hold many of the same stocks that their benchmark index holds. He calls the funds closet indexers if they overlap their index by 40% to 60%.

Prior to 1986, virtually all U.S. equity funds had an active share of 60% or more. Today, about half have a smaller active share than that. Of those, about half fall into the closet indexing range. Because they charge higher fees than index funds, closet index funds tend to underperform their benchmarks by about 90 basis points a year, Cremers said.

Indexing as a risk factor

Contrary to conventional wisdom, indexing itself may not be as benign for investors as is generally thought, said Ibbotson's James Xiong. In a presentation called "The Impact of Trading Commonality," he echoed Sullivan's earlier suggestion that indexing might represent a form of herding behavior that can be destabilizing.

"When everybody is doing the same thing, the whole thing breaks down," Xiong said.

In 1980, 54 institutions held the shares of any given NYSE-listed company, on average, he said. But, as a result of the impact of indexing, that average had risen to 125 institutions by 2000, and to 405 institutions in 2010.

In another possible effect of indexing, Xiong said, betas have been rising and converging. From 1980 to about 1998, betas of large-cap stocks and growth stocks average about .8 and betas of small-cap stocks and value stocks fluctuated around .6. In 2004, however, betas for all stocks merged at about 1.0, making the system as a whole less stable.

In a remarkable and somewhat mystifying series of slides, Xiong also demonstrated that it was possible to pick up signals that the equity markets are about to enter or leave periods of abnormal volatility. He offered a "regime switching model" that called for re-allocating from a 60% equity/40% short bond portfolio to a 30% equity/70% short bond portfolio when the likelihood of a normal trading range fell below 80%.

Another speaker, John P. Hussman of Hussman Funds, offered a dour prediction for the equity markets going forward. Hussman suggested that investors are willing to stay on the sidelines and hold cash equivalents at almost zero interest today primarily because they believe that the values of equities and commodities, after a run-up, have no more room to grow.

That helps explain why Fed policy hasn’t yet produced inflation. “The Fed did something remarkable in 2009,” Hussman said. In preventing a 1929-like collapse in equity values by driving down interest rates, it also pushed stocks to a new equilibrium point and, consequently, eliminated much of the potential for future growth in the equity markets. Taking that into account, a “normal” P/E ratio going forward should be 12.7, he said, rather than the conventional 15.

The single most provocative slide, in a conference thick with data-drenched slides, may have been the one from Rodney Sullivan illustrating that the equity price spikes of the past 15 years were anomalous departures from the gradual 60-year up-trend in U.S. GDP. It appeared that the 2008-2009 “crisis” was merely a reversion to the mean.