Be the crocodile

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By Geof Marshall | October 20, 2017

At the CI Leadership Conference in Palm Springs, I articulated an analogy to a small group in the Signature "Earn Better Income" breakout session that I wanted to share with our readers.

Each year, as part of their great migration across the Serengeti, two million wildebeest cross the Mara River to reach the grasslands in Kenya. Lying in wait is an unseen, patient, opportunistic, smart predator—the crocodile.

This reminds me of closet indexing and passive ETF investing.

The wildebeest, driven by mindless instinct and the comfort of the crowd, cross the river knowing the crocodile will have his fill. Yet, the wildebeest know on average they will survive. The crocodile does not care to be average; the crocodile needs to eat.

Passive investors and closet indexers strive to be average and often fail as evidenced by index-tracking passive high-yield bond ETF performance. To the passive investor and closet indexer, managing risk entails making small changes to relative security weights to chase relative returns. The pursuit of total returns and capital preservation is secondary to the unspoken management of career risk over market and security risks. Howard Marks of Oaktree Capital has been a long-time proponent of the differentiation required to generate superior long-term returns. In his *Dare to Be Great II* newsletter in August 2014, Marks makes the following point:

> Passive investors, benchmark huggers and herd followers have a high probability of achieving average performance and little risk of falling far short. But in exchange for safety from being much below average, they surrender their chance of being much above average.

At Signature we know we will be wrong at points in time, but we endeavour to learn from those mistakes, and we will not be wrong because we have bent our principles. We believe the Signature model—global fundamental sector specialists, proven cross-asset-class intelligence, a focus on constant improvement, and our commitment to our clients—drives our total return and capital preservation mindset as well as helps us mitigate the risks and impact of being wrong as best we can. As "beta," or index performance, becomes increasingly commoditized by passive index strategies, "alpha," or the above-index performance earned by active management, will become increasingly more valuable. This is the value proposition we present to our clients.

In an August 17th article from the *Wall Street Journal*, as Hiromichi Mizuno, chief investment officer of Japan's US$1.4 trillion Government Pension Investment Fund, was being interviewed by columnist James Mackintosh, he expressed his concern that "market efficiency will be damaged by the rise of passive funds, which rely on trading by active investors to set the price of stocks." Boil that down to its basic elements: Passive investors rely on active investors to determine the price of securities. This is delegated decision making at its worst. Go ahead, cross the river, the water's fine.

Be active. Be the crocodile.

Wildebeest crossing the Mara River