Epsilon Theory

Death in Slow Motion

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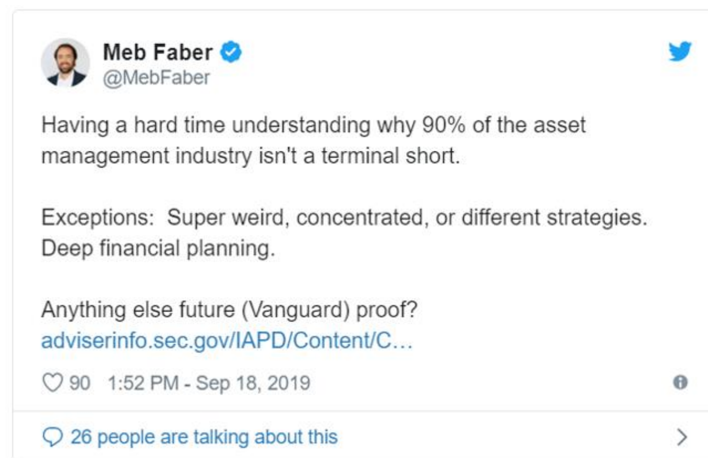
There is nothing quite like a slow-motion death scene.

And there is no slow-motion death scene quite like the classic from the 1973 Turkish film and popular 2012 meme *Kareteci Kiz*. The picture you clicked on to get to this piece gives you a small taste of its glory, but you really must watch the video to get the full experience.

Speaking of painfully drawn out deaths, let's talk about the asset management industry (hey-o!). To that end, I read an interesting thought experiment (read: writing prompt) from our friend Meb Faber yesterday.



Now, Ben has already put his views on the so-called "bubble" in passive management out there, which as per usual were contained in a post that launched a thousand hot takes. His actual observation was pretty uncontroversial. I'll put it this way: if your clients, boards or bosses are asking you "why didn't we just buy the S&P 500?" in response not only to stock-picking strategies that didn't work, but to **any** investments in foreign stocks, bonds, and other diversifying or objective-oriented investments, then you already understand the narrow point he was making about the always-be-buying impact of the indexing imperative.

As much as we may want it to be (or would like to pretend for argumentation purposes that it is), common knowledge about indexing is **NOT** confined to an expressed preference for the avoidance of active risk-taking on individual securities (or more accurately, for not paying fees for such activities). It absolutely **IS** common knowledge that indexing in practice also means a

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preference for long exposure to US stocks over any other way, place or method of taking investment risk. Honestly, anyone who denies this either hasn't talked to a client or board in years, is being hopelessly pedantic, or is deliberately or accidentally misleading you to some unknowable end.

Still, Meb's question isn't an active vs. passive question, really. It isn't even a question about active management. Meb's is a question about our industry, full stop. And it's a good one. Why do people still pay above-passive fees, when common knowledge about indexing has become so powerful? Is this practice doomed to die? And if so, is it shortable (by which I think we all understand we mean philosophically or conceptually, not whether you need to go find borrow on TROW)?

Like I said, it's a good question. And I don't know the answer. Sorry.

What I DO know is that there are a few strong inertial forces keeping the asset management industry alive as it flops around the room with a dozen ragged, bloody exit wounds. If you want to know where this industry is going, I think you've got to ask yourself what you think will happen to each:

1. **Human Preference in Advice:** Some humans prefer in-person human advice and are price-insensitive to getting it if it comes with relationship. This isn't a novel opinion, and I've **already written my piece** on this. Confined largely to HNW financial advice - wealth management - both the preference among many consumers for human advice and the fact that the *actual* value provided by a financial advisor is behavioral and emotional in nature are more powerful bulwarks against erosion than most observers allow. Short the market for advice, and I think you'll get burned.
2. **Revenue Sharing:** This is the uglier side of the otherwise benign influence of wealth management and financial planning. Put simply, actively managed mutual funds and their attendant industry infrastructure are still flopping around primarily because actively managed mutual funds are one of the few things keeping some wirehouse financial advisory platforms afloat. Without 12b-1s, platform participation fees and revenue sharing, many wires couldn't afford either the business or the staff, and wouldn't be able to keep FAs from escaping to the warm embrace of advice-driven RIAs. Where does this go? I think it bleeds out gradually, and when these compensation structures are no longer material to any ongoing business, they are killed off suddenly as a false-concession in some regulatory negotiation with the banks.
3. **Fiduciary Fear-Mongering**: If you have served on a 401(k) committee, and that committee has hired a consultant, this will not be surprising. If you haven't, it will probably be a surprise. But ERISA consultants routinely, formally advise plan sponsors that *not* offering actively managed mutual fund options as complements to passive offerings could subject them to risk of suits or DOL action. No, I am not kidding. This kind of garbage is sticky, and the consultants/lawyers/regulators in this space will keep it that way far longer than any of us would guess.
4. **Risk Transference:** An issue for both retail and institutional investors alike, huge categories of the professional money management industry exist simply because advisers or staff of asset owners have a career risk incentive to lay off accountability for missing goals. Separately, and probably more importantly, they must also grapple with a reality in which the theoretical alpha-generative potential of lucky active money management picks is the only thing that fills the gap between projected and actuarial returns. In other words, if asset owners are given the Hobson's Choice of recommending benefit cuts / spending cuts or telling legislatures / donors / family members that they need to increase contributions on the one hand, or buying actively managed strategies because doing so permits them to include an alpha assumption in their long-term strategic return projections that *theoretically could* fill the gap, guess which one they pick? Hope springs eternal, y'all.

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(And yes, I suppose there are still a few schmucks like us out there who think that occasionally paying someone to identify mispriced assets still makes sense.)

So yeah, I don't **know**, but if I were a betting man, I'm betting on this industry being around in something resembling its current form for much longer than most people would extrapolate from current trends. That means people and institutions continuing to pay above-passive fee rates for active management at the portfolio and asset class level. If you're a full-hearted FA trying to do good, I think you'll have your shot as long as you want it. If you're a full-hearted active investor who thinks there are still reasons to own things based on an assessment of their value, so will you.

But all of us would also benefit from eyes clear enough to see that the reasons for the persistence of some parts of our industry as they exist today are not ones to feel particularly good about.

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