FLAGSHIP QUARTERLY COMMENTARY

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ASSET MANAGEMENT

Winston Floquet | **END Q2 2017**

Global economic growth remains positive, advancing steadily in a more balanced and sustainable manner. Corporate profits have responded with some vigour and are recording double-digit gains, well ahead of the slow to negative momentum of the 2014 to 2016 period.

Worldwide equities have embraced the more buoyant underlying conditions and have advanced strongly, pushing valuation levels ever higher. Price/earnings levels are now almost the highest in history – exceeded only by the 1929 pre-crash levels and the dotcom hysteria of 2001. [CHART 1] Breaking into new high valuation levels does not, on its own, signal a top for the market: in 1999, after the p/e ratio in the US soared to a new high, the market continued to advance, eventually peaking some 49% higher! [CHART 2]

Nevertheless, at the current highly elevated valuation levels, the risks have undoubtedly intensified. And, this time around, the risks are magnified by a phenomenon not faced previously: the burgeoning growth of passive funds. These comprise not only ETF's, but passive unit trusts as well (already 25% of total equity unit trusts!). Together, these two passive categories now constitute a remarkable 39% of the combined unit trust/ETF market, having grown dramatically over the past decade. [CHART 3]

ETF trading alone accounts for at least 25% of consolidated trading activity. (Note ETF's are not only a retail client vehicle but are widely used by institutions in conjunction with active investing to anchor a portfolio's returns close to their benchmarks.)

Given the significant 39% of managed funds and the high trading activity, this will have profound implications for equity markets. The first key issue relates to stockpicking as the fundamentals of a company are now, in many cases, becoming less important than its inclusion in one or more indices. Strong fundamentals can be neutralised, and even overwhelmed, by market action in one or more of the indices in which it is represented.

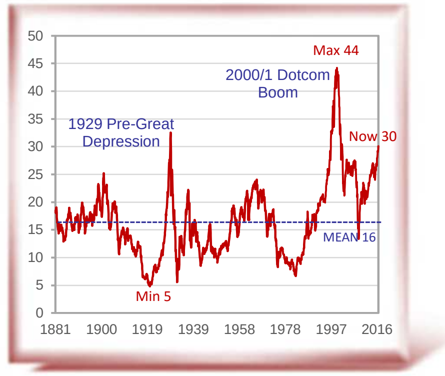
And the number and breadth of indices is continually widening. For example, there are ETF's covering the share's sector, sub-sector, industry, geography, and inclusions in growth or value indices, etc. Sales of the ETF's or passive unit trusts in which a share is included will automatically result in sales of its specific shares – regardless of its merits. A market which is increasingly moving away from company-specific fundamentals is not a helpful environment for stockpickers!

The second key issue relates to concentration and momentum risk. For example, in the tech-heavy Nasdaq (53% is technology), the top five stocks in the index (Apple, Microsoft, Amazon, Facebook and Google - all tech) have a 40% weight in the Nasdaq index. [CHART 4] Should technology shares fall out of favour for any reason, causing heavy sales of the Nasdaq ETF, all the shares in that index – whether technology related or not – would be dragged down. And it is not just the overall market indices like Nasdaq and the S&P 500 ETF which are affected. Apple, for instance, is included 237 ETF's and in 133 of these it is a top 15 holding. Google, similarly, is in 152 ETF's featuring as a top 15 holding in 87 of these.

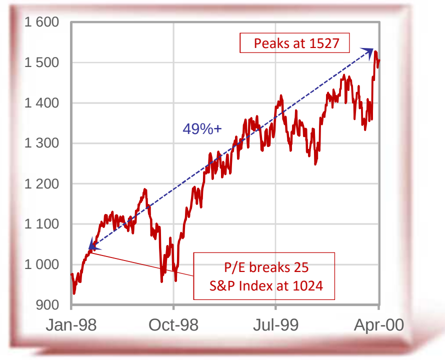
The concerning factor about this relatively new phenomenon is that a few large institutional sell orders of their core ETF's would obviously trigger sales of a myriad of individual stocks. This, in turn, could unleash a wave of selling and result in a vicious circle of panic sales, causing the market to tumble at a frightening pace once the decline is initiated. Prices of good and bad stocks will collapse simultaneously. The market could well eventually fall faster and deeper than any believe likely right now. Whether that will happen next week, month or year, is anyone's guess.

Indeed, it is difficult to isolate a potential trigger for a significant correction at present, apart from the sky-high valuations. And here, the unattractive nature of the alternatives is a useful, but not infallible, support. But when the herd heads for the exits, you don't want to be standing in the doorway.

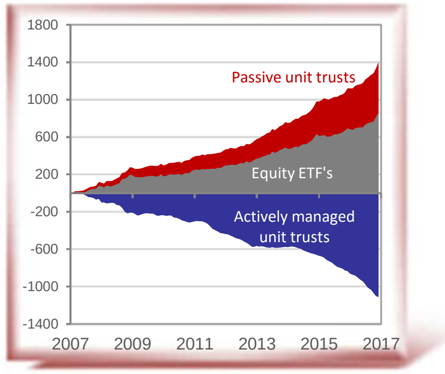
S&P Cyclically Adjusted PE Ratio
1880 - 2017



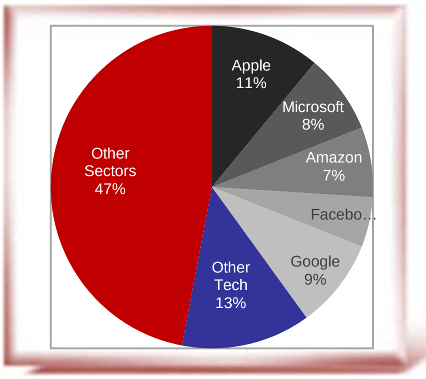
S&P Index
Jan 1998 to April 2000



The Rise of Passive Investing
Fund Flows



Nasdaq 100 Index



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