REGISTERED INVESTMENT ADVISOR

DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.832.7475 / 888.808.7475
Fax 303.832.7484
greg@growmydollar.com
www.growmydollar.com

May 24, 2018

OBSERVATIONS ON THE MARKET

No. 323

By Greg Denewiler, CFA

Wall Street is always looking for a silver bullet. The latest one is the robot. It seems simple enough, the robots are designed to eliminate emotion from the investment process. However, something must still tell the robot what to do. According to the *Wall Street Journal*, even robots make mistakes. Wealthfront, one of the larger new managers creating robot funds designed to automate the investment process, has given their clients something to be nervous about. One of their new funds, which started just four months ago, and can invest anywhere in the world, is currently down 9% since inception. It is not fair to judge a fund on such a short-term period, but there are two problems with the robots.

The first problem is something the *Wall Street Journal* article illustrates. Part of the appeal of these funds are their low expenses. Wealthfront only charges .25%. However, as always, it is the fine print that counts. Let's assume they want to own the S&P 500, they enter into a contract that states they earn the return of the stock market for however much money they want invested. The manager will buy a 'total return swap,' which mimics the return of the underlying asset. It sounds reasonable enough, but what is not in the expense section of the prospectus is the interest cost built into these contracts. Currently, they are 2%. In effect, the fund must earn 2.25% just to break even. Not all "robot" funds are managed using derivative contracts, however, there is another problem with robots.

When the market is calm and in a state of making new highs, nobody really cares about the fine print because they are making money. When the clouds build, and the winds of the storm start blowing, you tend to get serious about whether your boat is big enough to withstand the 10-foot waves crashing over it. If the waves continue to build, robots are a version of being blindfolded in the boat, it becomes a real test of faith that the robot will be able to navigate the rough waters. However, you will never know just how big your boat is because you don't know what they own on any given day. In times of stress, wearing a blindfold will either be a curse or redemption, you get to pick. Guess which one investors pick when they get nervous?

Last week, *Barron's* featured article was about index funds. There is a growing debate which states that because they continue to buy more of what is working well, they are driving up prices of companies beyond what rational investors would pay. There is a fear that suggests there are not enough investors making individual buy and sell decisions on an individual stocks and bonds. The indexes are beginning to dominate the market. Like robots, they buy or sell without regard to price, but purely based on money flowing to or away from them. They may be sowing the seeds of their own demise. Nobody knows if or when they fall from their own weight, but the best defense is to stick to what drives everything in the end. As the father of value investing, Benjamin Graham once said, in the short-term the market is a voting machine, but in the long-term it is a weighing machine.

Votes are usually based on emotion, however, weighing something becomes a tangible act. In investing, ultimately you are weighing the cash that a company pays or has the option to pay. The less you pay for that cash flow, and the more it grows over time, the more likely you are to end up with positive votes. The more favorable votes there are, that usually translates into higher stock prices. It will be interesting to see how these robots fair in the next real test of the market, which inevitably comes. It is not if, but when. These complicated investments never seem to end well, but when you don't even know exactly what they are doing, the votes tend to turn negative in a hurry, and in today's world, that could be hours or minutes.