The "cult of equity" isn't dying, it's going passive

Investors poured nearly $7.5B into ETFs that invest in U.S. large-cap stock July

By Jason Kephart

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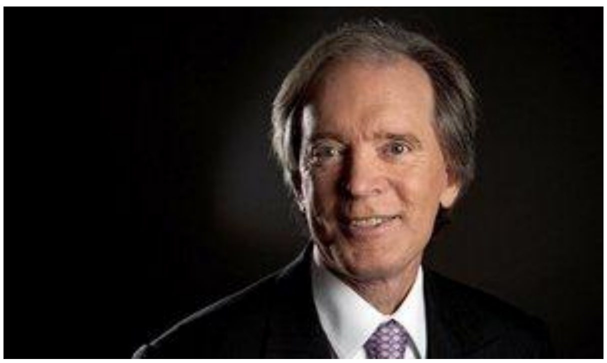
Bond guru Bill Gross made waves last week when he predicted the demise of “the cult of equity,” but while investors have been pulling out of actively managed equity funds for years, the same can't be said for their passive counterparts.



“The cult of equity is dying,” Mr. Gross wrote last week in his August Investment Outlook. “Like a once-bright green Aspen turning to subtle shades of yellow, then red, in the Colorado fall, investors' impressions of 'stocks for the long run' or any run have mellowed as well.”

Try telling that to investors of exchange-traded funds that invest in stocks.

Investors poured nearly $7.5 billion into U.S. large-cap-equity ETFs in July, according to Morningstar Inc. The research firm won't have flow numbers for actively managed mutual funds till next week; however, the Investment Company Institute last week reported that in the month ended July 25, U.S. equity mutual funds suffered withdrawals of more than $6.6 billion.

It follows a trend that's been going on for the last half a decade.

In the last five years, more than $500 billion in assets have been pulled out of U.S. equity mutual funds, while more than $219 billion has gone into low-cost, passive U.S. large-cap ETFs, according to ConvergEx Group.

In part, that's because active managers haven't given investors much reason to believe in the “cult of equity” over the last half decade.

Only 36% of actively managed U.S. large-cap mutual fund managers have outperformed the S&P 500 over the previous five years, according to Morningstar. The past three years have been even worse, as less than 17% of actively managed funds outperformed. That poor relative performance has spelled doom for mutual fund firms such as American Funds and Janus Capital Group Inc. that rose to prominence thanks to their stock-picking ability and helped turn The Vanguard Group Inc. into the largest mutual fund manager in the world.

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Stocks returning 6.6% above inflation a thing of the past, says Pimco bond king; 'cult of equity is dead'

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When Bill Gross started Pimco's most recent effort to expand into stocks three years ago, he vowed not to repeat the mistake he made in the 1980s, when his bond traders overwhelmed a handful of equity managers at strategy meetings, eventually prompting them to quit.

Last week, the manager of the world's largest bond fund at Pacific Investment Management Co. in Newport Beach, California, compared long-term returns from equities to a "Ponzi scheme" and said returns of 6.6 percent above inflation, known as the Siegel Constant, won't be seen again. "The cult of equity is dead," Gross, 68, said in an Aug. 2 interview with Betty Liu on Bloomberg Television.

"I can imagine the equity managers cringed the same way corporate-credit managers cringed when he said earlier in the decade he wouldn't buy a corporate bond at any price," said Bill Powers, who worked at Pimco from 1991 until 2010 and was a member of its investment and executive committees. "Bill will always speak his mind about value in the markets."

The dismissal of a long-held belief among stock pickers highlights the challenge Pimco faces in building an equities business while aligning its managers with an economic philosophy outlined by bond king Gross that predicts diminished returns across asset classes. Since starting its first equity strategy in 2010, Pimco has gathered $3.2 billion in the four main stock funds, less than 1 percent of the firm's $1.8 trillion, held back by investor aversion to equity funds and subpar performance. The firm's four main stock funds are trailing a majority of rivals this year.

'Invest Globally'

Neel Kashkari, the former head of the U.S. government's Troubled Asset Relief Program who was hired in December 2009 and oversees Pimco's global equities, said Gross's comments are consistent with Pimco's outlook for stocks in a "new normal" environment of below-average economic growth.

"This makes it even more important to invest globally and actively select the companies best-positioned to deliver attractive returns," Kashkari, 39, said in an e-mail.

Pimco's first two equity strategies, EqS Pathfinder Fund (PATHX) and EqS Emerging Markets Fund, account for about $2.6 billion of the firm's stock assets. Neither is beating its benchmark index in 2012, and both lagged behind at least 62 percent of peers as of Aug. 2, according to data compiled by Bloomberg.

EqS Emerging Markets Fund, which began in March 2011, and Pimco's third equity strategy, EqS Dividend Fund, which started in December, have attracted less than $900 million in combined assets. Gross's Total

Return Exchange-Traded Fund (BOND), an ETF variation on his flagship fixed-income mutual fund, has soared to $2.4 billion in assets since it was started five months ago.

First Experiment

Pimco first experimented with stocks in the mid-1980s, a foray that was short-lived when the equity managers quit after about two years. Lessons from that time, when bond traders would shoot down equity managers' bullish arguments for stocks during strategy meetings, led Gross to try to give the equities team more freedom, he told Bloomberg Markets magazine in its August 2010 issue.

“Those sessions basically said, 'Hey, we're a bond shop. This is what we're going to do. It's the party line,'” Gross said in the 2010 interview. “If I've been a problem, then I can be the solution in terms of allowing equity investments to grow and prosper.”

Another effort was set up in 1999 by Pimco's then-parent company, which created an equity unit separate from the bond business to take advantage of the Pimco name. Five years later the unit was one of several fund companies accused by the Securities and Exchange Commission of allowing a hedge fund to engage in market timing, a practice of making short-term trades to exploit market inefficiencies, and was dissolved after paying fines and repayments to settle the lawsuits. It didn't admit or deny wrongdoing.

'Stepchild' Funds

Pimco's latest stock effort came as Gross anticipated an end to the 30-year bond rally, which helped fuel Pimco's growth since Gross co-founded the firm in 1971. The prediction was undermined as Europe's sovereign-debt crisis sent investors to the perceived safety of bonds and out of stocks. Stock funds have seen client withdrawals in every year since 2008.

Investors have pulled about $197 billion from stock funds since the start of 2010 through this June, according to data from the Investment Company Institute, a trade group based in Washington.

“No one should be surprised that Pimco equity funds are a stepchild,” said Joshua Brown, vice president of investment for New York-based Fusion Analytics Investment Partners LLC, which has part of its $300 million under management in Pimco bond funds. “What they have against them is distaste for open-end mutual funds, dislike for equities and the fact that it's a bond shop in everyone's mind.”

Gross's Apology

Gross's forecast also prompted an ill-timed move out of U.S. Treasuries last year, resulting in the worst performance for his $263 billion Total Return Fund (PTTRX) relative to peers based on records going back to 1995. Gross, who apologized to clients for the underperformance in a letter calling 2011 a “stinker,” rebounded this year to beat 98 percent of rivals. The fund has also outperformed 98 percent of peers over five years.

Pimco has added smart stock pickers who will benefit from the firm's resources and be compatible with its macroeconomic view of a larger global role for developing nations, said Kashkari, who also worked as an investment banker at Goldman Sachs Group Inc. The firm, which manages $1.82 trillion in assets, has hired about 50 people for its equity strategies, which are all globally focused.

Franklin Team

Anne Gudefin and Charles Lahr, former Franklin Resources Inc. (BEN) managers, were brought in to oversee the first stock fund, EqS Pathfinder. The $2.13 billion fund's managers follow a deep- value strategy of picking stocks they consider to be cheaper than they're worth. In the 12 months through Aug. 2, it declined 0.2 percent, putting it ahead of 66 percent of similarly managed funds, according to data compiled by Bloomberg. This year the fund returned 4.1 percent, trailing 62 percent of peers.

The Pathfinder fund follows a more conservative strategy and tends to hold more cash so it hasn't benefited as much from this year's stock rally, said Karin Anderson, a senior mutual- fund analyst for Morningstar Inc. (MORN) The MSCI ACWI Index of global stocks is up 6.2 percent and the U.S. benchmark Standard & Poor's 500 Index has risen 11 percent this year through Aug. 3.

Gross's Total Return Fund returned 7.6 percent this year through Aug. 2 and the ETF version gained about 8.3 percent since it started trading in March. Pimco's bond funds on average outperformed 59 percent of peers this year through June 30, according to data compiled by Chicago-based Morningstar.

Downswing Protection

Masha Gordon, who joined Pimco from Goldman Sachs, manages the $519 million Emerging Markets Fund, which fell 22 percent in the 12 months ended Aug. 2, putting it behind 90 percent of peers. The fund declined 0.5 percent this year, trailing 89 percent of rivals. The fund uses tail-risk hedging to protect investors from losses during extreme volatility.

“In equities, we want to deliver outperformance over the three-to-five-year period,” Kashkari said. “The common element is protection, so the funds may give up some upside to protect during the downswings.”

Gross, in an August investment outlook published on Pimco's website, said the 6.6 percent real return that stocks produced annually over the past century were the result of a flaw much like that of a Ponzi scheme. In Ponzi schemes, named after 1920s swindler Charles Ponzi, money from newer investors is typically used to pay earlier participants.

If stocks returned almost twice as much as the 3.5 percent annual economic growth over the period, that implies that investors participated disproportionately in the wealth that was being created, at the expense of workers and government, who saw real wages and tax revenue shrink in proportion.

Debt Reduction

With governments forced to reduce their debt, the decline in real wage growth eventually reaching an end and GDP growth slowing, the return rates of stocks will suffer, Gross said. So will returns on bonds, for that matter, as yields on long-term Treasuries have fallen to 2.55 percent, he said.

Pimco's two biggest and longest-running equity funds have been less volatile than their benchmark indexes. The standard deviation of return, a measure of price swings, for Pimco EqS Pathfinder was about 16 percent over the past year, compared with 22 percent for the MSCI World Index, according to data compiled by Bloomberg. Pimco EqS Emerging Markets Fund had a standard deviation of return of 25 percent, compared with 27 percent for the MSCI Emerging Markets Index.

Pimco EqS Dividend Fund, started last December, is run by Brad Kinkelaar and Cliff Remily, who joined from Thornburg Investment Management. The fund, which invests in dividend- paying stocks globally, returned 6.2 percent this year through Aug. 2, trailing 72 percent of rivals.

More Time

The firm opened a fourth equity strategy in April, Pimco EqS Long/Short Fund, which lets clients participate in long-term stock ownership while seeking to limit losses when markets turn bearish by holding cash or selectively betting against securities. The strategy is run by Geoffrey Johnson, who joined Pimco in April from Catamount Capital Management LLC, and uses the same investment process as a hedge fund Johnson oversaw since 2003.

“It's going to take more time to see what these managers can do with these tools at their disposal,” said Anderson of Morningstar. “It could be a hindrance if they're constantly trying to think about this macro view and force stocks in and out based on it.”

Institutional Requirements

One barrier to attracting equity assets for Pimco may be that institutional investors such as pension funds generally require a three-year performance record before they can buy a fund, said Fusion Analytics' Brown.

Pimco is focusing marketing of the funds to its long-term clients first and expects the customer base to eventually be about 50 percent retail and 50 percent institutional like the rest of the firm, Kashkari said.

“We are taking a measured and deliberate approach to grow organically, hire the very best people and integrate them fully and this is going to take seven to 10 years,” Kashkari said. “We're in this for the long term and will do whatever it takes to make sure this is a viable part of the business.”

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