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Blog Post: Pender Book Review
<u>The Clash of the Cultures: Investment vs. Speculation</u>
By John C. Bogle

At Pender, we see three sources of potential competitive advantage for investors today, analytical, behavioural and organisational, or cultural.

In our day to day, we spend a large percentage of our research time trying to figure out the underlying quality of a business. What are the margins, what is the cash flow, how do we think revenue and subsequent cash flows will change over time, and what influence can the management team have on that outlook? This is the analytical side of our process.

We also apply a behavioural component to our investing. As we navigate the market, we are trying to figure out what opportunities are attractive and why. On any given day investors have reasons to buy a stock and reasons to sell a stock. As contrarians we look at stocks when they are out of favour or misunderstood. There are usually some very public reasons why a stock may be down and most of the time the market is right in its assessment and price. But every now and again we find a business that we like, based on our analysis, but which the market doesn't like. A key part of our behavioural approach is to understand the sell side thesis. Why are people selling the stock? By fully understanding the key drivers of the sales thesis, we can then determine whether the stock is cheap temporarily or cheap for good reason.

Understanding the other side of an argument quite often provides more useful information than trying to uncover reasons to confirm that your current thesis is the right one. It is with this in mind, that I recently read Jack Bogle's book, Clash of the Cultures to get a better understanding of the Exchange-Traded Fund (ETF) market from the father of passive investing himself.

We have found ourselves in a number of opportunistic investment situations that have arisen from a security's index inclusion or exclusion. Of even greater interest to us is the ongoing shift from active to passive management and the impact it is having on markets. By digging deeper into the genesis and promise of the passive side of the industry, we are searching for more opportunities to exploit mispricings arising from the framework of passive instruments.

I did find it to be a bit of a sermon from the pulpit but hey, you don't start a brand new type of fund structure and launch the market leading firm when you're short on passion! Contra to my expectations, there wasn't a lot to take away in terms of passive investing strategies that we could leverage. But what really caught me off guard was how much I agreed with Bogle. It wouldn't be that far-fetched to visualize Warren Buffett sitting there, reading this book, nodding in agreement with a wry smile on his face.

These days a lot of the passive vs active debate centres on cost. It is simple. Cost is the only thing you can actually control in your investment. The promise of active investing should be that you get more back than you pay for, i.e. the performance has to justify the costs. But we know that active management has been overshadowed by funds masquerading as active, which have been unmasked as doing little more than high fee index hugging.

But Bogle spends the majority of the book talking about all the reasons active management doesn't work, rather than cost concerns. Active management is too short term; it turns managers into speculators, not investors; large managers act like renters not owners of companies resulting in management teams and boards of directors being left to their own devices. And large publicly traded financial service supermarkets become marketing-led rather than investing-led as they strive to line the pockets of shareholders of the management company instead of acting as stewards of investor capital.

All of these points tie into what we see as our third source of competitive advantage and that's cultural – being stewards of capital and focusing on long term investing.

My key take away from the book was what Bogle highlights as the difference between investment vs. speculation and the fact that speculation is bound to produce unsatisfactory investment results in the long term. Since the majority of investment industry assets were (and still are) based on speculation, Bogle's approach was to devise an investment instrument that saved people the pain of trying to figure who the investors were from the slick salesy speculative majority, an approach Buffett has agreed with in one of his annual letters.

Interestingly, Bogle sounded a warning bell on the proliferation of ETFs. The ETF bandwagon has long since left behind the principles on which he engineered the first fund and the loop back to speculation over investing is complete. While index funds can be bought and sold daily, ETFs can be bought and sold instantaneously whenever markets are open. This decreasing friction means people can speculate on all sorts of different asset classes. Clearly, the formation of so many ETFs recently is feeding this speculation. From our perspective, this will help fill our opportunity funnel, as investors continue to buy financial products from the supermarket and remain detached from the much more interesting endeavour of investing in businesses that can create real value over the long term.

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