CREWCIAL® PARTNERS

Q3 2023 | Quarterly Commentary

ONE MAN'S SHOVEL…

"MEN CAN DIG WELLS, BUT THEY CAN'T CREATE WATER."
— CRAIG D. LOUNSBROUGH

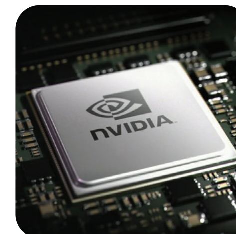
One Man's Shovel…

You're stuck at the bottom of a pit. Never mind how you got here. It's currently sheltered from the sun and the three-day forecast doesn't call for a storm, so the situation isn't existentially threatening, at least not yet. In fact, it's dry and somewhat comfortable. Perhaps you can get used to it, although it is a bit cramped. In the corner you see a handful of materials: wooden planks, tempered metal, rivets, strips of leather, etc. The perfect tools to assemble a shovel, to keep digging in, widening the space to range and relax. Or, on the other hand, are these the ideal materials for a ladder, to help you back to the vast, open surface, with all its promise and uncertainty?

As economic and monetary conditions become increasingly complex, many investors are finding solace in the Magnificent Seven[1] and/or the indices that are increasingly concentrated in a small number of "obvious" winners; For much of the last decade, one just needed to buy the S&P 500 Index, forgetting about all of the other strategies out there. However, this assumes the past is prologue, in that the state of affairs of the last umpteenth years is in fact the "new normal" and simply tracking the market will continue to provide all the performance needed to scale an endowment or corpus ad infinitum while shoring it against potential future challenges. As history shows, this has never been the case; the wheel always turns.

This doubling down on popularity and passivity mirrors complacency in other areas of the market, society, and overall resource distribution. Sometimes doing what's working for the moment obscures what's breaking down behind the scenes, preventing the deliberate, decisive action required to build a better way forward, not just a way forward. Such complacency is paralleled in the existing systemic bias of the investment industry and its critical talent pipeline, the American education system, particularly in terms of the current plight of Historically Black Colleges and Universities (HBCUs).

Despite their ethical dissimilarity, regardless of whether we're discussing passive investing or systemic bias, a lack of reflection and excessive comfort with the familiar in both spheres can hinder progress, financially and otherwise. By understanding the historical context of HBCUs and recognizing the importance of empowering underrepresented communities, we can foster a path towards a more equitable and sustainable future for both education and the broader economy; whereas for passive investment, for all the short-term and recent certainty around the status quo, a travel through the not-so-distant past reveals that hands off ultimately means leaving money on the table.

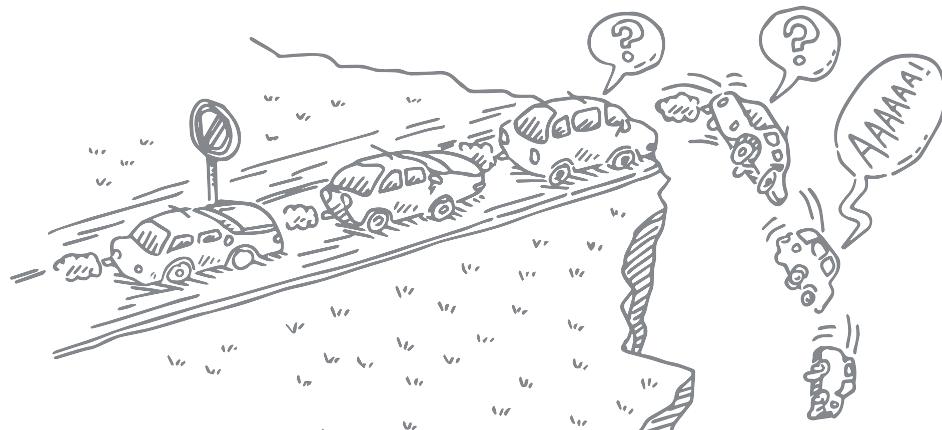


Digging In

At some point in everyone's life, as a child, an adult has likely said, "just because everyone else is jumping off a cliff, does that mean you should too?" After the initial eye roll, you probably considered the wisdom in that advice, eventually begrudgingly admitting no, you shouldn't jump off the cliff. Yet, when applied to investments, we are all too eager to follow the crowd.

It's easy to follow the crowd. It's comfortable, and when expressed through popular indices such as the S&P 500, such an approach doesn't appear to require an investor to assume risk outside of that basically inherent to every investment. But if one truly wants to pursue exceptional investment outcomes, what wisdom is there in following the crowd? Expectations should be set, definitionally, for average outcomes.

While the S&P 500 Index has recently provided an above-average outcome on an absolute basis, this approach has yielded below-average, even problematic outcomes for investors in past periods. Two distinct decades come to mind to illustrate this point: the 2000s and the 1970s.



Decade Ended Dec	Annualized Real Total Return %
1920s	34.9
1930s	3.5
1940s	9.4
1950s	27.6
1960s	6.3
1970s	0.4
1980s	13.8
1990s	28.4
2000s	-0.9

Source: S&P, Cowles Commission, BLS Citi Investment Research and Analysis
Note: Periods end in Dec 1930, 1940 etc, to 2010

The 2000s, often referred to as "The Lost Decade," yielded an annualized, inflation-adjusted return of -0.9% for the S&P 500 Index. The decade began with the bursting of the tech bubble, when investors began to realize that companies would never deliver on valuations set as large sales multiples, nor would any business with a ".com" moniker be an instant, unquestionable success. Prices were rightfully adjusted downward—severely. The decade ended in the aftermath of the Global Financial Crisis, in which the government took unprecedented monetary and fiscal measures to support the financial system in a period of deep distress caused by speculative lending. Given the bookends, it's easy to understand the anemic returns. However, several asset classes performed quite well: emerging markets (2.7x return), US small-cap value (1.8x return), and even US mid-cap core (1.7x return). The path to investment success, in retrospect, was quite obvious—diversifying away from the S&P 500 Index (0.9x return) was highly beneficial for those investors that did so.

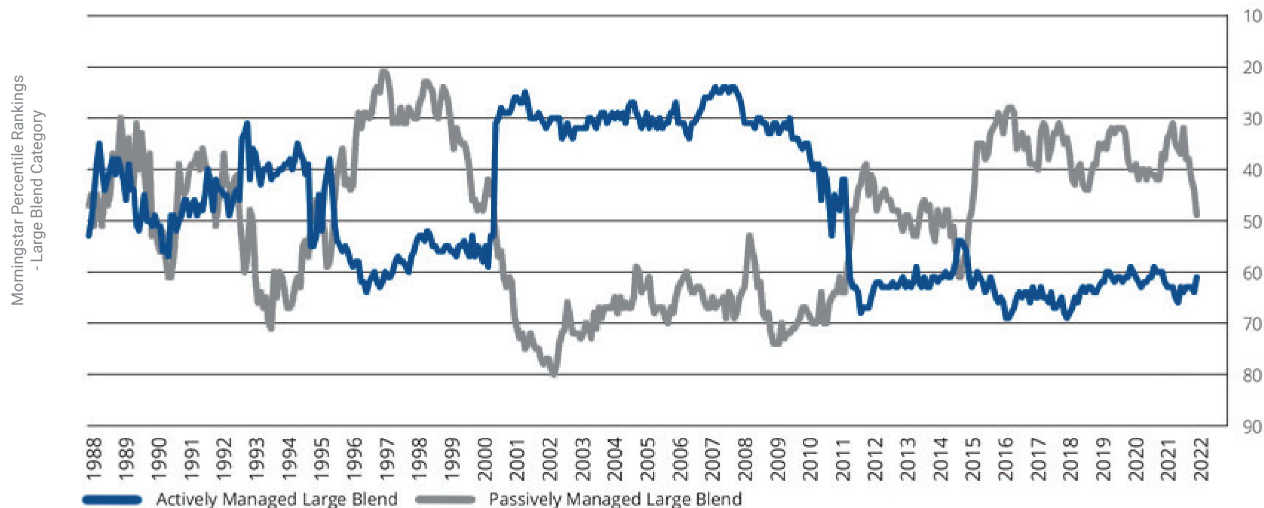
Investing is cyclical, a truism that can be extended to the active vs. passive debate as well. The graph below shows all of the Morningstar actively managed large-blend strategies (blue) versus the passively managed large-blend strategies (grey). The cycle is fairly obvious; it's also an exemplary illustration of the Lost Decade.

Passive is having its moment in the sun, but the graph is a clear reminder that this cycle will not last forever.

The 1970s, though not depicted below, again exemplifies this dynamic. The decade, at least economically, was defined by its stubbornly high inflation, underscored by tremendously high energy prices (the infamously long gas-station lines and fuel rationing) and high interest rates (15% mortgage rates). The S&P 500 Index produced a whopping 0.4% CAGR after inflation in the 1970s. Perhaps, in this case, an index fund investment was truly a jump off the proverbial cliff : every dollar invested in the S&P 500 fell just over 80% short (cumulatively) of what was needed to support a typical institution's mission; such an outcome has a permanent negative impact on any philanthropic organization.

ACTIVE AND PASSIVE OUTPERFORMANCE TRENDS ARE CYCLICAL

ROLLING MONTHLY 3-YEAR PERIODS (1988-2022)



However, the setup to this decade is perhaps of more useful interest. Investors believed an investment in the "Nifty Fifty" was a fool-proof strategy to beat the market; this was a collection of quality growth companies viewed to be extremely stable with unending promise for their future (sound familiar?). Constituents included Eastman Kodak, JCPenney, Sears Roebuck & Co., and Polaroid. Faced with rapidly rising interest rates, valuation multiples tumbled, as did the prospects for many of these companies; for the record, not one of the current Magnificent 7 were a member of the Nifty Fifty (none of them yet existed).

Faced with this reality, what did work in the 1970s? Small caps returned 11.5% per annum; large-cap value returned 12.3%; and international equity returned 10.1%—while 12.4% per year was the bar, these areas helped avoid disaster. Critically, diversifying away from popularity benefited investors with an appreciation of history and farsighted (dare we say brave) enough to break away from the pack.

The parallels between these two decades are simple and stark. Highly valued, high-quality stocks dominating indices subsequently floundered when faced with very different realities defined by their own unique challenges. The world is always changing. It would be folly to suggest that the winners of the last ten years will be the winners of the next ten years.

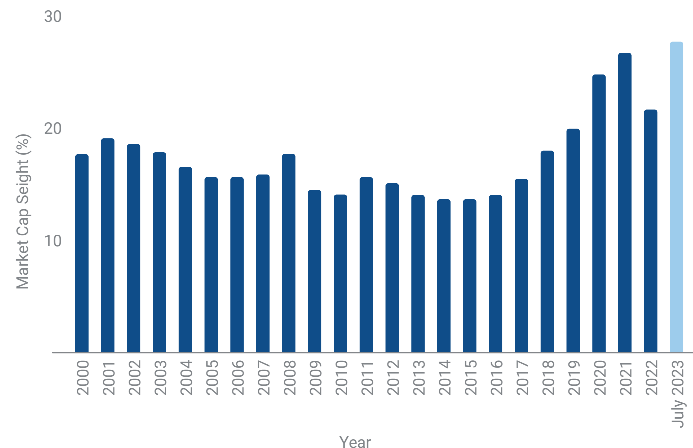
But surely the index offers enough diversification to overcome the challenges posed by just seven popular securities? Not exactly. For the last 20 years, the top seven names in the S&P 500 accounted for roughly 15% of the cap-weighted index; today, that figure has ballooned to 28%. Concentration and risk go hand and hand. Yes, the S&P 500 is diversified by asset class and sector, but with nearly twice as much capital allocated to today's group of 'cool kids,' the risk of a failure to generate sufficient forward returns is also higher.

But true diversification is not simply owning the breadth of the market (this too produces average returns). Rather, diversification needs to have a purpose based on putting together a curated set of assets to gain exposure to disparate geographies, economies, industries, and types of companies; this is what drives exceptional outcomes. Purpose-driven diversification, whether driven by valuation, geography, or market capitalization to carve up the public equity universe, helps drive exceptional investing.

However, diversification considered even more broadly, extending beyond the usual suspects, to ways of thinking, varied life experiences, age, gender, and ethnicity, can provide a more truly differentiated profile to better insulate your portfolio from the dangers of group think, positioning a long-term-oriented institution for sustained outperformance. Again, sticking with the crowd and following the usual suspects misses a far more expansive world of opportunities.

EXHIBIT 2

MARKET CAP WEIGHT OF TOP 7 COMPANIES IN THE S&P 500 INDEX OVER TIME



Digging Out

Might this time be different? Could life at the bottom of the pit be both safer and better than in the more complex world above? Certainty has no place in investing, but probabilities do, and in this case, history, logic, and mission alignment demand that we build that ladder. In doing so, we not only tap into the potential for starkly superior outcomes, but we also moderate risk by expanding both the variety of decision makers and the types of businesses they hold.

For example, investing in companies that prioritize diversity and inclusion can potentially increase portfolio returns in a few ways.

- First, diverse companies may be better equipped to understand and meet the needs of a diverse customer base, which can ultimately lead to increased sales and sustainable profitability over a longer-term horizon[2].
- Additionally, diverse companies may be more innovative than their homogenous counterparts and better able to adapt to changing market conditions, which can help them maintain a competitive advantage over time[3].

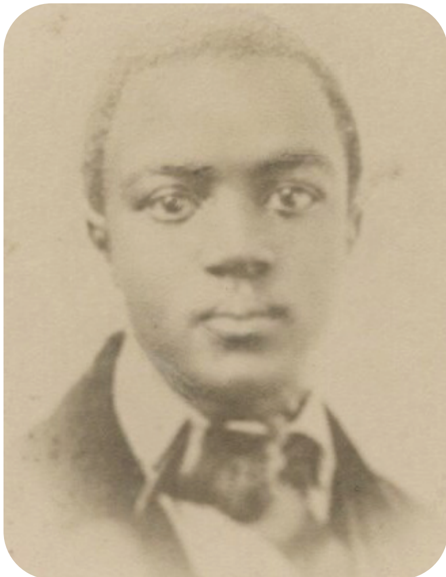
If you are not seeking out these (almost by definition under-the-radar) opportunities, you limit your chances of access until they become more consensus-driven names.

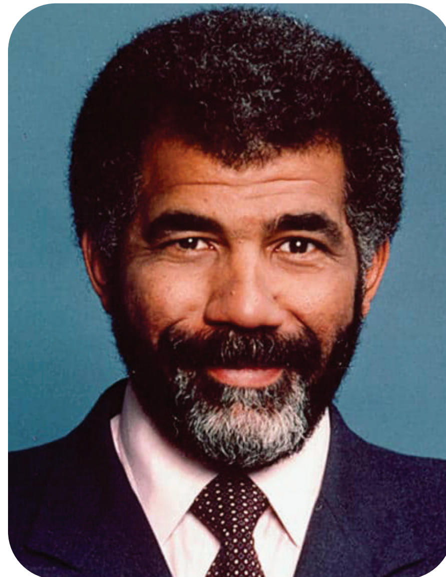
That is why, at Crewcial, we put such an emphasis on engagement and education among our crew. We aim to mitigate the impact of ingrained systemic paradigms of thought by educating ourselves on the behaviors that lead to social injustices and limit the visibility of diverse talent. It's been a long road and we still have much work to do, but we are committed to advocating for diversity in asset management and supporting equitable policies across the sectors in which our clients are involved, perhaps most urgently in education, as this reflects the primary talent pipeline of tomorrow's investable world and our industry[4]. For institutions with a mandate to invest for their survival in perpetuity, such forward thinking is tantamount to the Aesop fable The Ants and the Grasshopper[5], with savvy investors preparing for the inevitable winter while others enjoy a seemingly endless summer.

Because we believe, in essence, eschewing such an approach leads to probable failure that need not have occurred. The solution requires an expanded horizon and looking farther afield than the familiar. But this requires deliberate effort, as historical neglect and myopia, among other factors, have led to systemic disparities, whereas complacency helps to cement such inequality. In terms of ensuring the future pipeline is well-stocked and plugged in, one need only turn to HBCUs, which continue to face numerous challenges as compared to their better-resourced educational counterparts.

Secure Your Footing

CHEYNEY
UNIVERSITY
OF PENNSYLVANIA
Est. 1837





Proudly standing as the nation's oldest HBCU, Cheyney University has been a highly respected institution of higher education since its founding in 1837. For 186 years, its alumni have emerged as leaders affecting the social, economic, and political history of Philadelphia, the surrounding region, the nation, and the world. Well-known alumni include the late Ed Bradley, a correspondent for the CBS program "60 Minutes." [pictured left: Cheyney's first graduate.]

HBCUs were created out of necessity at a time when Black people were becoming free from conditions of bondage in the United States and still lacked access to existing primary and higher education. They are generally described as institutions established before the enactment of the Civil Rights Act of 1964 to provide post-secondary education to Black people at a time when only two colleges—Oberlin and Berea—accepted applications of Black students. 59 years after the passage of the Civil Rights Act, HBCUs compete as the most racially diverse in the United States; many have a roughly 1:4 ratio of non-Black students in attendance (including international students)[6]—significantly higher than the ratio of non-White students at PWIs[7]. HBCUs remain a protected space for Black learners to grow and develop free from bias, the need for covering[8], and the resulting difficulties and distractions.

On the positive side, some of the larger and more well-known HBCUs (e.g., Spelman College, Morehouse College, Howard University, Hampton University, and Florida A&M University) are well-funded and thriving, although "well-funded" in this case does not mean that these institutions have endowments comparable to those in the Big Ten or Ivy League institutions. But importantly, this is not the case for most HBCUs.

Ongoing investment is critical to the next generation for these institutions[9]. Some companies and donors like Netflix, Spotify, and Mackenzie Scott have recognized that HBCUs are the primary producers of next-generation Black professional talent in the United States; they have invested tens of millions of dollars each to supplement the costs of tuition and fees for many, including some that may be first-generation higher-education entrants and first-generation professionals. This mission is a critical one if America is to close the racial and ethnic gap in representation and disparity regarding participation in the broader marketplace.

HBCUs produce the vast majority of all Black doctors, military officers, and federal judges; they are also significant producers of Black PhDs, technology and financial professionals, and specialists in many other industries[10]. Some large employers like Wall Street's Big Three do recruit from among the most well-known, visible HBCUs in a similar way that law firms recruit from Yale and Harvard. Yet nearly 90% of Black college students considering a financial services career report they believe challenges exist that specifically affect Black advisors and financial professionals in the industry today; this sentiment is echoed by a comparable percentage of current Black advisors and financial professionals[11].

Underinvesting in HBCUs has a clear, direct impact in this case; it restricts access to such opportunities for non-traditional, non-legacy students, thereby limiting the possibility of future progress and potential solutions to current barriers. Reducing such access reduces the number of Black professionals produced and, in dire cases, results in the closure of some critically needed institutions.

Investment in capital projects helps institutions keep their infrastructure viable, investment in tuition-based funding increases student access to education designed for them in the first place, and investment in programming creates pipelines to future employment and access to talent by connecting businesses directly to the learner. Importantly, this is not an investment in a failing proposition: studies show that Black graduates of HBCUs do tend to outperform their peers from less diverse institutions, even those who entered college with lower academic credentials[12].

101

There are currently 101 HBCUs in the nation.

More than 50% of HBCUs serve 2,500 or fewer students.

HBCUs represent only 3% of all four-year nonprofit colleges and universities, but enroll 10% of all African American students.

25% of African American graduates with STEM degrees come from HBCUs.

Source: https://uncf.org/the-latest/by-the-numbers-how-hbcus-stack-up

Towards the Surface

For the same reasons that discussing bias is so fraught with challenges, building awareness can lead to discomfort for participants. Discussing money as it relates to a single demographic group can appear as a zero-sum game, especially given the competitive nature of the educational sector and certain industries, whereby existing participants believe they must lose something to create pipelines and access for others. However, the truth is that the research is settled that homogeny across viewpoints results in lower-quality outcomes[13]. Viewpoint diversity provides the opposite.

This is the crux of why we believe it is important to cultivate such viewpoints in spaces that allow them to reach their full potential, especially historically marginalized ones such as HBCUs. Representation across a variety of backgrounds and experiences, identities and beliefs, and thoughts and directions substantially improves outcomes across industries.

At Crewcial, when pursuing investment manager talent, we are keenly focused on the power of "variant perception," or diversity of thought, which leads to differentiated outcomes and acts as a further risk-mitigation tool, more naturally leading to various diverse founders with exceptional backgrounds. We do this because complacency should never be an option when acting as a responsible fiduciary.

In terms of index-tracking strategies, we're not railing against passive investing as such, and of course there is a place for it in portfolios, nor are we blaming investors for their impulse in seeking comfort in something familiar, which acts as a powerful magnet on human sentiment. Beyond purely passive programs, the large segment of the active management/advisor community that essentially hugs the indices while maintaining the fiction of meaningful differentiation with a handful of negligible outside allocations is representative of the same disease: Group think, which manifests its symptoms as, once again, complacency.

Passive investing can lead to a concentration of money in certain industries or companies, shoring up existing imbalances; this concentration means that a significant portion of passive investment funds is allocated to these top companies, perpetuating a homogeneity that dampens the potential for outsized investor returns. Similarly, systemic biases in education and investing lead to concentration and a lack of diversity in the workforce. These biases result in disparities in access to resources and opportunities, perpetuating inequality. In investing, such biases can result in a lack of diversity in investment portfolios, leading to missed opportunities and increased risk.

However, an approach that critically considers each factor is able to discern the opportunity at the intersection of both. It's important to remember to make space for the future, into which you can grow.

The enemy of progress is complacency. A reflexive move towards passive investing and an avoidance of large swathes of talent and potential for the sake of what's familiar and supposedly easy undermines the ability to grow and scale at a rate sufficient to maintain operations in perpetuity. We should not lose sight of this principle as the driving directive underlying all such advice as a dedicated fiduciary. While there is truly an ethical imperative towards equity, and that in and of itself should be adequate reason to pursue it, much like active investment, the primary reason we look to such options is because of their potential to strengthen portfolios and fortify any investment program to withstand the inevitable bumps on the road towards long-term, above-market returns.

Because, eventually, for the person in the hole at the start of this commentary, it will start to rain, and the individual comfortably set up below will realize the actions of their skyward counterpart were neither needlessly contrarian nor over-cautious; they were prescient. Because it will always eventually start to rain.

Luckily, it's never too late to start building that ladder.

Endnotes

[1] Apple (AAPL), Microsoft (MSFT), Nvidia, Tesla, Meta Platforms, Alphabet, and Amazon

[2] https://smallbusiness.chron.com/advantages-diverse-workforce-18780.html

[3] https://www.forbes.com/sites/forbesinsights/2020/01/15/diversity-confirmed-to-boost-innovation-and-financial-results/?sh=40f103fbc4a6

[4] https://www.ibm.com/thought-leadership/institute-business-value/en-us/report/hbcu-technical-talent

[5] https://read.gov/aesop/052.html

[6] https://www.equityinhighered.org/indicators/spotlight-on-minority-serving-institutions/undergraduate-enrollment-at-hbcus/

[7] https://www.ucda.com/journal/diversity-in-higher-education/

[8] https://www.nytimes.com/2006/01/15/magazine/the-pressure-to-cover.html

[9] https://www.responsiblelending.org/media/student-loan-debt-plagues-hbcu-students-prevents-wealth-building-according-new-report

[10] https://files.eric.ed.gov/fulltext/ED513988.pdf

[11] https://news.nationwide.com/nf-and-industry-partners-work-to-promote-equity-and-inclusion/

[12] https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1259&context=jlasc

[13] https://www.forbes.com/sites/sianbeilock/2019/04/04/how-diversity-leads-to-better-outcomes/?sh=73fc56e165ce

CREWCIAL®
PARTNERS