Biblically Responsible Investing Within Efficient Markets

"There are three classes of people who don't think markets work; the Cubans, the North Koreans and active money managers." Rex Sinquefield quoted by Burton G. Malkiel, "Are Markets Efficient?" *The Wall Street Journal*, December 28, 2000.

Disclaimer: Although I helped launch a wealth management company, served on its board, and obtained multiple regulatory licenses in the past, I am not a financial adviser and all my licenses have lapsed by design. This article is, in part, a challenge to the Biblically Responsible Investing (BRI) community that we need to meet significant felt needs within the investments arena. These needs include the fiduciary performance requirements that are often thwarted by high fees as well as minimize dispersion risk from published benchmarks that often have negative expected returns. This article also seeks to assist anyone responsible for managing wealth, even our own family's wealth, to better understand the evidence related to investment fees and fund performance.[1]

A recent email from a missionary went something like this: "Hi Bob! I'm considering investing some money for our retirement. I have an account already with HIGH Family of Funds, and I know my adviser personally. He is my age, and recommends investing in what he invests in, which is called High Fee Fund (HFF). He thinks it's the best conservative investment fund. I know you prefer Low Fee Funds (LFF) offered by the LOW Family of Funds. Can you give me any counsel about HFF?"

Although I would prefer to have an improved BRI-based response, it remains challenging. My response went something like this: "Please see the attached fact sheets. Key Observations (HFF is fund recommended by adviser, LFF is comparable passive index fund):

1. Fund expense ratios: HFF = 0.79%, LFF = 0.03%.
2. Your adviser will likely charge wealth management fee on top of the 0.79%.
3. Three year performance: HFF = 8.7%, LFF = 10.47%.

It is up to you. Having an advisor is helpful but it is just a question of costs (0.79% + advisor management fees + active management performance decrement, here, –1.77% over the past three years, HFF = 8.7% less LFF = 10.47%, + unnecessary dispersion risk).

I prefer low cost, do it yourself. On the other hand, I hire all kinds of folks to fix things around the house because I do not know what I am doing :)."

The goal here is to address questions such as these and to present a call to the Christian investment community. We first review the role of markets seeking to understand investments within the context of a social science. Second, we turn to the notion of efficient markets with a deep dive into the oft-ignored overwhelming empirical evidence. Like the carcinogenic nature of cigarette smoking, it is equally challenging to convince the investment industry of the severe damage inflicted with high fee funds, especially when the net result of active management is decrementing performance. Third, an outsider's perspective is given on the current state of BRI within public markets. Finally, a genuine call is made to the BRI community to provide viable low cost, passively index investment instruments.

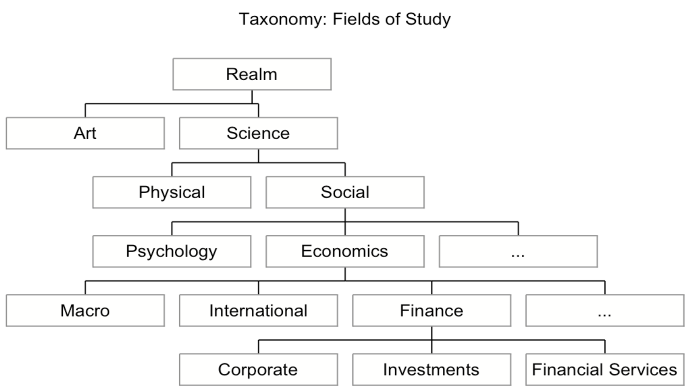
[1]BRI goes by other names, such as Faith-Driven Investor (FDI). BRI is used here to encompass all the various efforts to align one's investments with a biblical worldview.

Role of Financial Markets

Often overlooked are the powerful human flourishing consequences of well-functioning financial markets. Within liberty-based economies, financial instruments are constantly being created, exchanges are formed, and efficient trading is conducted.

A medium of exchange as well as a means of exchange are essential. Modern financial markets, based on electronic platforms, allow for efficient trading of financial instruments. Instruments in our context is an all-encompassing term to reference financial securities, financial contracts, as well as many other items (even data measurements such as corporate donations). The capacity to transact financial instruments efficiently within a trustworthy infrastructure result in significant increases in financial instrument's valuation greatly enhancing human flourishing.

We need to recognize that investment management falls within the social (or human) sciences. As such, the epistemic certainty of various propositions is typically much weaker than the physical (or natural) sciences. The nearby figure highlights one view of the taxonomy of various fields of study. As illustrated, investments is categorized within the finance field, a subspecialty of economics (really microeconomics). The key insight is that propositions within investments are within the social science realm. Thus, because humans adapt and create (imago dei), we never have the capacity to replicate—a key attribute within the physical sciences. Further, as Alex Edmans notes: "Evidence is not proof: It may not be universal. Data is not evidence: It may not be conclusive. A fact is not data: It may not be representative. A statement is not fact: It may not be accurate."[2] There are, however, investment propositions that enjoy a high level of epistemic certainty. Later, we examine the investment proposition that low fee, passive index funds significantly outperform high fee, actively managed funds.



One direct consequence of well-functioning financial markets is the efficient processing of information. We now examine the empirical evidence and logical consequences of markets being informationally efficient.

Efficient Markets

A financial market in which prices reflect all relevant information is said to be efficient. More formally: The costless and available current information set contains all the relevant information from which participants generate their expectations of future instrument performance. There exists a function that transforms these expectations into a single current security price. The implication of the efficient market hypothesis (EMH) is not that financial markets are always right. Almost by definition, financial markets are always wrong. The challenge is that the embedded valuation errors are unbiased and impossible to discern in advance.[3]

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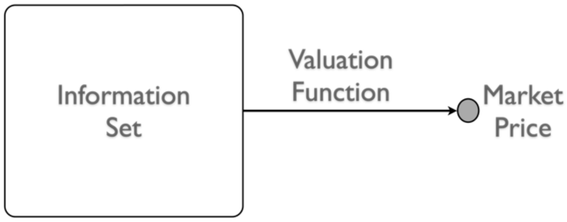
[2]See https://maycontainlies.com, website by Alex Edmans.

[3]The human appetite to know the future, God's willingness to reveal the future (rarely), and the human inability to forecast accurately is well documented throughout the Bible. See, for example, James 4:13-17.

The nearby figure illustrates EMH. Two essential questions arise: What constitutes the relevant "Information Set" and what is the appropriate "Valuation Function"? Academic finance has exhaustively explored EMH and as you might expect, the evidence varies. One of the most compelling arguments is normative: If markets are perfectly efficient, then expending effort to capture inefficiencies would be absent. Hence no one would pursue inefficiencies resulting in inefficient markets. EMH requires there to be some inefficiencies as a reward to those seeking to make markets efficient.



The research related to the information set can be viewed as a continuum illustrated in the nearby figure. At one extreme, the information set is empty (or no information). That is, information is not used at all—clearly false. At the other extreme, the information set contains all past, current, and future information—again clearly false. A currently unknown future innovation would not be reflected in current prices. The first break point in this continuum, weak form efficiency, is where the information set contains at least all information related to historical financial prices. The second break point, semi-strong form efficiency, is where the information set contains all publicly available information. The final break point, strong form efficiency, is where all currently known information, public and *private*, is contained in the information set. Thus, the notion of an efficient market is one of degree and varies across different markets as well as across time.

To arrive at a current market price, we need more than an information set. We need a valuation function. Thus, some argue that you can never fully ascertain if a particular financial market at a particular point in time is efficient because it is joint hypothesis of the correct information set and correct valuation function.

Several candidate valuation functions have been offered. First, for those who do not believe markets work (and lean toward a statist-run economic systems), a naïve or random valuation function is assumed. A phrase like "animal spirits" would be used. Second, the valuation function is built on speculative equilibrium that focuses primarily on resale. The primary analysis is on whether the financial instrument will be sought in the future by some investor groups. Third, the valuation function is built on intrinsic value that focuses on fundamentals.[4] This traditional approach to valuation is to forecast some future expected cash flows and then to take the present value of this future expected cash flow stream. John Burr Williams (1938) is usually credited with first articulating this procedure for common stocks. He states, "The investment value of a stock [is] the present worth of all the dividends to be paid upon it adjusted for expected changes in the purchasing power of money." Interestingly, Williams goes on to argue "That neither marketability nor stability

[4]Note that intrinsic value is metaphysical by definition and never observed in space and time; hence, there are as many intrinsic values as there are fundamental analysts. This term is often misused to leave the unsuspecting person believing that it temporally does exists.

should be permitted to enter into the meaning of the term investment value."[5] As markets developed, it is now abundantly clear that both marketability and stability (now known as volatility) deeply impact financial instrument valuation. Fourth, and most popular, the valuation function is a combination of speculative equilibrium and intrinsic value and known as the rational expectations approach.

If public financial markets in liberty-based economies are efficient, say semi-strong form based on rational expectations, then there are several significant implications.

1. Financial markets provide effective capital allocation due to unbiased price signals.
2. Speculation is a zero-sum game—any perceived mispricing usually suggests the analyst is missing critical publicly available information.
3. Technical analysis as well as fundamental analysis is useless.
4. As new information arrives in financial markets, it is instantaneously reflected in prices.
5. Markets will remain efficient only if enough people do not believe it is efficient. The marginal gains available to these traders will tend toward zero and often negative after costs.
6. Financial advisers should build needs-driven portfolios for clients, where the focus is matching the stochastic nature of client liabilities (explicit and implicit) with stochastic nature of available low fee financial instruments. Needs-driven portfolio management is widely practiced in financial institutions and insurance companies (known as asset-liability management) as well as defined-benefit pension plans (known as liability-directed investments).
7. No entity has an edge on information or information processing above the marginal cost of producing that edge.
8. Some investment managers, particular those who are currently advertising excessively, will have impressive records, but as is often disclaimed, "past performance will not be a predictor of future performance."
9. Financial advisory practices will pivot from view-driven with numerous "seers" currently known as economists to needs-driven. Specific advisory practices changes include:
   A. Diversify—for example, passive index funds, one of the few "free lunches" offered in markets.
   B. Monitor risk levels related to client preferences.
   C. Minimize interest rate risk levels related to client liability analysis.
   D. Trade timing will be driven by client liquidity needs and tax exposure.
   E. Maintain appropriate marketability levels.

Efficient financial markets do not simply spring into existence within any culture. Liberty-based economic frameworks in the West are conducive. Jürgen Habermas, when summarizing the West's philosophical foundations concludes, "Universalistic egalitarianism, from which sprang the ideals of freedom and a collective life in solidarity, the autonomous conduct of life and

[5]See John Burr Williams. The Theory of Investment Value (Cambridge, MA: Harvard University Press, 1938). Reprinted in Charles D. Ellis, Classics: An Investor's Anthology (Charlottesville, VA: Institute of Chartered Financial Analysts, 1989). See Ellis (1989), p. 153 and 156.

emancipation, the individual morality of conscience, human rights and democracy, is the direct legacy of the Judaic ethic of justice and the Christian ethic of love."[6]

Within this culture, Harry Markowitz in the 1950s proposed a purely mathematical means to build optimal investment portfolios, reducing the investment decision to a handful of statistical parameters. Implicit in his analysis was the assumption that company managers would adhere to the pillars of Western civilization.

The 1970s saw the explosion of deeply useful quantitative financial models along with technological advances. With emerging empirical insights, John Bogle created the Vanguard Company in 1974, based in part on the evidence related to passive investing. Academic and technological advances together provided wide-spread financial benefits. Examples include improved corporate decision-making leading to better products at lower cost, lower overall borrowing rates, and improved investment performance.

Many have noted that the shared traditional values are now starting to crumble. Even John Bogle noted, "There no longer can be any doubt that the creation of the first index mutual fund was the most successful innovation — especially for investors — in modern financial history. The question we need to ask ourselves now is: What happens if it becomes too successful for its own good?"[7] One key issue he identified was the concentration of corporate voting rights in the hands of a few investment firms. This would not be a problem if these firms' managers based their voting decisions on shared principles.

We turn now to briefly examine the empirical evidence related to active investment management versus passive indexing. Remember, absent efficient passive index instruments, the above discussion is simply academic.

Passive indexing versus active management: Empirical evidence based on SPIVA

There are very few testable assertions within investments with such overwhelming evidence favoring the dominance of passive index instruments over active management-based instruments. One authoritative source for conducting this analysis is the semi-annual S&P Indices versus Active (SPIVA) scorecards.[8] Based on the SPIVA data, Langley, a Wall Street Journal reporter, notes, "Over the long run, few funds manage to beat their benchmarks. Over the 20 years through June [2022], only about 5% of large-cap U.S. funds beat the S&P 500, according to the S&P report. Just staying in business was an accomplishment, with about 26% of the funds surviving over that time."[9]

SPIVA provides an enormous amount of empirical evidence, evidence worthy of deep consideration within the BRI community. For example, Karen Langley, a *Wall Street Journal* writer based on data through 2022, noted "Echoing a frequent theme of SPIVA Scorecards over the past 20 years, **underperformance rates generally rose with the length of the period over which they**

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[6]Jürgen Habermas, *Time of Transitions*, Polity Press, 2006, pp. 150-151, a translation of an interview from 1999.

[7]John C. Bogle, "Bogle Sounds a Warning on Index Funds," *Wall Street Journal*, November 29, 2018.

[8]For starters, see https://www.spglobal.com/spdji/en/documents/education/education-spiva-scorecards-an-overview.pdf.

[9]See Karen Langley, "Almost Half of Stock Pickers Beat the Market in Early 2022 Selloff," *Wall Street Journal*, September 15, 2022, online.

were measured. Of 39 reported categories, eight displayed majority outperformance over a one-year horizon, falling to just two categories over a five-year horizon." (bold in original)[10]

In a study of equity mutual funds from 1991 to 2012, Livingston, Yao, and Zhou (2019) conclude that "active management does not provide a foolproof guarantee of better results for investors. Further, we find that not only do higher expense ratios or higher portfolio turnover reduce mean performance, but they also increase the dispersion of performance — a doubly adverse effect."[11]

In a presentation to The World Money Show, John C. Bogle, Founder and Former Chairman of the Vanguard Group (one of the largest fund families in the world), concludes with three rules, "First, in investing, realize that you get what you *don't* pay for. [Seek to minimize costs.] … Second: Don't do something, just stand there. [Broadly diversify.] … Third, Stay the course. [As we do not know the future, invest for the long term.]"[12]

To summarize the vast EMH literature related to public markets: Passive index instruments overwhelmingly outperform actively managed instruments by any reasonable metric.[13] For those who believe in a God to whom we must give an account of how we managed his resources, we would be wise to acquire the latest SPIVA report and carefully digest its conclusive nature. Jordan Peterson asserts, "The future is incomputably different from the present and the past."[14] If true, then the BRI community would be better served with biblically aligned passive index funds.

Quest to lower all-in investment-related fees

One of the most significant predictors of financial instrument performance is all-in costs or fees. With mutual funds or exchange traded funds, the expense ratio is one of the best leading indicators of long run performance. The higher the expense ratio, the lower the expected long run average returns. Pritcher reports in the Wall Street Journal that State Street now has ETFs with 0.02% expense ratio. "An individual investor can now build a fully balanced portfolio using ETFs without paying more than 0.05% in total fees, said Susan Thompson, head of SPDR Americas distribution at State Street, compared with around a 1% average fee 20 years ago."[15]

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[10]See "SPIVA U.S. Scorecard: Year-End 2022," page 2.

[11]Miles Livingston, Ping Yao, and Lei Zhou, "The Volatility of Mutual Fund Performance," *Journal of Economics and Business*, 2019, online.

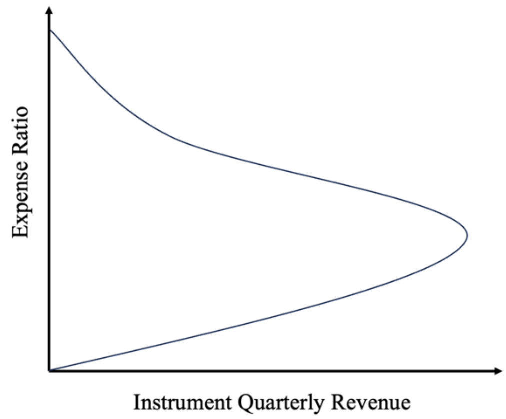
[12]See John C. Bogle, "In Investing, You Get What You *Don't* Pay For," Keynote speech at The World Money Show, Orlando, Florida, February 2, 2005. Available at https://johncbogle.com/speeches/JCB_MS0205.pdf.

[13]Passive index portfolios do suffer from removing voting rights from the investor posing a challenge for the BRI community.

[14]Jordan Peterson, Bitcoin as an Incorruptible System of Value Podcast, https://www.youtube.com/watch?v=FQlA-I7PXf0. Also supported biblically in James 4:13-17.

[15]See Jack Pritcher, "You Might Be Paying Too Much for That Index Fund: Push toward zero-cost ETFs nears the finish line," *Wall Street Journal*, September 18, 2023, online.

Having been involved in managing various financial instruments, the financial plumbing is extremely expensive, especially if managing a small number of funds. In modern markets, the gains from economies of scale are critical. Consider the nearby diagram of the instrument quarterly revenue, say an ETF, to the fund manager with respect to the expense ratio. Clearly, if the expense ratio is 0%, then the investment quarterly revenue is $0. If the expense ratio is 100%, then the investment quarterly revenue is $0 because the manager would have no funds to manage! Logically, the fund management team seeks to find the expense ratio that maximized the investment quarterly revenue. As revenue is clearly tied to assets under management (AUM), the hope is that this optimal revenue will also correspond to quality after-fees returns to clients.



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Over the past several decades, there has been enormous change within financial markets. The emergence of BRI-based financial instruments is deeply encouraging. The purpose here is to issue a challenge to seek continuous improvement. We desperately need a "Virtuous Vanguard," that is, a family of funds targeting the low fees of passively index funds. Further, the BRI community is fully capable of producing financial instruments that are competitive with the low fees of passive index funds while simultaneously addressing biblically various corporate actions.

Does it really have to be the case that in public markets, BRI necessarily means paying high fees and accepting decremented performance? BRI firms need to consider straightforward screens eliminating say the worst 10 to 20 percent bad actors based on some "Mere Christianity" standard. As C. S. Lewis notes, "In reality, moral rules are directions for running the human machine. Every moral rule is there to prevent a breakdown, or a strain, or a friction, in the running of that machine."[16] Thus, companies that lean in the direction of "Mere Christianity" will function well and serve the needs of its shareholders.

The BRI-based, passive index could simply adopt an annual screen, value-weighted index, rebalance infrequently, and operate tax efficiently. BRI firms may discover that by lowering expense ratios their AUM rises and the net result is higher revenues.

Finally, many BRI-based firms advertise their great charitable giving commitments. It is difficult not to ask why those same firms did not lower their fees and thus enhance client performance, enabling *clients* to meet their biblically-based responsibilities to care for their families as well as be more charitable themselves.

The goal here is to challenge all faith-based investors to carefully appraise the fee structure of their current portfolio as well as challenge the BRI-based investment firms to see their investing activities as their Christian mission, not just investing for Christian missions.

[16]C. S. Lewis, *Mere Christianity*, Book III, Chapter 1, page 59.

Robert E. Brooks, Ph.D., CFA
Financial Risk Management, LLC
FRMHelpForYou@gmail.com
www.robertebrooks.org
https://www.youtube.com/@FRMHelpForYou
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