Conservative Equities in historical perspective: Fund investing since 1774

WHITE PAPER
September 2016

Jan Sytzte Mosselaar, CFA
Pim van Vliet, PhD
<table>
<thead>
<tr>
<th>Contents</th>
<th>Intro</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Introduction</td>
<td>5</td>
</tr>
<tr>
<td>Classic mutual funds 1770-1960</td>
<td>8</td>
</tr>
<tr>
<td>Modern funds grow rapidly 1960-2000</td>
<td>13</td>
</tr>
<tr>
<td>Post-modern fund era in the 21st century</td>
<td>20</td>
</tr>
<tr>
<td>Conclusion</td>
<td>24</td>
</tr>
</tbody>
</table>
As portfolio managers of the Robeco Conservative Equities strategies, we want to place our role into a historical perspective and learn from the history of financial markets in general and mutual funds in particular. In this paper we take you on a tour through the history of fund investing.
NEGOTIATIE
onder de Zinspecok
EENDRAGT MAAKT MAGT.
Opgedikt in AMSTERDAM.

CONDITIEN.

Artikel I.
Ditte Negoitatie is onder 't oogt van DE WEL. EDELE HEEREN
DIRK BAE BACKE.,
FRANS JACOB HESHUYSEN.
Als Commissarissen hoe 't vermoeg en gunst uweis.
En van den Meheer ABRAHAM VAN KETWICH, als Administrateur.

tis lidhende en divers Caffs, alie onderling met alanderen Goegemeened en Ver-
baange; eir Caff in Hoofd. Amstel; eir Aandeel groot in Capital f 700, —

Art. II.
Het Capital van eir Caff deze Negoitatie, bevat in de volgende
Effelen, als:

1. Obligatien op de DIESISCHE en WEEMER-BANKEN.
2. Ann op de DIESISCHE TOLLEN, en HOLESTYN.
3. Ann op RONLAND, en ZWEDEN.
4. Ann op BRUSSELY, en MELKEBURG.
5. Ann op de SASSISCHE POSTERIJEN, en BRABANDISCHE MOERLANDEN.
6. Ann op de SPAANSISCHE CANAAllen IMPERIAAL en TACUTE.
7. Ann op de ENGELISCHE COLONIJEN, onder Burgmeester en Gouverneur van de
Heeren J. Del. Comps., Vereen. en Comp., J. Hulsema, Duit en Ro-
guin, en E. van Hoornich.
10. Ann op de DEESISCHE AMERIKAANISCHE EILANDEN, ten Comptoir van de
Heeren Duyve en den der Stadt, J. Hofstyn, H. Stehme en Zeew,
L entre en de Bruijn, en Neve Herasch & Folkmun.

2a. Obligatien, eirde groot Een duizend Gulden, is in nomes in Capital f 50,000.

En eir Caff ten meette in 8 en 18 verschillende roosten van terzelming Effeeen,
dag niet meer als 2 of 3 Obligatien van een en dezelfe Negoitatie, syns verder in
elix, zo veel mogelijk war, met gelycke vermenigvuldigd in acht genomen.

Art. III.
Executive summary

The first ever mutual fund was launched by Abraham van Ketwich in 1774. Ever since then, the industry has blossomed, while the growth in assets over the last few decades has been explosive. The investment management industry has grown into a multi-trillion dollar business. Today there are more than 100,000 funds, collectively managing more than USD 38 trillion in assets (ICI.org).

The latest trend is the rise of academically inspired funds, based on extensive research and empirical evidence. In this paper, we put the quite recently developed investment style of low-volatility investing into a broader historical perspective. We discuss the latest trends, but also draw lessons from 19th century funds and attempts to build modern low-risk funds in the 1970s. History tells us that good ideas do not necessarily guarantee successful funds and emphasizes the significance of timing. In addition to this, we demonstrate that capital protection, high income and low turnover are timeless factors when it comes to benefiting clients and contributing to their long-term wealth.

As portfolio managers of Robeco Conservative Equities, we are not only passionate about research-based investing, we are also fascinated by history. As professional investors we are entrusted with other people’s money. We therefore want to place our role as money managers into a historical perspective and learn from the history of financial markets in general and mutual funds in particular. In this paper we take you on a tour through the history of fund investing. We identify three periods which characterize our industry: pre-modern, modern, and post-modern.

First, the pre-modern period. This is a rather long period which ended around the late 1950s. During this early age of investing the industry was virtually non-existent, but the objectives of the first funds look surprisingly relevant for investors today. Then too, the focus was on classical investment objectives that benefit clients such as stable returns, high income and low turnover. We look at the first mutual funds launched back in the 1770s, the first closed-end investment trusts from the 1860s, and the first, modern open-end mutual funds of the 1920s.

Second, the modern period starts in the swinging sixties, when the first modern mutual funds as we know them today started to appear. Not only did the industry grow rapidly, the investment focus also shifted from conservatism to outperformance and we saw the rise of ‘star managers’. At the same time, influential capital-market models were developed by academics, leading to the rise of market-weighted indices which became common benchmarks. These developments were all supported by the increase in computational power. Early attempts to build a low-beta fund in the 1970s were unsuccessful.
Third, since the late 1990s the industry has witnessed the rapid rise of evidence-based investing. The simplest rules-based funds just tracked market indices and offered diversification at very low cost. However, academics also started to acknowledge that market indices are not efficient. Based on these insights, new rules-based funds started to target factors such as low-volatility, value and momentum, to achieve a better risk-return profile. The current post-modern period is characterized by the co-existence of a range of investment philosophies offered in different fund structures. We argue that low-volatility is a special factor, which brings us back to the original goals of the first mutual funds.
Throughout the years all pre-modern funds had similar objectives: a focus on capital protection, income and low turnover. Quite different to the focus on short-term outperformance and the peer group pressure that dominate today’s investment funds.
The first part of this history paper focuses on the very first mutual funds which date back to the 1770s, as well as the first modern mutual funds from the 1920s. Interestingly, throughout the years all these pre-modern funds had similar objectives: a focus on capital protection, income and low turnover. These objectives were often clearly stated in their prospectus. This is quite different to the focus on short-term outperformance and the peer group pressure which dominate the average investment fund nowadays. We also discuss the short-lived interest in closed-end investment trusts, which started off as a good idea in the UK of the 1860s, but came to a sudden and dramatic end in the Wall Street Crash of 1929.

1774 – Ketwich the financial innovator | As with many innovations, it is debatable exactly when the first mutual fund in history was introduced. In the 1770s, investment vehicles with all the characteristics of a mutual fund were created in what was the global financial center of the 18th century, Amsterdam.

We will take a closer look at a financial innovator and probably the first value manager in the world. Abraham van Ketwich owned one of the many brokerage offices in the city. Many of his clients invested in the English East India Company and lost a great amount of money. The prospects of this company were greatly exaggerated, leading to a stock market crash and credit crunch in Amsterdam and London in 1772/1773.

Van Ketwich came up with the idea of offering a diversified fund of bonds that would mitigate the investment risk for small investors. He named his fund Eendragt Maakt Magt (unity makes strength). The prospectus of the fund, called a Negotiatie, clearly outlined the investment strategy:

- The fund would consist of several share classes and would invest in ten different categories of securities, 50 in total, which were all listed in the prospectus. The categories included government bonds from Russia, Sweden and Denmark, as well as bonds securitizing Danish and Spanish toll revenues, but the fund focused mainly on Caribbean plantation loans, the predecessors of mortgage-backed securities.
- Dutch government bonds were not included, as their perceived low risk was felt not to require diversification. Equity investments were deemed to be too risky and were excluded from the investment universe.
- The fund wasn’t supposed to trade much – something which was safeguarded by a strict separation between the investment manager and the broker, Van Ketwich, who handled the trades.
- The starting point was to equally weight the investments to ensure the benefits of diversification.
- The fund would pay an annual dividend of 4%.
- The fund would be terminated after 25 years.

1 See for example Berghuis (1967) and Rouwenhorst (2004)
Two years later, a second fund was launched, Voordelig en Voorsigtig (profitable and prudent), and was more or less a copy of Eendragt maakt Magt. This time, Van Ketwich was not the initiator, but his brokerage served as a registration office.

The third fund, called Concordia Res Parvae Crescunt (where there is harmony, small things will grow) and launched by Van Ketwich in 1779, had more investment freedom. It was supposed to seek securities that traded below their intrinsic value, as this would lead to handsome profits in the future, according to the prospectus. This might well have been the world’s first value fund.

Not all three Ketwich funds were a big success though, neither in terms of assets under management nor investment results. Abraham was too early and his investment funds suffered serious headwinds. A few years after the launch of these funds, the Fourth Anglo-Dutch War broke out in 1780. Investors’ sentiment deteriorated and the Caribbean plantation loans suffered as colonial goods could not be shipped back to Holland. In 1795, the situation worsened as the Dutch Republic went to war with France and as a result the Dutch Caribbean colonies were confiscated by the British. The Dutch economic hegemony, already in decline, was now over; London took over from Amsterdam as the financial center of the world. Eendragt maakt Magt was eventually liquidated in 1824.

The other two funds did not fare much better: Voordelig en Voorsigtig was probably liquidated just a few years after its launch, while Concordia Res Parvae Crescunt had to halve its 4% dividend in 1796. Still, this particular value fund did continue to exist until 1893 when it was liquidated at 80% of its initial nominal value. Although this fund probably still holds the record for the longest-running mutual fund ever, it was clearly not a big success in terms of investment returns.

Van Ketwich’s idea of a diversified investment vehicle for the small investor was brilliant, but his timing was unfortunate given the unforeseen macroeconomic events in the years after his funds were launched. As investors know: timing is everything. You need to be patient in life and when investing, but history shows that in the case of Abraham van Ketwich, even a century is sometimes not long enough...

One of the first investment funds outside the Dutch Republic was the Foreign & Colonial Trust, which was launched in 1868. The trust grew into F&C Asset Management and is nowadays part of BMO Global Asset

1868–1929 — The rise and fall of investment trusts | One of the first investment funds outside the Dutch Republic was the Foreign & Colonial Trust, which was launched in 1868. The trust grew into F&C Asset Management and is nowadays part of BMO Global Asset

2 The fund existed much longer than the planned 25 years. At the planned termination year in 1799, the fund was trading far below par and the managers wanted to liquidate above par. They managed to do this only in 1824 and after having bought back many participations in their own fund at depressed prices.
Management. Another investment trust that still exists, is the Scottish American Investment Company. The trust initially invested in railroad bonds, but later expanded its business into shares and bonds in other sectors as well. A typical closed-end trust in the UK in the 19th century invested in around 500 to 1000 companies, and was actively managed by professional money managers.

Until the 1920s, the use of investment trusts by investors was confined to the UK. Only in the equity bull market of this decade did this grow into a serious business in the US as well. Part of the reason for this were US newspaper articles about the popularity of investment trusts in the UK, which stated that the US was falling behind in financial innovation. In 1927 the number of trusts nearly doubled from around 160 to 300. In 1928, another estimated 186 trusts were launched, and in 1929 a record 265 new trusts saw daylight (Galbraith, 2009).

Along with the growth of the investment trust industry, a number of excesses related to investing also increased, however. Manipulation, insider trading, and worst of all excessive leverage turned the sound concept of a diversified investment trust into a dangerous vehicle. Several trusts had leverage on leverage as they invested in other trusts. Furthermore, issuers of trusts artificially pumped up their value to attract new uninformed investors, while insiders had been given the chance to buy into the trust at an earlier stage and at lower prices.

The most notorious examples were the trusts introduced by Goldman Sachs. The investment bank was relatively late to jump on the bandwagon, and sponsored the trust called Goldman Sachs Trading Corporation on 4 December 1928, issued at a price of USD 100 per share. Although the trust rose over 100% in the first three months, in 1932, after the crash, its price was quoted at USD 1 ¾. Most other investment trusts did not fare much better. And the effects of the leverage were felt with a vengeance during the crash of 1929-1933.

Because of the troubles with leverage in investment trusts in the 1929-1933 crash, the mutual fund model became the definite way forward. This development was helped by the Investment Company Act of 1940 that clearly favored mutual funds over closed-end investment trusts. In the post-depression era it was time for unleveraged, transparent and open-end mutual funds.
Conservative Equities in historical perspective: Fund investing since 1774

1920 – The first open-end mutual funds  |  The first modern, open-end mutual funds in the US had already been launched a few years before the exponential growth in the investment trust market. In Boston in 1924, five years before the start of the Robeco fund in Rotterdam in 1929, the still existing Massachusetts Investors Trust (MIT) started to offer an open-end low-cost vehicle that would give small investors the chance to have a diversified portfolio, similar to Van Ketwich’s idea. The fund stayed close to the Dow Jones Index and was even accused of index hugging in a 1949 article in Fortune Magazine. The response of MIT was: “Owning the market is not a bad thing at all for the small investor”.

After the Great Depression of the 1930s, the four oldest mutual funds – the MIT Fund, the Investors Incorporated Fund, State Street and Wellington – were run by experienced fund managers who invested conservatively as the depression era was still fresh in their minds.

Their goal was to give their investors a prudent, mutual fund with a focus on controlling risks. For example, in its prospectus, active manager Wellington, founded in 1928, stated that its investment objective was: “to pay reasonable dividends, to secure profits without undue speculation, and to conserve principal”. These objectives are similar to the principles of the Prudent Man Rule of 1830, which we discussed in a previous Robeco research paper on investment history.

Prior to the 1960s, the mutual fund market was still small. The December 1949 edition of Fortune Magazine stated that “mutual funds may look like pretty small change”, but that they had very good prospects. The article also forecasted that the “rapidly expanding and somewhat contentious industry could be of great potential significance to US business”.

---

3 Fox (2009)
4 The Economic Role Of The Investment Company - Articles | ETF.com
5 Conservative Equities in historical perspective: Investment behavior since 1602; Mosselaar and Van Vliet, Robeco Research Paper, April 2016
6 As quoted by Bogle (2003)
In the modern period, mutual funds showed rapid growth, accompanied by an increased focus on relative performance. We consider this to be an important cause of the low-risk anomaly.
The words of Fortune Magazine in 1949 turned out to be prophetic. The mutual fund industry started booming in the 1950s and 1960s, as shown in Figure 1. After the equity market stalled in the 1970s, a second period of fast growth followed in the 1980s and 1990s, supported by one of the biggest bull markets ever. This was accompanied by the increased use of benchmarks, performance measurement techniques and the focus on short-term outperformance. We see this increased focus on relative performance as one of the root causes of the low-risk anomaly.

Figure 1 shows that the US fund industry has posted an average annual growth rate of 16% in the last 40 years. The global fund business has experienced similar growth rates.

**Figure 1** | US fund assets, in USD billions 1940-2016 (log-scale)

1960 – Did John Bogle advocate active low-volatility investing? | The high growth in the number of mutual funds in the 1950s led two academics, Renshaw and Feldstein, to write an article in the 1960 Financial Analysts Journal that advocated a passive, indexed approach. They stated there were far too many (>250) mutual funds to choose from. An index fund would relieve investors of the task of making any choices at all. Back then, this good idea of theirs was not picked up by any asset manager.

Ironically, today’s embodiment of index investing, John Bogle, who worked at active manager Wellington at the time, wrote a reaction in the same journal a few months later. In this article, he advocated active(!) mutual fund investing. He argued that the mutual funds that were founded in the 1920s had all outperformed the market index since 1930 and

---

7 Renshaw and Feldstein (1960)
8 Armstrong (1960)
on average had a lower volatility than the market, as is displayed in Table 1. When choosing from a large number of mutual funds, he argued, one should focus primarily on a fund’s investment objective, its investment strategy and its volatility, not just on outperformance. As the table shows, the two funds with the lowest volatility (A and D) also had the highest dividend (income), while the two funds with higher volatility (B and C) had lower dividend and lower returns. The low-risk anomaly in a nutshell. With the knowledge we have today, one could even conclude that as early as 1960 there was already anecdotal evidence, provided by John Bogle, indicating that active low-volatility funds were preferable.

Table 1. Total return of the four oldest US mutual funds over the period 1930-1960

<table>
<thead>
<tr>
<th></th>
<th>% Appreciation</th>
<th>% Income</th>
<th>% Total increase</th>
<th>Relative volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund A</td>
<td>348%</td>
<td>205%</td>
<td>553%</td>
<td>0.80</td>
</tr>
<tr>
<td>Fund B</td>
<td>233%</td>
<td>109%</td>
<td>342%</td>
<td>1.11</td>
</tr>
<tr>
<td>Fund C</td>
<td>157%</td>
<td>114%</td>
<td>271%</td>
<td>0.99</td>
</tr>
<tr>
<td>Fund D</td>
<td>478%</td>
<td>193%</td>
<td>671%</td>
<td>0.76</td>
</tr>
<tr>
<td>Average</td>
<td>304%</td>
<td>155%</td>
<td>459%</td>
<td>0.91</td>
</tr>
<tr>
<td>Dow Jones Average</td>
<td>174%</td>
<td>133%</td>
<td>307%</td>
<td></td>
</tr>
</tbody>
</table>


1960s – The rise of quant models and performance benchmarks | At the same time the mutual fund market was booming, a new academic discipline was gradually being developed at the University of Chicago: quantitative finance. The capital market theories and performance measurement techniques developed in the 1960s have been embraced by professional investors ever since.

The most widely used model, the Nobel-prize winning Capital Asset Pricing Model, or CAPM, builds on Harry Markowitz’ work on diversification and his modern portfolio theory which he developed back in 1952. The CAPM states that the undiversifiable market risk of a stock, called the beta, is the single determinant of stock market returns: higher risk should lead to higher returns. The theory is based on solid micro-economic assumptions of utility and makes a prediction on a macro level. A very elegant model, which is still useful today, even though it has been empirically rejected many times since the late 1970s.

Although he did not mention the names of the funds, only four mutual funds had a long track record over the sample period. The volatility is calculated only for the period 1950-1956, so should be used only as a rough estimate of the funds’ volatility over the entire 30-year period. As Bogle stated: ‘The two sets of figures cannot be properly combined or integrated. However, they indicate a probability that long-term mutual fund performance is even more outstanding on a relative basis than on an absolute basis’.

See for example Fox (2009), Bernstein (1992), or Mehring (2005).
Performance measurement techniques followed in the wake of these new financial market models. As early as 1957, Bogle had proposed using the return/volatility ratio to measure risk-adjusted performance and to showcase the low-risk approach of the Wellington Fund.

In 1965 Jack Treynor wrote that a fund’s return should be divided by its beta, a ratio which we call the Treynor ratio. In a research note, Treynor concluded that the high beta exposure of many of the high-performance funds in the 1960s was the reason for their excellent investment returns in the bull market in the first half of the decade, and hence he proposed the adjusted Treynor ratio: dividing Jensen’s alpha by the beta in order to correct for this leverage effect.

A year later, fellow CAPM engineer William Sharpe introduced his reward-to-volatility measure, nowadays known as the Sharpe ratio. Then, in 1968, Michael Jensen argued that CAPM alpha would be the best measurement to assess the true added value of fund managers.

The performance measurement techniques developed by Treynor, Sharpe and Jensen have become important tools for institutional investors to evaluate investment results, especially relative to benchmarks. The use of benchmarks caused the concepts of tracking error and information ratio to become two of the most used performance indicators in the fund management industry.

In 1969, Capital International introduced its first global equity index, later known as the MSCI World Index, which has served as a benchmark for global institutional investors ever since. Today USD 9.5 trillion is benchmarked against MSCI indices, USD 10 trillion against FTSE/Russell indices and USD 7.9 trillion against the S&P 500 Index.11

The focus on benchmarks and relative performance could discriminate against low-risk stocks and low-risk funds. Especially when alpha is used, which is defined as simple excess return, rather than Jensen’s alpha which also corrects for market beta. From a relative and benchmark perspective, low-risk stocks are not very attractive, as they are characterized by high tracking errors and thus have a high relative risk. The low-risk anomaly has grown stronger over time in line with the increased use of benchmarks. We believe these two trends are related other, although there are many reasons why investors shun cheap low-risk stocks and would rather buy expensive risky stocks.

Conservative Equities in historical perspective: Fund investing since 1774

Shortly after the CAPM was developed in the 1960s, several academics such as Black, Fama, Jensen and Scholes, showed that the actual relationship between risk and return was flatter than the CAPM suggested. They provided the first evidence for the low-risk anomaly.

In practice, since the 1960s, active managers have focused on high-beta stocks, as these stocks are the fastest way to stardom as most money and attention flows into the best performing funds in strong equity bull markets. This shift by fund managers from low-risk stocks to high-risk stocks is nicely demonstrated by another Bogle study, published in 2013, half a century after his first mutual fund study. Table 2, taken from his paper, shows that equity funds have become riskier over the past few decades. This confirms not only the view that most mutual fund managers focus primarily on high-risk stocks, but also that funds before the 1960s focused more on absolute risk reduction than the average mutual fund does today.

Table 2. Relative volatility equity mutual funds: 1950-1956 versus 2008-2011

<table>
<thead>
<tr>
<th>Relative volatility</th>
<th>1950-1956</th>
<th>2008-2011</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 1.11</td>
<td>0%</td>
<td>38%</td>
<td>38%</td>
</tr>
<tr>
<td>0.95-1.11</td>
<td>34%</td>
<td>37%</td>
<td>3%</td>
</tr>
<tr>
<td>0.85-0.94</td>
<td>30%</td>
<td>10%</td>
<td>-20%</td>
</tr>
<tr>
<td>0.70-0.84</td>
<td>36%</td>
<td>6%</td>
<td>-30%</td>
</tr>
<tr>
<td>Below 0.70</td>
<td>0%</td>
<td>9%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Source: Bogle (2013, Exhibit 5 on page 137). Relative volatility versus the S&P 500 (=1.0)

Huij and van Gelderen (2014) came to the similar conclusion that most funds have a beta higher than the market. They investigated whether strategies with significant factor exposure fared better than those without. And this is empirically indeed the case: funds with low-beta, small-cap or value exposure outperform the market. This proves that the academically observed low-risk anomaly can be successfully implemented in practice. However, only 6% of investment funds investigated by Huij and van Gelderen could be characterized as low-beta funds, defined as having a beta below 0.8.

So even though academics have found very strong empirical evidence for the low-risk effect, only a small percentage of active mutual funds have a beta which is significantly lower than the market. Translating academic evidence into actual investment strategies is not as easy as it seems, as Fischer Black and Myron Scholes found out back in the early 1970s. This modern story is similar to the story of financial innovator Abraham van Ketwich, they were all too early.
**1969-1974 – The first attempt to build a low-beta fund** | In the late 1960s, one bank eager to put the findings of the finance academics into practice was Wells Fargo. They not only hired Fischer Black and Myron Scholes, but also contacted William Sharpe, John Lintner, Merton Miller, Eugene Fama and Michael Jensen: basically all the finance professors involved with the new financial market models were asked to help. This shows just how serious Wells Fargo was in its desire to replace the existing structure with a more systematic and evidence-based approach; they wanted to beat the market with quantitative analysis.

To stimulate the interaction between theory and practice, the bank organized a series of academic conferences where the professors would present their main findings. The most significant research outcome of the first conference was a paper from Black, Scholes and Jensen, that showed that low-beta stocks outperformed high-beta on a risk-adjusted basis, a conclusion that empirically rejects the CAPM. They saw leverage constraints as the main reason for the low-beta anomaly: to generate outperformance by exploiting this anomaly, one would need to construct a leveraged low-beta portfolio. For an investor facing borrowing constraints, this could prove problematic.

In December 1969, Black and Scholes made three different proposals to Wells Fargo: (1) a leveraged market portfolio, (2) a leveraged low-beta fund (3) and a long-short approach.

Wells Fargo was convinced by the strong back-test results and opted for the second approach, leveraging up a low-beta portfolio. There were objections, however, to this low-beta fund idea, for example, from Bill Fouse, who worked in the Financial Analysis department. His main worry was that a low-beta strategy would be concentrated mostly in utility, food and bank stocks.

Fouse convinced the bank to go for a leveraged market fund. The design of the strategy meant it could never achieve superior risk-adjusted returns and it never became a low-beta fund, despite the strong empirical evidence Black and Scholes had given. The fund was introduced in January 1972 but was terminated a year later, as regulatory constraints prohibited the bank from marketing it. For Black and Scholes however, the fund had already died on the day the low-beta approach was rejected. Evidence-based investing proved to be more difficult to put into practice than they had expected. Only recently has evidence-based investing started attracting more interest from investors, but the total assets under management in evidence-based strategies are still very small compared with both traditional active funds and passive index strategies.
Conservative Equities in historical perspective: Fund investing since 1774

In the current post-modern era, multiple investment philosophies and funds co-exist. The latest addition is the growth in evidence-based funds. During the last two decades, the investment industry has been heavily impacted by (1) the breakthrough of index-tracking funds, (2) the rise of quantitative funds and (3) the increase in low-risk funds.
Unfortunately, Wells Fargo was too early with the low-beta fund idea and did not succeed in translating academic knowledge into a successful investment strategy in the 1970s. But if they had started in the 1990s they probably would have been more successful. Over the past decades, professional investors have become more knowledgeable and most have had solid academic training and are familiar with the CAPM and multi-factor extensions.

Today, many evidence-based funds exist and there are so many names floating around, this sometimes leading to Babylonian confusion. Here are some examples of evidence-based fund labels: passive, (smart) beta, style, factor, risk premia, quant, systematic, or rules-based. What unites them is that they are all based on academic research. That’s why we discuss them together and see them as one group. Still, there are differences. Some are semantic, while others are more fundamental. But let’s start with the first big evidence-based idea: passive investing.

**1990s – Breakthrough in passive market investing** The first big idea and the simplest rule to implement is what is known as ‘passive investing’. You simply buy and hold the market-weighted average of all stocks. That’s it. This involves very low turnover and costs and creates a highly diversified portfolio. Passive market-weighted investing is underpinned by solid academic research and empirical evidence. First, according to the CAPM the market portfolio has the best risk/return profile. Second, after management costs and transaction costs the average mutual fund underperforms the market. Hence, a cheap passive fund which tracks a market index is a superior alternative to the average active fund.

The idea of index investing goes back to the 1970s. The aforementioned efforts of Wells Fargo to put their new finance theories into practice, led to the first index fund in July 1971, funded for USD 6 million by the Samsonite pension fund. John Bogle’s Vanguard First Index Trust followed in 1975, making index investing available for the individual investor. This fund, initially referred to as ‘Bogle’s Folly’, exceeded the USD 100 billion mark in 1999 and currently has around USD 230 billion in assets. Although it was considered ‘un-American’ to settle for the market average, many institutional investors started to adopt passive investing in the 1990s. In the last ten years, retail investors have also started to invest passively. The growth of passive investing was further spurred by the invention of the Exchange Traded Fund, better known as the ETF. The total ETF market surpassed the USD 3 trillion mark in 2015 and continues to grow, also outside the US.

**2000s – Quantitative funds new kid on the block** The second big idea, which naturally follows on from the first, is also based on academic evidence. From the early 1980s studies started to shoot holes in the theoretical concept of market efficiency, showing the superior performance of different factors such as size and value. This academic shift in consensus was marked by the seminal 1992 Fama & French study, in which they show a flat relationship
between risk and return. They go on to show that beta is not related to return, but size and value are. This new evidence supported the introduction of funds to create style tilts towards these factors. One example is Dimensional Fund Advisors, which explicitly offers size and value funds. A year later, a paper by Jegadeesh and Titman (1993) added momentum to the list of factors. In 1994, Cliff Asness argued that value and momentum should be considered together. He delivered compelling evidence for his thesis (Fama was his supervisor) and implemented this first at Goldman Sachs and later founded AQR in 1997.

Of all factors, the market factor is still the most important factor. This factor is efficiently exploited by passive funds and offered to clients at very low cost. All other factors are deviations from the market portfolio and require trading, which makes them by definition active. In our view ‘passive’ smart beta investing is therefore a contradiction in terms. Some quantitative funds are fully transparent and track public factor-tilted indices, while others target proprietary factors. Some funds target one factor, while others target multiple factors. It’s easy for investors to get lost in the factor jungle.

Quantitative funds have several things in common. All of them basically continue the ideas of Wells Fargo and Black and Scholes in the 1970s and try to translate academic evidence into real investment strategies. They are based on academic evidence, implemented in a systematic (rules-based) way and target a limited set of proven factors. The most common factors are value, momentum, low-volatility, quality and size. They are offered both in an exchange-traded structure and as mutual funds. It is easy to use online tools to compare these funds based on their factor style tilts. For example, a value fund can easily be found by looking up the average P/E ratio of several funds. As a rule of thumb, more factor exposure is usually better, unless the fund scores are negative on other proven factors. Nowadays most of the largest institutional investors have included factor-based quantitative funds in their equity portfolios.

2010s – Low-volatility back to basics | The third big idea, brings us back to the beginning of fund investing. Historically investors have always had a twin desire for capital growth and capital protection. Among all these other quantitative factors, the low-risk factor is an investment style which needs special attention. Especially since, in contrast to the others, this factor does not promise significant outperformance. Therefore a multi-factor fund with a clear outperformance target will not find this factor very useful. Without outperformance, the information ratio will be zero. However, if risk is reduced without giving up return, the

12 Often the funds tracking public indices are ETFs, while the proprietary funds are often mutual funds. The form (mutual vs exchange traded) and substance (public index or proprietary strategy) should not be confused. There are index-based mutual funds and also ETFs based on proprietary strategies. The only fundamental difference between the two structures is intra-day liquidity.
13 To avoid unnecessary negative factor loadings all Robeco quantitative funds integrate multiple factors. The Conservative Equity funds integrate value and momentum factors in an active low-volatility strategy leading to a portfolio which scores mostly positive on all five factors, with the most pronounced tilt to low-risk.
Sharpe ratio will be higher as a consequence. This is a subtle difference, but also a very important one, as Sharpe ratio is an absolute return/risk measure, while information ratio is a relative measure.

To illustrate: at Robeco the first multi-factor models and funds did not include the low-risk factor in the late 1990s. Neither did Fama and French add low-risk as a fourth factor to their three-factor model (market, size and value). Because of the lack of a clear premium, the low-risk factor is easily ignored both in practice and in academic circles.

So it was a long time after Black & Scholes’ attempt before low-volatility strategies were accepted. Basically, it took until the 2010s before low-risk investing emerged as a separate investment style. In 1999, Geneva-based Unigestion was the first asset manager to launch a low-risk equity fund. Like Robeco and many others, they were influenced by the academic work of Robert Haugen, a founding father of low-volatility investing. Besides Robeco, a few other asset managers started offering low-volatility funds around 2006. MSCI was the first major index provider to offer a low-volatility index, which it launched in April 2008, a few months before the global equity market crash.

The crisis of 2008 was a blessing in disguise for low-volatility investing. It made clear that risk needs to be managed if investors are to achieve high long-term returns. They often say ‘never waste a good crisis’. In a way this is what happens, as people start to appreciate old investment virtues such as capital preservation, low costs and income again. Many investors want to go back to basics. In fact, not all that much has changed since the days of Abraham van Ketwich. Most investors simply want to achieve stable capital growth, with good income.

With 250 years of fund history in the back of our minds, we believe that systematically investing in attractive low-risk stocks with upside potential is one of the best ways to achieve this classic investment goal. We integrate value as a protection against overcrowding and overpricing and momentum to select the most attractive low-volatility stocks. Still, the experiences of Ketwich and Black & Scholes keep us humble and show that patience and a bit of luck are important factors as well.
Conclusion  In an industry focused on the short term and relative performance, we advocate the centuries-old investment virtues of capital protection, income and low turnover.
As fund managers of Conservative Equities we want to place the story of low-volatility funds into a historical perspective. On the one hand, as part of the more recent rise in evidence-based investing which has played a role in the growth of passive and quantitative investing. On the other hand, we also want to document the attempts prior to that in the early 1970s and link the risk-reduction objective to the roots of our industry back in 1774.

We look at Abraham van Ketwich with a combination of admiration and envy – the former for his financial innovations, the latter because he had no peer group pressure or benchmark to beat. Above all, his story also makes us humble since neither his fund, nor the low-beta idea of Black and Scholes, succeeded. We appreciate his focus on the original virtues of mutual fund investing: capital protection, income and low turnover. In an industry obsessed with short-term relative performance and high turnover, we want to preserve, promote and live these age-old investment virtues.

Jan Sytze Mosselaar, CFA
Portfolio Manager

Pim van Vliet, PhD
Portfolio Manager
References


Willem Berghuis, *Ontstaan en ontwikkeling van de Nederlandse beleggingsfondsen tot 1914*, (Van Gorcum, 1967)


Important Information

Robeco Institutional Asset Management B.V., hereafter Robeco, has a license as manager of UCITS and AIFs from the Netherlands Authority for the Financial Markets in Amsterdam. This statement is intended for professional investors. Therefore, the information set forth herein is not addressed and must not be made available, in whole or in part, to other parties, such as retail clients. Robeco disclaims all liability arising from users other than those specified herein. Without further explanation this presentation cannot be considered complete. It is intended to provide the professional investor with general information on Robeco’s specific capabilities, but does not constitute a recommendation or an advice to buy or sell certain securities or investment products. All rights relating to the information in this presentation are and will remain the property of Robeco. No part of this presentation may be reproduced, saved in an automated data file or published in any form or by any means, either electronically, mechanically, by photocopy, recording or in any other way, without Robeco’s prior written permission. The information contained in this publication is not intended for users from other countries, such as US citizens and residents, where the offering of foreign financial services is not permitted, or where Robeco’s services are not available. The prospectus and the Key Investor Information Document for the Robeco Funds can all be obtained free of charge at www.robeco.com. Investment involves risks. Before investing, please note the initial capital is not guaranteed. The value of the investments may fluctuate. Past performance is no guarantee of future results. Historical returns are provided for illustrative purposes only. The price of units may go down as well as up and the past performance is not indicative of future performance. If the currency in which the past performance is displayed differs from the currency of the country in which you reside, then you should be aware that due to exchange rate fluctuations the performance shown may increase or decrease if converted into your local currency.

Additional Information for investors with residence or seat in France

Robeco has the freedom to provide services in France. Robeco France has been approved under registry number 10683 by the French prudential control and resolution authority (formerly ACP, now the ACPR) as an investment firm since 28 September 2012. Robeco France is only authorized to offer investment advice service to professional investors.

Additional Information for investors with residence or seat in Germany

This information is solely intended for professional investors or eligible counterparties in the meaning of the German Securities Trading Act.

Additional Information for investors with residence or seat in Italy

This document is considered for use solely by qualified investors and private professional clients (as defined in Article 26 (1) (d) of Consob Regulation No. 16190). If made available to Distributors and individuals authorized by Distributors to conduct promotion and marketing activity, it may only be used for the purpose for which it was conceived. Therefore, the information set forth herein is not addressed and must not be made available, in whole or in part, to other parties, such as retail clients. Robeco disclaims all liability arising from uses other than those specified herein.

Additional Information for investors with residence or seat in Spain

The Spanish branch Robeco Institutional Asset Management BV, Sucursal en España, having its registered office at Paseo de la Castellana 42, 28046 Madrid, is registered with the Spanish Authority for the Financial Markets (CNMV) in Spain under registry number 24.

Additional Information for investors with residence or seat in Switzerland

This document is exclusively distributed in Switzerland to qualified investors as such terms are defined under the Swiss Collective Investment Schemes Act (CISA). RobecoSAM AG has been authorized by the FINMA as Swiss representative of the Fund(s), and UBS Switzerland AG, Bahnhofstrasse 45, 8001 Zurich, postal address: Badenerstrasse 574, P.O. Box, CH-8098 Zurich, as Swiss paying agent. The prospectus, the key investor information documents (KIID), the articles of association, the annual and semi-annual reports of the fund(s), as well as the list of the purchases and sales which the fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, at the head office of the Swiss representative RobecoSAM AG, Josefstrasse 218, CH-8005 Zurich. If the currency in which the past performance is displayed differs from the currency of the country in which you reside, then you should be aware that due to exchange rate fluctuations the performance shown may increase or decrease if converted into your local currency. The value of the investments may fluctuate. Past performance is no guarantee of future results.

The performance data do not take account of the commissions and costs incurred on the issue and redemption of units. The prices used for the performance figures of the Luxembourg-based funds are the end-of-month transaction prices net of fees up to 4 August 2010. From 4 August 2010, the transaction prices net of fees will be those of the first business day of the month. Return figures versus the benchmark show the investment management result before management and/or performance fees; the fund returns are with dividends reinvested and based on net asset values with prices and exchange rates of the valuation moment of the benchmark. Please refer to the prospectus of the funds for further details. The prospectus is available at the company's offices or via the www.robeco.ch website. Performance is quoted net of investment management fees. The ongoing charges mentioned in this publication is the one stated in the fund’s latest annual report at closing date of the last calendar year.

The material and information in this document are provided “as is” and without warranties of any kind, either expressed or implied. Robeco and its related, affiliated and subsidiary companies disclaim all warranties, expressed or implied, including, but not limited to, implied warranties of merchantability and fitness for a particular purpose. All information contained in this document is distributed with the understanding that the authors, publishers and distributors are not rendering legal, accounting or other professional advice or opinions on specific facts or matters and accordingly assume no liability whatsoever in connection with its use. In no event shall Robeco and its related, affiliated and subsidiary companies be liable for any direct, indirect, special, incidental or consequential damages arising out of the use of any opinion or information expressly or implicitly contained in this document.

Additional Information for investors with residence or seat in the United Kingdom

Robeco is subject to limited regulation in the UK by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.

Additional Information for investors with residence or seat in Hong Kong

Investment returns not denominated in HKD/US$ are exposed to exchange rate fluctuations. Investors should refer to the fund’s Hong Kong prospectus before making any investment decision. Investors should ensure that they fully understand the risk associated with the fund. Investors should also consider their own investment objective and risk tolerance level. Any opinions, estimates or forecasts may be changed at any time without prior warning. If in doubt, please seek independent advice. The content of this document is based upon sources of information believed to be reliable. This fund may use derivatives as part of its investment strategy and such investments are inherently volatile and this fund could potentially be exposed to additional risk and cost should the market move against it. Investors should note that the investment strategy and risks inherent to the fund are not typically encountered in traditional equity long only funds. In extreme market conditions, the fund may be faced with theoretically unlimited losses. This document has not been reviewed by the Securities and Futures Commission. This document has been distributed by Robeco Hong Kong Limited (‘Robeco’). Robeco is regulated by the Securities and Futures Commission in Hong Kong.

Additional Information for investors with residence or seat in Singapore

This document is not intended as a recommendation or for the purpose of soliciting any action in relation to Robeco Capital Growth Funds or other Robeco Funds (the “Fund”) and should not be construed as an offer to sell shares of the fund (the “Shares”) or solicitation by anyone in any jurisdiction in which such an offer or solicitation is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.

Nothing in this document constitutes accounting, legal, regulatory, tax or other advice. Any decision to subscribe for interests in the Fund must be made solely on the basis of information contained in the prospectus (the “Prospectus”), which information may be different from the information contained in this document, and with independent analyses of your investment and financial situation and objectives. The information contained in this document is qualified in its entirety by reference to the Prospectus, and this document should, at all times, be read in conjunction with the Prospectus. Detailed information on the Fund and associated risks is contained in the Prospectus. Any decision to participate in the Fund should be made only after reviewing the sections regarding investment considerations, conflicts of interest, risk factors and the relevant Singapore selling restrictions (as described in the section entitled “Important Information for Singapore Investors”) contained in the Prospectus. You should consult your professional adviser if you are in doubt about the stringent restrictions applicable to the use of this document, regulatory status of the Fund, applicable regulatory protection, associated risks and suitability of the Fund to your objectives.

This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject the Fund and its investment manager to any registration or licensing requirement within such jurisdiction. Investors should note that only the sub-funds listed in the appendix to the section entitled “Important Information for Singapore Investors” of the Prospectus (the “Sub-Funds”) are available to Singapore investors. The Sub-Funds are notified as restricted foreign schemes under the Securities and Futures Act,
Additional Information for investors with residence or seat in Shanghai

This material may not be copied or used with the public. This material is prepared by Robeco Investment Management Advisory (Shanghai) Limited Company (Robeco Shanghai for short) and is only provided to the specific objects under the premise of confidentiality. This material must not be wholly or partially reproduced, distributed, circulated, disseminated, published, adapted, modified or translated in any form and for any purpose without the prior written consent of Robeco Shanghai. Information and/or analysis contained in this material have been compiled or arrived at from sources believed to be reliable but Robeco Shanghai does not make any representation as to their accuracy, correctness, usefulness or completeness and does not accept liability for any loss arising from the use hereof or the information and/or analysis contained herein. Neither Robeco Shanghai nor its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained herein. The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations which involve assumptions, risks, and uncertainties and is only as current as of the date indicated. Based on this, there is no assurance that such events will occur, and may be significantly different than that shown here, and we cannot guarantee that these statistics and the assumptions derived from the statistics will reflect the market conditions that may be encountered or future performances of Robeco Shanghai. The information in this material is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. The information contained herein may not reflect the latest information on account of the changes and Robeco Shanghai is not responsible for the updating of the material or the correction of inaccurate or missing information contained in the material. Robeco Shanghai has not yet been registered as the private fund manager with the Asset Management Association of China. This material was prepared solely for informational purposes and does not constitute a recommendation, professional advice, an offer, solicitation or an invitation by or on behalf of Robeco Shanghai to any person to buy or sell any product. This material should not be viewed as a recommendation to buy or sell any investment products or to adopt any investment strategies. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. Robeco Shanghai is a wholly foreign-owned enterprise established in accordance with the PRC laws, which enjoys independent civil rights and civil obligations. The statements of the shareholders or affiliates in the material shall not be deemed to be a promise or guarantee of the shareholders or affiliates of Robeco Shanghai, or be deemed to any obligations or liabilities imposed to the shareholders or affiliates of Robeco Shanghai.

Additional Information for investors with residence or seat in Australia

This document is distributed in Australia by Robeco Hong Kong Limited (ARBN 156 512 659) (‘Robeco’) which is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth) pursuant to ASIC Class Order 03/1103. Robeco is regulated by the Securities and Futures Commission under the laws of Hong Kong and those laws may differ from Australian laws. This document is distributed only to “wholesale clients” as that term is defined under the Corporations Act 2001 (Cth). This document is not for distribution or dissemination, directly or indirectly, to any other class of persons. It is being supplied to you solely for your information and may not be reproduced, forwarded to any other person or published, in whole or in part, for any purpose. In New Zealand, this document is only available to wholesale investors within the meaning of clause 3(2) of Schedule 1 of the Financial Markets Conduct Act 2013 (FMCA). This document is not for public distribution in Australia and New Zealand.

Additional Information for investors with residence or seat in the Dubai International Financial Centre (DIFC), United Arab Emirates

Robeco Institutional Asset Management B.V. (Dubai Office), Office 209, Level 2, Gate Village Building 7, Dubai International Financial Centre, Dubai, PO Box 482060, UAE. Robeco Institutional Asset Management B.V. (Dubai office) is regulated by the Dubai Financial Services Authority ("DFSA") and only deals with Professional Clients and does not deal with Retail Clients as defined by the DFSA.

Additional Information for investors with residence or seat in Brazil

The fund may not be offered or sold in the public in Brazil. Accordingly, the fund has not been nor will be registered with the Brazilian Securities Commission - CVM nor have they been submitted to the foregoing agency for approval. Documents relating to the fund, as well as the information contained therein, may not be supplied to the public in Brazil, as the offering of the fund is not a public offering of securities in Brazil, nor used in connection with any offer for subscription or sale of securities to the public in Brazil.

Additional Information for investors with residence or seat in Colombia

This document does not constitute a public offer in the Republic of Colombia. The offer of the fund is addressed to less than one hundred specifically identified investors. The fund may not be promoted or marketed in Colombia or to Colombian residents, unless such promotion and marketing is made in compliance with Decree 2555 of 2010 and other applicable rules and regulations related to the promotion of foreign funds in Colombia. The distribution of this document and the offering of [Shares] may be restricted in certain jurisdictions. The information contained in this document is for general guidance only, and it is the responsibility of any person or persons in possession of this document and wishing to make application for the fund to inform themselves of, and to observe, all applicable laws and regulations of any relevant jurisdiction. Prospective applicants for the fund should inform themselves of any applicable legal requirements, exchange control regulations and applicable taxes in the countries of their respective citizenship, residence or domicile.

Additional Information for investors with residence or seat in Panama

The distribution of this fund and the offering of Shares may be restricted in certain jurisdictions. The above information is for general guidance only, and it is the responsibility of any person or persons in possession of the prospectus of the fund and wishing to make application for Shares to inform themselves of, and to observe, all applicable laws and regulations of any relevant jurisdiction. Prospective applicants for Shares should inform themselves of the above legal requirements as well as any applicable exchange control regulations and applicable taxes in the countries of their respective citizenship, residence or domicile. This document does not constitute an offer or solicitation to any person in any jurisdiction in which such offer or solicitation is not authorized to or any person to whom it would be unlawful to make such offer or solicitation.

Additional Information for investors with residence or seat in Peru

The fund has not been registered before the Superintendencia del Mercado de Valores (SMV) and are being placed by means of a private offer. Documents relating to the fund, as well as the information contained therein, may not be supplied to the public in Peru, as the offer of the fund is not a public offering of securities in Peru, nor used in connection with any offer for subscription or sale of securities to the public in Peru.

Additional Information for investors with residence or seat in Uruguay

The sale of the fund qualifies as a private placement pursuant to section 2.0 of Uruguayan law 18,627. The fund must not be offered or sold to the public in Uruguay, except in circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The fund is not and will not be registered with the Financial Services Supervisory Agency of the Central Bank of Uruguay. The fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

Additional Information for US offshore investors

The Robeco Capital Growth Funds have not been registered under the United States Investment Company Act of 1940, as amended, nor the United States Securities Act of 1933, as amended. None of the shares may be offered or sold, directly or indirectly in the United States or to any US Person. A US Person is defined as (a) any individual who is a citizen or resident of the United States for federal income tax purposes; (b) a corporation, partnership or other entity created or organized under the laws of or existing in the United States; (c) an estate or trust the income of which is subject to United States federal income tax regardless of whether such income is effectively connected with a United States trade or business.