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Unconventional Wisdom

Why Passively Managed Funds Are Not a Suitable Investment

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In investment terms, passive management is the opposite of active management. In fact, the entire concept of passive management is a perfect oxymoron. Nothing that is truly passive is managed, and nothing that is truly managed is passive. Passive benchmarks hold investors hostage to the vagaries of the market.

Indeed, as a stock's price appreciates, it accounts for a greater proportion of a market-cap-weighted index. The reason that these stocks become popular, however, is that they are expected to continue to appreciate in value. It is this line of reasoning that undermines the notion of passive management as a neutral holding for investors.

Because the popularity of a given stock drives its subsequent weight in the index, those indexes become inherently biased. Stock prices are, after all, driven by something that is tantamount to no more than a speculative bet. Market-cap-weighted benchmarks encapsulate the sum of all those speculative bets. They therefore take on a heavy structural bias that changes over time. Take the early-2000s dot-com bubble. Tech stocks were incredibly overhyped: They represented nearly 35 percent of the S&P 500 at their peak before plunging. By the end of 2002, tech stocks accounted for only 15 percent of the index. We saw a similar trend in the lead-up to the 2008–’09 financial crisis. Financial stocks nearly doubled as a proportion of the index, from 10 percent in the mid-1990s to 20 percent by mid-2007. By the end of 2008, the proportion of financial stocks in the S&P 500 was back down to about 11 percent.

Nobody would buy a stock they expected to fall, or sell one they expected to rise, right? It is important to understand that whether they like it or not, investors in passive funds endorse an implicit view that stocks or factors that are overweighted in the cap-weighted index will outperform going forward. In a nutshell, the investor allocates the greatest proportion of his investment to the most overvalued stocks and the least to the most undervalued stocks, right up until the moment a market correction hits. This isn’t a sound strategy for reaping the highest investment returns. The greater the imbalance in the index, the greater the impact of changes in price and therefore greater risk — and the potential for greater losses. Yet because they are not actively managing risk exposure, investors have no room to react accordingly. Everyone knows enormous concentrations eventually correct, but investors in passive strategies are powerless to take action. Like the proverbial deer in the headlights, investors are caught waiting for the crash.

Any vehicle that leaves investors trapped by the markets’ collective mood swings cannot reasonably be dubbed a “managed” one. Rather, it is a custodial one: It takes into account marginal fluctuations in its index, reinvests dividends and responds to corporate actions. By using a cap-weighted benchmark to establish a desired outcome and by focusing on the tracking error of a portfolio’s performance versus that benchmark, investors effectively ingrain passive behavior by rewarding strategies that perform in line with those indexes. This makes it very hard for them to meet an absolute risk-return target, rather than a relative one.

Asset managers have a crucial economic role: capital allocation. By following speculative cycles, managers of passive portfolio strategies have signed away their ability to help shape a healthy and sustainable economy.

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