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CORE INVESTMENTS

An Oxymoron gone too far: Why passive management isn't suitable as a core investment

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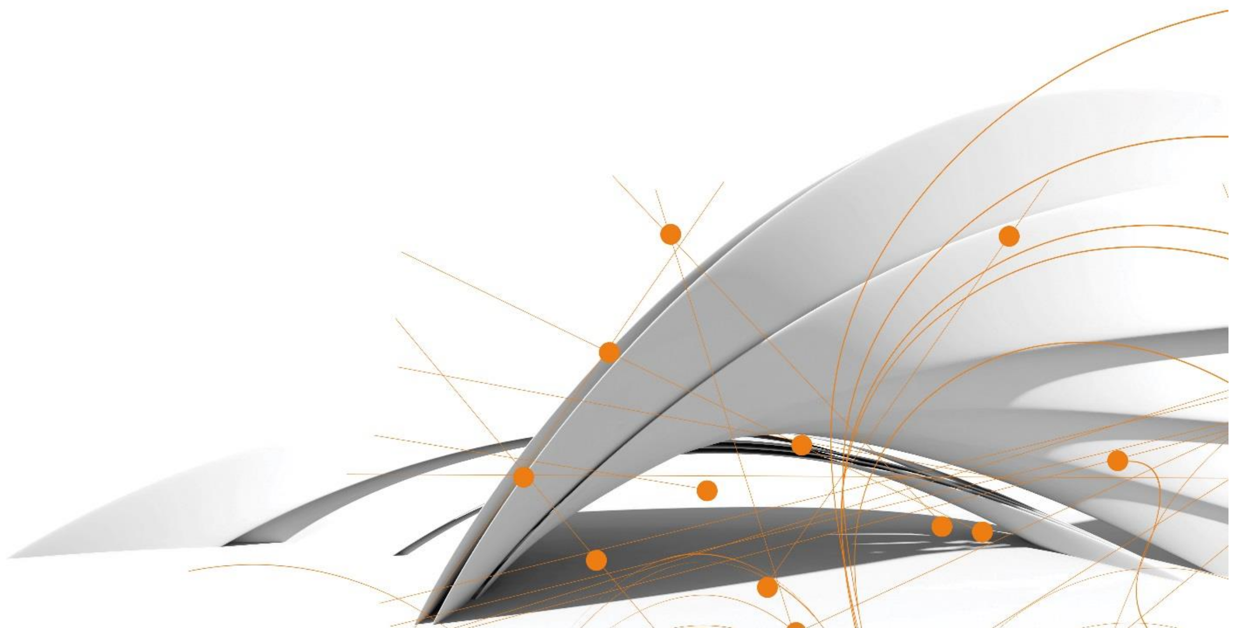
March 2015



By definition, passive management is the contrary of active management. The "activity" of a portfolio/strategy is measured by its turn-over. The less you trade in proportion of the assets of the portfolio, the less you are active, the more passive you are.

'Passive management' is a perfect oxymoron: nothing that is truly passive is managed and nothing that is managed is passive. Passive management is the absence of management.

When management isn't really management

The use of the word 'management' implies that someone is making decisions that influence a process. This is not the case for passive management. In fact nothing could be further from the truth: passive benchmarks hold investors hostage at the worst possible times to the vagaries of the market and its collective mood swings.

Indeed, as a stock becomes popular and its price appreciates, the greater proportion of a market cap-weighted index it becomes. But these stocks become popular because they are *expected* to increase further. And it is this expectation that undermines the notion of passive management as a neutral holding for investors.

Because the popularity of stocks drives their price and subsequent weight in the index, those indexes become inherently biased. Popularity is, after all, driven by expectation which is nothing else than a speculative bet. In this way, market cap-weighted benchmarks encapsulate the sum of all the speculative bets made in the market on its underlying constituents. They therefore take on heavy structural biases that change over time. Being passive has nothing to do with being neutral.

For example, in the early 2000s, information technology stocks became so popular on the expectation they would continue to rise, they represented nearly 35% of the S&P 500[1] the day before they embarked on a precipitous fall, taking them down to 15% of the index by the end of 2002. The same pattern occurred in the lead up to the Financial Crisis. Financial stocks nearly doubled as a proportion of the index from 10% in the mid 1990's to 20% by mid-2007. By the end of 2008, they were back down to about 11%.

These inherent biases present a significant danger to investors if they become overexposed to passive management. The higher the price of a stock goes, the greater its proportion in the index and the more it needs to outperform the others in order to justify its increased concentration in the index and growing risk allocation. Passive management is blind in this regard.

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 the implicit view that stocks or factors that are over risk-weighted in the cap-weighted index will outperform going forward. Passive investors are abiding by the implicit speculations of these indices.

[1] Sectors size are measured according to Global Industry Classification Standard (GICS)

In a nutshell, the investor allocates the greatest proportion of his investment into the most over-valued stocks, and the least in the most under-valued stocks, right up until the moment a market correction hits.

In other words, investors are forced to allocate high and dis-allocate low, which is a costly exercise for investment returns.

Furthermore, the greater the imbalance (or bias) in the index, the greater the impact of changes in price, and therefore the greater is the risk. And with greater risk comes the potential for greater losses. Yet, because they are passive (not actively managing risk exposure), there is no room for investors to react accordingly. Everyone knows enormous concentrations eventually correct, but investors in passive strategies are powerless to take action. Like the proverbial rabbit staring into oncoming headlights, they must simply wait for the crash.

If an investor is hostage to the impact that the collective mood swings of markets have on asset prices this cannot reasonably be classified as ‘management’. “Passive managers” do not belong to the field of asset management, they are literally custodians. Passive management is a custody business; it consists in taking into account marginal changes in the index’s universe, re-investing dividends, responding to corporate actions. A custodian’s job.

What role should benchmarks play?

Traditional benchmarks are very useful, not least because they are representative of the aggregated expectations in the market as they encapsulate the sum of all speculations.

Benchmarks were originally designed as a reference point to show the combined expectations of market participants and still serve a valid purpose in this specific regard. But it is important to remember that they are an output of the asset management industry. To use them as an input, would make the industry as productive as a dog following its tail. It would not go far away this way. Neither would the economy.

By using a cap-weighted benchmark to establish a desired outcome, and focussing on the tracking error of a portfolio’s performance versus that benchmark, investors effectively engrain passive behaviour by rewarding strategies that perform in line with those indexes. This makes it very hard for them to meet their own financial objectives: an absolute return/ risk target rather than a relative one.

As such, passive investments hurt investors, but they are not the only ones affected. Asset managers have a crucial economic role: capital allocation. By following speculative cycles, passive managers have resigned this very important role: a positive contribution to a healthy and sustainable economy .

So, if passive management is not, in fact, management, and leads investors to act in a manner that runs contrary to their own financial success, then allocating a core proportion of a portfolio to market cap-weighted benchmark tracking vehicles is oxymoronic.

For more information

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