IGNITES ASIA
A Financial Times Service

Opinion

Passive investing: pitfalls, misconceptions in Asia

July 29, 2015

Yves Choueifaty

Yves Choueifaty is president and founder of TOBAM, a French asset manager serving Asian institutional investors.

The asset management industry and the Asian asset management sector are assuming pivotal roles in the world economy. In this context, "core" asset managers run the bulk of investors' portfolios. They seek to deliver returns in line with their long-term strategic asset allocation while creating wealth for investors. However, we argue here that passive investment is preventing core asset managers from properly fulfilling these crucial tasks.

What really drives wealth generation?

The main source of wealth creation is not the "skill" of a portfolio manager, but the "skill" of the employee working in the companies in which savings are invested. Therefore, it is labour which creates wealth for the investor. Thus, core asset managers act as a link between savings and labour. And for the risk premium to be accessed as purely as possible, investors' core portfolios need immunisation against speculation. (And in this framework, the risk premium represents the return generated by the undiversifiable portfolio.)

Core asset managers are access providers to that risk premium, without which a core allocation to any asset class is not justified. This is the case regardless of the manager's potential skill. Ultimately, this process involves building portfolios that are as protected as possible from any hypothetical speculative bets, focusing purely on the existence of a future risk premium.

Passive is not the same as neutral

For managers to maximise the risk/reward ratio and avoid speculation, they need to build a portfolio that offers access to "pure", neutral beta in the most diversified way possible.

Passive investing, often described as beta investing, has interestingly nothing to do with neutral. For a start, the expression itself is a perfect oxymoron: nothing that is truly passive is managed, and nothing that is managed is passive. The use of the word “management” implies that someone is making decisions that influence a process. Yet in passive management, 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. Popularity is 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. As a result, they take on heavy structural biases that change over time.

This can be shown with some historical examples. At the time of the 1979 oil shock – the second such crisis in a decade – the weighting of energy stocks in the S&P 500 index was at its highest; when the technology bubble burst in 2000, information technology shares represented nearly 35% of the S&P 500. By the end of 2002, they represented just 15%. Similarly, the weighting of the financial sector was at its highest just as the global financial crisis struck in 2008.

Also, a look at the current sector weights of the MSCI Asia ex-Japan index shows the strong concentrations of risks of market cap-weighted benchmarks: more than one third of the weights are concentrated in one unique sector: financials.

These inherent biases present a significant danger to investors when they become overexposed to passive management. The higher stock prices go, the greater percentage of the index they comprise and the more they must outperform others to justify the increased index. If an investor is hostage to the impact of the market’s collective mood, then he must not be participating is something that can be reasonably classified as “management.” Passive managers are not in fact asset managers but custodians.

What role should benchmarks play?

Traditional benchmarks mentioned here are very useful. Indeed, they are representative of the aggregated expectations, as they encapsulate the sum of all speculations. It is important that they remain an output of the asset management industry. After all, to use them as an input would make the industry as productive as a dog following its tail.

By using a cap-weighted benchmark to establish a desired outcome, and focusing on the tracking error of a portfolio’s performance versus that benchmark, investors engrain passive behaviour by rewarding strategies that perform in line with those indices. 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 have therefore much more serious implications than just hurting investors. Overall, by following speculative cycles, passive investors give up on the positive contribution they can make to a healthy and sustainable economy.