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FAMILY WEALTH REPORT

EDITORIAL ANALYSIS: Why We Can't Be Relaxed About The Passion For Passive Investing

Tom Burroughes, Group Editor , July 11, 2017

The push towards passive investing has been one of the hallmarks of the financial age but how far can it go and what are the risks?

More than nine years into a bull market in equities - a long stretch by historical standards - and a drumbeat of noise is rising about whether the “passive” approach to managing money is reaching a peak and becoming a source of future trouble.

Although wealth industry practitioners dislike the term, “passive” is broadly useful in meaning an investment that involves tracking some kind of index rather than picking and choosing individual securities in order to outperform a market to capture "Alpha". The case for passive rests on the notion that most modern financial markets are efficient and discount available information, and that opportunities to capture market-beating Alpha aren’t as great as supposed, and that paying for such Alpha is seldom worth the money. These are big claims, of course, and some markets are more liquid and efficient than others, which is why the active/passive debate is an endless one.

Even so, with regulatory costs rising, it is easy to see why wealth managers have embraced cheap index-tracker entities such as exchange-traded funds. ETFs break new worldwide records for assets under management every month with monotonous regularity. At the end of April, ETFs and exchange-traded products held more than $4 trillion in AuM (source: ETFGI). To put those figures into context, the total value of the global stock market was around $65 trillion last year (source: World Bank); that number has increased since. ETFs still make up around 6 per cent of the total stock market, so there may be further room for growth yet. The growing use of ETFs has squeezed fees: firms such as Vanguard and BlackRock have cut fees. Organizations such as Cerulli Associates and others have said for some time that asset management increasingly resembles a "barbell" shape, with one end dominated by low-cost, index-tracker businesses where economies of scale dominate, and the other end of the "bar" is full of high-fee alternative, Alpha-chasing areas such as hedge funds, private equity and private credit. The guys in the middle get squeezed out. Arguably the same trend can be seen in other fields: mass markets at one end; niche, high-end services/products at the other.

The rise of passive is understandable for a number of reasons, therefore, but does the growth of passive investing bring new risks? One issue is that if actively-managed funds become less significant, the price of a company's stock will say less about what investors think about the nuts and bolts of a company and its management, and instead only reflect broad-based investor sentiment, driven by forces such as central banks' interest rates. It is also harder for activist-minded fund managers to make a difference if everyone is "going passive". Arguably, such passive investing also further divorces the end-investor from the underlying companies that generate earnings and capital growth, making the capitalist system even more remote from those supposed to benefit from it. (At a time when political populism and hostility to free markets is on the rise, this aspect of passive investment is more significant than many may realize.)

Another argument, made in early May by the Economist Intelligence Unit, is that the rise of passive investing makes investors more vulnerable to system-wide crashes, especially after a boom period wherein large-cap stocks are overvalued, as they arguably are today. According to Psigma, the UK-based investment house, the US S&P 500 Schiller Price To Earnings Index is at 29.87 – the same level as during the peak immediately prior to the Wall Street Crash of 1929. It is higher than when stocks plunged in October 1987.

Even so, as the EIU study shows, passive investing isn't going away, given the attractions of cost. The EIU study cites comments from Bernstein & Co, the investment firm, stating that on existing growth rates, passive funds will account for half of all US equity assets by January next year. If that is the case, a fall in US stocks, as may be likely if this long-in-the-tooth bull run loses steam, could leave a lot of investors scrambling for an alternative.

Passive is not neutral

Away from the broad market and macro-economic considerations are more specific questions, such as the kind of benchmark that passive investors are using.

Some market benchmarks only capture a few drivers of returns, Yves Choueifaty, founder of TOBAM, a Paris-headquartered investments firm managing $8.5 billion of assets, told this publication.

A problem with many so-called passive investments is that they reflect the biases and distortions of the indices they track, so they should not be seen as a "neutral" activity, Choueifaty said.

A problem, for example, is that with capital-weighted indices, more weight - and hence exposure - will be taken by those securities that have already rallied and performed strongly. An investor can end up systematically being overweight of certain parts of a market, he continued.

His own firm argues that it goes for the greatest possible type of diversification, based upon an approach that seeks to avoid such distortions, Choueifaty continued. He argued that the broader investment/wealth management sector is in danger of becoming complacent and lazy in how it uses passive investments.

"It is very important to use the appropriate terminology [in investment]," he said. To some extent, he said, the trend of "factor-based investing" or Smart Beta, in which indices are composed of securities that exhibit certain characteristics (yield, value, momentum, etc), shows that there is a move towards a more sophisticated idea of what index-based investing should involve.

The Smart Beta approach has developed considerably, he said.

Another organization, Barings, argues that passive investing simply doesn't work well in certain areas, such as high-yield securities. In a recent note, the firm said: "The often-touted fact that the 'average' active manager routinely underperforms the index has encouraged investors to embrace passive investing over the last decade. In many asset classes, like large-cap US equities, this has proven to be a lucrative strategy. Investors gain exposure to an underlying asset class while incurring much lower costs. The problem, of course, is that this 'one size fits all' passive investment strategy does not work equally well across all asset classes. Fixed income markets are a good case in point, particularly the high yield bond and senior secured loan markets."

Explaining why high-yield debt is problematic for the passive approach, it continued: "Fixed income's more limited capital appreciation potential means investors stand to lose significantly more than they may gain on any given bond - so avoiding 'losers' is critical for success. However, that's harder for ETFs to do, since their investment decisions are flow- and rules-based as opposed to value-based. Active managers of high yield, on the other hand, are not restricted to any reduced 'list' of issuers, and can exercise greater flexibility on when to trade."

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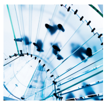

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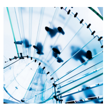

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