Possible Unintended Consequences *of* Passive Investing

By Ian Kilcullen,
Chief Investment Officer,
Key Capital Private

Introduction

Passive investing began to gain traction following the 2008 financial crisis, with the trend reflecting the view that the higher fees of active managers would exceed the excess returns that they were able to generate.

This resulted in the belief that passive investing will outperform an actively managed strategy. Almost ten years on, are we now at reaching a point where the popularity of passive investing is influencing the market in ways that were never envisaged.

Growth in Passive Investing

"Record ETF Inflows" is a recurring headline in the financial media and the reason is clear: the numbers involved are staggering. US-listed ETFs saw $283 billion in net inflows in 2016, which was matched by an almost equal withdrawal from actively managed funds, taking aggregate passive assets under management in the US to $2.5 trillion, according to Citigroup. Including index mutual funds and separate accounts, it is estimated that as much as US$20 trillion is being managed passively worldwide, according to Brown Brothers Harriman- or approximately one third of the total global market cap.

The narrative supporting these capital flows is compelling: the active equity fund manager universe has generally under-performed passive investing over recent years. A reluctance to pay management fees to under-performing fund managers is a logical response. The simplicity and low cost nature of ETFs provides investors an alternative by facilitating a passive investment approach. However, what is often overlooked is that such an approach represents a fundamental change in how investor equity capital is allocated to companies and that it might result in unforeseen consequences for the market and for investors.

Historic Approach to the Allocation of Capital

Prior to the advent of index funds, 'stock pickers' believed they had insights not available to lesser informed investors. The better informed investor could buy a stock based on certain information, and when that information became more widely appreciated by the market, the share price would rise and the investor would benefit.

This process simply describes the mechanics behind *Price Discovery* where the interaction of buyers and sellers and those with better information and judgement determines the price of an asset. There are a number of requirements for price discovery but at its core it relies on informed traders actively acquiring information and trading around it, thus incorporating it into stock prices. Conversely, indexation is based on avoiding individual company selection. It is not concerned about the reasonableness of the price being paid or distortion to the market. Therefore, an increase in passive (uninformed) investors, where company-by-company due diligence is ignored, may be impacting the efficiency of market operations.

Vanguard's ETF business saw net inflows of $2 billion per business day during the first quarter of 2017, which if it continued for the full calendar year would result in almost half a trillion of new cash going to one asset manager. If an active fund received daily inflows of that size, they would probably close the fund within weeks, as it would become increasingly difficult to invest without adversely affecting prices and thus negatively impacting returns.

JP Morgan estimates that only 10% of trading volume now originates from those making decisions based on the fundamentals of the stock market or an individual stock, therefore, capital allocation is being dominated by automatic or algorithmic methods. This has the effect of downgrading the importance of price discovery and increasing the herd effect where certain assets are crowded with no regard to fundamentals. Analysts create narratives based on fundamentals to explain price action but if investors are not buying or selling stocks based on stock specific fundamentals is it possible that the narrative is being backfilled to explain the price movements? The old maxim that *good companies are not always good investments* is worth bearing in mind.

Scale Amplifies the Challenges

A market that is dominated by actively managed funds should be insulated from the influence of passive investing.

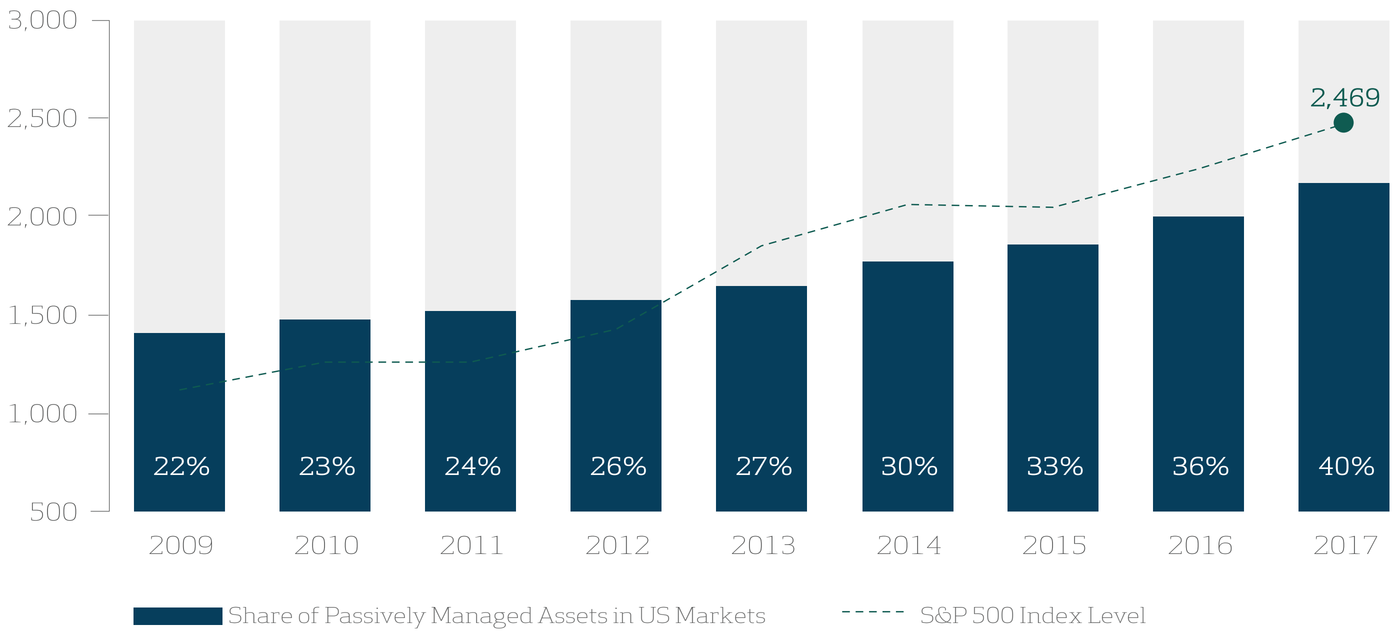
This may explain why there is no evidence that passive investing has resulted in any market distortions even though it has been part of the financial landscape for 20+ years. However, as highlighted below, the role played by passive strategies has increased exponentially in recent years; therefore, we are only now likely entering the phase where any influence might be felt.

The more capital that flows into ETFs, the less power active managers possess to influence the market through allocating capital to companies that they believe will out-perform in the future. In fact, the wholesale adoption of the "active bad / passive good" narrative places increasing pressure on active managers to join the herd—they underperform if they challenge ETF movements based on price discovery. Indeed, the European Securities and Markets Authority (ESMA) has been active in highlighting the risk posed by active funds whose equity selections are unduly influenced by the composition of their reference benchmark index. The practice, known as *index hugging*, is estimated by ESMA to be used by 5 – 15% of purportedly active funds. The sheer quantum of potential *closet indexers* highlights the pressure the active investment universe is under to ensure performance can be evaluated favourably relative to their benchmark index.

The logic of passive investing is that investors can avoid the need to focus on security selection by being a 'passenger' - taking a free ride on the back of a market made 'efficient' by active investors focussed on gaining equal access to information, staying rational at all times and performing analysis to derive a fair price. If the sheer volume of passive investors looking to 'get a free ride' on the back of a dwindling number of active investors becomes too large, the ability of the market to remain efficient is compromised. At that point, the passengers inadvertently move into the driving seat. This is where the passive investing approach breaks down because it assumes that companies that were good investments yesterday will be good investments tomorrow. It is essentially a backward looking approach to allocating capital – not the best direction to be facing when in the driving seat.

Rising S&P Index Levels and Growth in the Share of Passively Managed Assets

(Source: Bloomberg & Atlas.com)



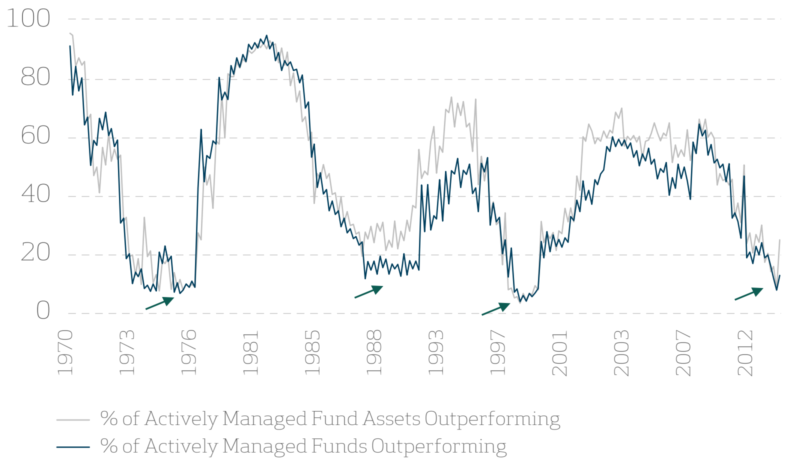
Who is in the Active Corner?

One of the challenges with evaluating the risks associated with the flow of capital into passive funds is that market participants willing to support the active investment community are in the minority.

Some of the best thinking around the risks posed by ETFs is coming from the active management universe, which undoubtedly impacts its credibility. There is limited willingness among investors to place much reliance on the utterances of investment firms who are haemorrhaging capital, as they seek to defend their ability to select stocks. This is compounded by the data which doesn't support the benefits of active investing: by most measures, active managers have, on average, under-performed their respective passive benchmarks. However, as below shows if we take a longer time perspective the relative performance between active & passive is much more cyclical.

Percentage of Funds (Fund Assets) Outperforming S&P 500 on a 5 year basis

(Source: Kopernik Global Investors LLC, CRSP, Bloomberg, Robert Shiller data and Instinet Research)



Are there any historic parallels?

It can be dangerous to attempt to draw historic parallels to the current challenges facing active fund managers. However, there are certainly some historic touchpoints worth considering. Q1 2000 saw a number of 'stock pickers', whose fundamental approach placed greater emphasis on valuation, struggle in the face of the 'herd mentality' afflicting the market. The tech bubble, and especially the period from April 1998 to March of 2000, which saw the technology and telecom sectors grow close to 40% of the S&P 500, placed enormous pressure on fund managers who were underweight the sector.

Further back, the so-called Nifty Fifty – a term used to describe a group of high growth/high quality US stocks that were considered "one-decision" stocks meant to be bought once and not sold – were an early forerunner of passive investing.

The willingness of investors to buy these stocks irrespective of valuation created a mentality of owning "growth at any price". These were generally high quality companies such as McDonalds, Coca-Cola, IBM, etc., but by 1972 when the broader market P/E stood at 19, the Nifty Fifty's average P/E was more than twice that at 42. When the market correction came in 1973-1974 these stocks were significantly more impacted than the broader market. While these companies would generally have continued to generate strong earnings and their share prices would have recovered, it does highlight the risks associated with a simplified single approach to allocating capital.

The Nifty Fifty was considered a simple and low risk approach of gaining equity market exposure by focussing on quality companies. However, a consequence of this was that investors were left exposed to a portfolio of large cap stocks whose valuations had moved outside normalised ranges. While the core logic underpinning the Nifty Fifty: of investing in high quality businesses with strong growth profiles was fundamentally sound, executing it in a formulaic way with no evaluation of individual company fundamentals was flawed. The similarity with the current market is the tendency to be overly reliant on one approach, which places no weight on the importance of analysis.

Summary

The standard explanation for the underperformance of active managers, that they have simply lost their touch, is certainly a possibility, but it requires an acceptance that information, analysis and judgement are no longer important skills for investing.

The alternative, which gets significantly less consideration, is that the sheer volume of capital flows into passive strategies has created some unintended consequences in equity markets around the valuation, and index weightings, of certain companies.

Passive investing has a role in client portfolios but potential drawbacks are being overlooked by some investors. Financial history highlights the risks of overreliance on any one investment approach. Furthermore, history shows that passive investing outperforming active investing is more cyclical than some proponents of passive investing acknowledge. ETFs are likely to continue to make the headlines; however, the narrative of the story may change and those investors with a more diversified range of investment strategies may be better positioned.

KEY CAPITAL

Key Capital Private, Huguenot House,
St. Stephen's Green, D02NY63, Ireland.

T +353 (0) 1 638 3850 www.keycapital.ie