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Passive Investing

Remember the debt passive funds owe active managers

Active managers are struggling but passive investment boom needs them

INSIGHT

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In the current low-return environment savers can be forgiven for asking, why should an ever-larger fraction of their meagre gains be paid to active asset managers?

After all, the alternative — passive investing — is beguiling. Passive funds offer many advantages, including a menu of low-cost opportunities to spread risk across markets, greater transparency versus the less visible picks of active managers and, for advisers, the benefit of not having to explain at some point why returns have been subpar. Unsurprisingly, nearly a quarter of a trillion dollars has left the active management sector in the past year, with much of it finding a home in ETFs.

Pro-passive arguments, made so successfully by providers of ETFs in recent years, however, gloss over an important fact. Passive investing would not be possible if it were not for the work of active managers.

Partly, that is because true passive investing is rare. By definition, a passive strategy dictates following the market capitalisation index and nothing more. The advent of a large variety of low-cost strategies, including ETFs, suggests instead that they are instruments for active use, such as in so-called smart beta strategies.

Low fees have been instrumental in driving their growth. Multi-asset managers today can take positions across asset classes, styles and strategies at less than one-20th the cost before ETFs became commonplace. Active use of so-called passive instruments lies behind much of the explosive growth of ETFs.

A purely passive approach, on the other hand, is based on the strong form of market efficiency, where systematic opportunities to generate excess risk-adjusted returns are not possible. Pure passive investors believe the market capitalisation-weighted index cannot be regularly bested.

But market efficiency, particularly its strong form, requires active management to ensure that any inefficiency is bid away. Pure passive investing can therefore be seen as leveraging the work of active managers whose efforts are required to maintain market efficiency.

By analogy, if we consider markets as repeated elections, pure passive approaches are akin to showing up at the polling booth and marking the ballot “abstain”, hoping that those who actively choose will consistently deliver the best electoral outcome. Smart beta by extension, is analogous to voting for a party but not the individual representative that might best deliver local public services.

That’s not all.

In their pure form, passive strategies bid up the prices of the largest companies that command the largest fraction of index capitalisation. They also ignore evidence that markets are not strongly efficient. Some factors, for instance momentum, have produced consistent excess risk-adjusted returns. Ironically, therefore, pure passive strategies appear to be taking implicit bets, eg, (anti)momentum. That creates opportunity, for example via systematic strategies, to generate persistent “alpha” by investing in “passive contrarian” fashion.

Pure passive strategies can also misallocate capital. By purchasing shares based solely on market capitalisation, passive strategies may overlook changes in underlying profitability, which are otherwise spotted by active managers. A world of “pure passive” investing, therefore, would lead not only to less efficient markets but potentially to suboptimal capital spending.

Investing is, like so many other examples in economics, subject to the fallacy of composition. What is good for the individual investor — low cost, passive investing — fails if everyone does the same. Perhaps the nearest comparison is the LafferCurve — tax collection is nil at both a zero and a 100 per cent tax rate. The optimal public finance policy is the happy medium somewhere in between. The same is true in fund management.

Investor preferences may come and go, pendulums swing, but the market will ensure that equilibrium is found at the point on the active-passive spectrum that maximises after-fee performance and minimises market inefficiency.

To succeed, therefore, passive needs active and vice versa. The two approaches are complementary, not competing. And with global savings inexorably rising, the future for both passive and active management remains promising.

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