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NICK VAN RENSBURG: Is passive investing a trend, or a cycle?

Most assume it will go on in perpetuity, but I believe it is finite and will probably end with a bang, not a whimper

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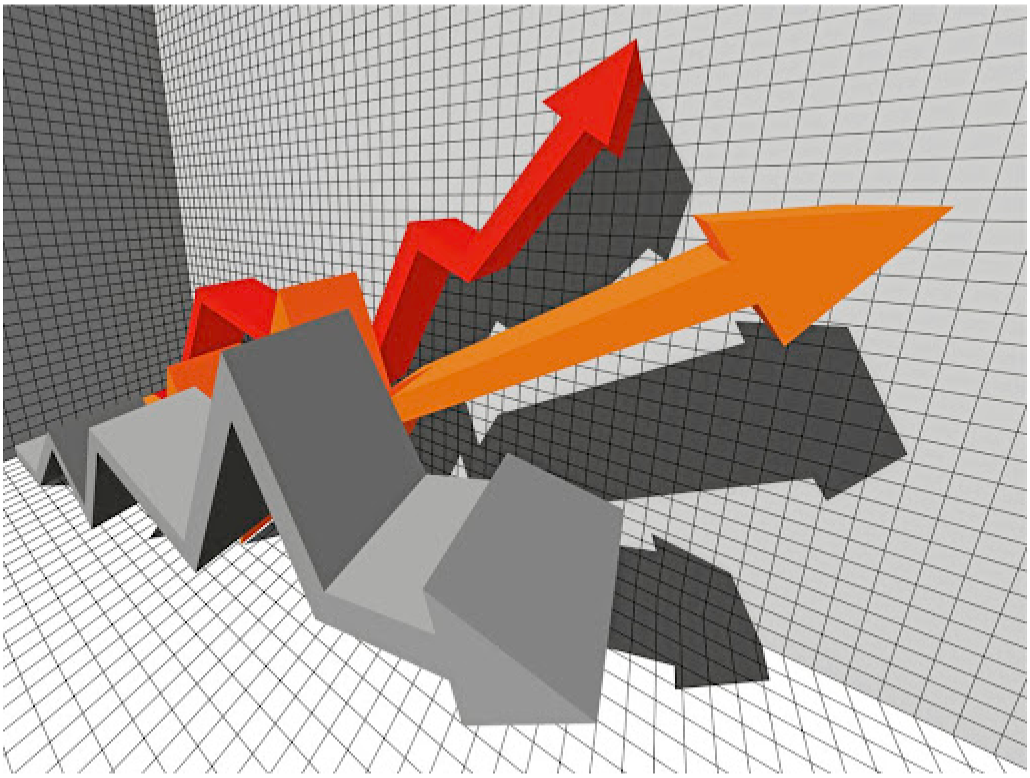
by NICK VAN RENSBURG



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Passive investing has grown rapidly over the past decade, and for good reason. Investors are attracted to the lower fees of passive funds, as well as the lower risk of underperforming one's chosen equity benchmark.

Passive also has a significant benefit in that it holds no cash, and thus avoids cash drag. You want the Nasdaq; you will get probably 99.8% Nasdaq exposure. Active funds are often required to hold a cash buffer.

In the US, passive grew from 20% of mutual fund assets to 60% over the last 15 years. This flow has been at the expense of active managers.

Most assume this trend towards passive management will continue into perpetuity, and that it is an unequivocally positive trend.

I believe that the move to passive is finite. What is more, the cycle will probably end with a bang, not a whimper. To understand why, we need to understand how passive affects the structure of the stock market.

Let us start with some controversial but factual statements: passive investing makes markets less efficient, less liquid, more backward looking, less forward looking, more momentum driven and less mean reverting. On the positive side, it makes the market less correction prone, but also more crash prone.

Active managers analyse the fundamentals of a company by reading the annual report, meeting with management, seeing the operations, assessing the competitive environment, and then producing a fair valuation for the company, generally called intrinsic value. If the valuation is significantly above the market price, the manager would buy the stock, and if the valuation is below the price, the investor would avoid the stock.

All Weather does fundamental analysis on companies and takes its responsibility to vote at AGMs very seriously. The context provided by fundamental analysis guides how it votes on behalf of clients, which may affect executive remuneration, capital allocation, and the like.

When active managers manage the majority of equity assets, the combination of different active investors creates a wisdom of crowd's effect, where different investor biases tend to cancel out, leaving the market somewhere approaching an efficient market. The downside is that this comes with higher fees, as fundamental analysis costs money, and there is the cash drag.

Passive funds on the other hand, do no assessment of valuation. It receives a fund inflow and buys every stock in the index according to its current index weight. The largest companies get the most flow, and the big get bigger. And because passive funds hardly know what the underlying companies do, they tend to outsource voting.

Passive works well when it is a minority of equity assets, as passive free rides off the price discovery by active market participants. However, once passive is the dominant owner of assets, then fundamental factors become less relevant over time. Apple has 70% of production exposed to China, who cares?

I watched an interview with a large quantitative fund manager who tracks 52 separate investment factors. Their data showed that in the US equity market, company earnings are price relevant for only eight days a year. Why eight? US companies report quarterly, and earnings are relevant for the day of the quarterly results, and the day after. That is eight out of 250 trading days a year. Price discovery is more a function of the inflows at Vanguard, than the falling margins at Tesla.

In SA, active management remains the dominant form of asset management and fundamental analysis is thus more relevant than in the US. That said, passive managers such as Vanguard, BlackRock, State Street, and a variety of sovereign wealth funds, have increased their passive stakes over time.

I made a controversial statement earlier in the article that passive is a finite cycle and not a perpetual trend, and that it's more likely to end in a crash than a whimper. Time to explain why.

Passive funds have only ever seen inflows, as the trend from active to passive has been unrelenting. With passive at 60% of US mutual fund assets, it is now the dominant vehicle for US household-owned equities.

Any remaining active managers had to become similarly momentum-driven to stay in business. And thus have a similar reaction function to passive.

Passive funds are unlikely to sell to passive funds, as flows into and out of passive funds operate on similar decision rules. A recession requiring the need to cash, the Dollar changing the attractiveness of different jurisdictions, or retirement.

Using Federal Reserve data, we estimate that people in the US over the age of 60 own about 66% of US household equity wealth. Baby Boomers are the wealthiest cohort in human history, and retirement makes them natural sellers of US equities over the coming decade.

Who will this huge cohort of retirees sell too? Over the coming decade, passive funds are likely to have their first net outflows, ever.

Markets require a diversity of participants to enable effective price discovery. If markets lack diverse participants, the eventual price discovery could be abrupt. Price momentum is a lot of fun, until it turns against you.

As Vanguard's founder John Bogle told Bloomberg in a 2017 interview: "If everybody indexed, the only word you could use is chaos, catastrophe". It's time to balance the low fees of passive with price discovery provided by active. It might lower your risk.

• Van Rensburg is a strategy consultant to All Weather Capital.

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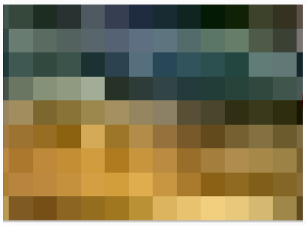

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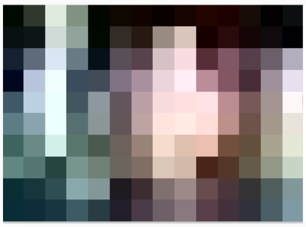

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