Active is dead, long live active (Part 1) – The rise of passive

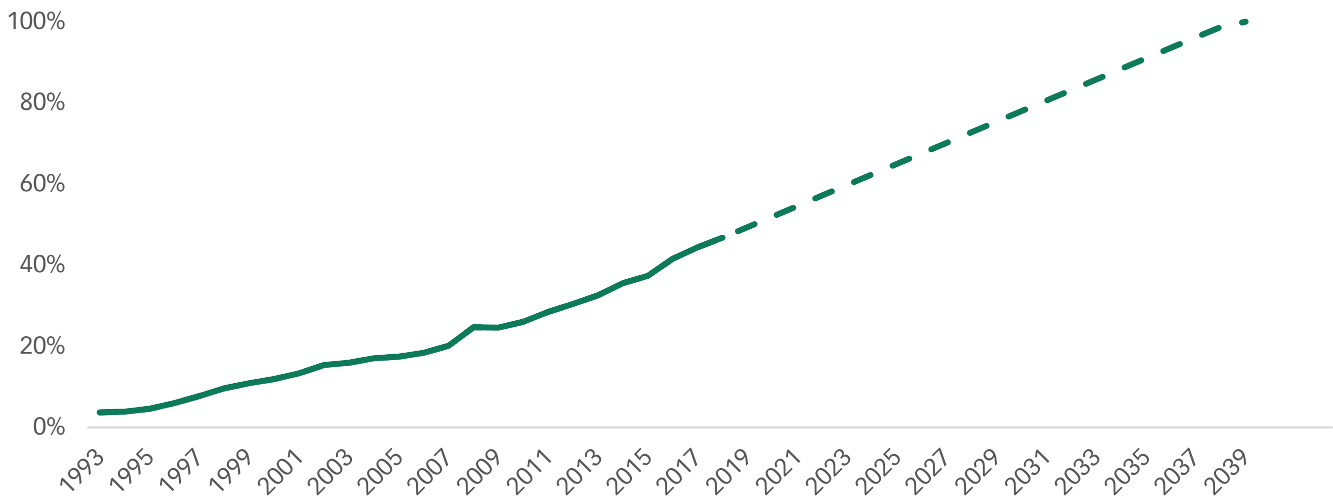
November 2019 – Patrick Hodgens, Managing Director & Portfolio Manager

Passive investing continues to grow in popularity. In the US alone, 50% of equities are invested via passive strategies. While low fees are an attraction, history has shown multiple instances of material capital loss from allocating to passive strategies. Two major events include, the de-rating of Japan in the 1990's and the fall of Nokia in Finland. Today, we believe there are three big risks bubbling away in passive strategies including valuation distortions, unproven investment strategies and the implications of rules-based decisions.

Passive strategies are growing in popularity

Today, half of all money invested in US equity funds is through passive exposure. If the trend continues, 100% of US equities exposure will be passive within 20 years. In Australia, passive investing and ETF's are also on the rise, now accounting for almost 30% of the equity market.

Chart 1. Passive exposure as a % of the total US equity market



Source: Firetrail Research

What has driven the rise of passive investing? In our view, there are three key factors:

1. **Low cost, ease of access** – Passive strategies that track a market cap weighted index such as the S&P 500 and S&P/ASX 200 provide a low cost, efficient way to access the market. As leading passive providers such as Vanguard, State Street and Blackrock have emerged costs have further reduced and access to passive strategies has become easier.

2. **Traditional active management has not delivered** – On average, many active managers have failed to deliver returns above the index. In part due to higher fees and costs. But also due to the competitive nature of investing and the difficulty in outperforming the average investor consistently through time.

3. **Ability to implement active views through passive vehicles** – Today there are thousands of different variations of rules-based strategies such as Income, Growth, Quality, Low-Vol, Tech, Gold… you name it! Everyday investors can now access numerous passive vehicles and ETF strategies as a low-cost alternative to active management. However, the risks in these strategies are not always well known or understood,

The above factors, combined with a better understanding of performance drivers across markets, means that investors are now only willing to pay for performance that is truly differentiated to the Index (**alpha**). Whilst implementing everything else cheaply through passive exposure (**beta**).

The trends are clear. Passive strategies continue to grow in popularity. However, despite the benefits, there are risks associated with passive investing that you should consider.

History has shown that passive strategies are NOT risk-free

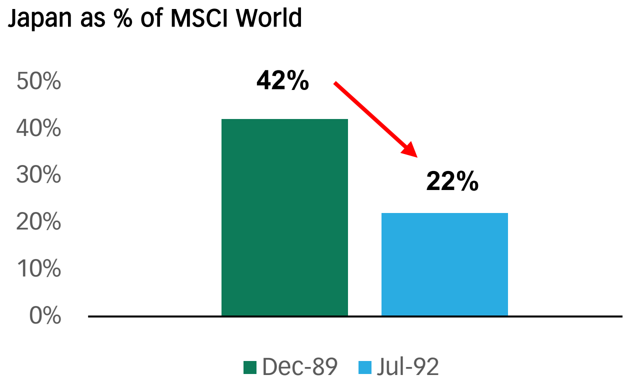
Passive investing is low risk relative to a benchmark. In fact, you are almost guaranteed to receive the index, less fees. However, total or absolute risk is what matters to most investors. That is, the permanent (or avoidable) loss of investors' money. And history has shown multiple instances of material capital loss from following passive strategies.

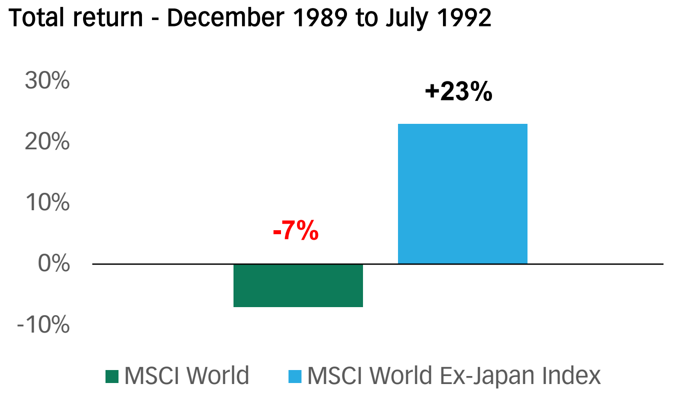
Japan in the 1990's

In 1989, Japan had emerged as an economic superpower and investors were excited. So excited, that in 1989, the trailing PE for the Japanese stock market hit 60x. And the Nikkei (MSCI Japan Index) accounted for around 42% of the MSCI World Index (the largest country exposure at the time).

However, Japan's strong economic growth ended abruptly at the beginning of 1990. To curb excessive loan growth, rising inflation and a growing asset price bubble, the Bank of Japan sharply raised the interbank lending rate in 1989. The swift policy change, combined with the unwinding of excessive cross-company holdings, became the catalyst that burst the Japanese stock market bubble and saw the Nikkei fall more than 50% from its peak in December 1989 to trough in July 1992.

Passive investors were significantly impacted. Over the period, the MSCI World Index lost 7%. In contrast, the MSCI World Ex-Japan delivered a positive 23% return. Many professional active managers were underweight Japan over the period. A 10% underweight resulted in 7.3% outperformance of the Index. Having zero exposure to Japan delivered 30% outperformance of the benchmark – a meaningful difference.





Source: Firetrail Research

The rise and fall of Japan wasn't the only time passive investors have lost significant capital. History is littered with examples of capital loss resulting from the composition of an underlying index:

- The fall of Nokia in Finland – Between 1993 to 2004, Nokia grew from 10% to more than 80% of the Helsinki Stock Exchange. Today, Nokia has fallen to 20% of the index following the disruption of mobile phones by smart phones. Whilst many investors benefitted from the rise of Nokia, the fall resulted in permanent capital loss for passive investors following the index.

- Australian Banks – Make up almost one quarter of the S&P/ASX 200 Index. Following an extended period of outperformance, Australian Banks have underperformed the Index by approximately 6% per annum for the last 4 years. Many active managers (including Firetrail) have owned less Banks than the index, allocating capital to better opportunities to deliver outperformance for investors.

- MSCI All Country World Index – Currently has less than 4% total exposure to China, the 2nd largest economy in the world. The largest economy (the US) accounts for 55% of the Index. Being underrepresented in China results from the rules-based methodology used to construct the index. For passive investors, this is a risk of following an index. For active managers, these misallocations of capital are an opportunity.

Three big risks we see today in passive strategies

Today, there are three big risks in passive strategies we believe every investor should be aware of. These include:

1. **Valuation distortions** – Passive investors rely on active investors to keep the market efficient. The rise of passive exposure relative to active means there is less money in the market focused on price discovery. With less active 'price seekers' and more passive 'price takers,' the potential for price distortions can increase. Is this good or bad for active investors?

   In short, the answer is both. Less efficiency = more opportunities. However, research shows that stocks with high passive ownership react less to surprises. So, in the short-term, active 'price seekers' may not be rewarded. However, opportunities to profit from mis-pricings across the market may become more abundant and extreme over the long term. The key to capturing these is staying patient and taking a long-term view.

2. **Unproven investment strategies –** Have emerged across the market. ETFs that invest in a specific theme, sector or industry have become increasingly popular. According to ETF.com, there are more than 77 Technology based ETFs in the US managing $100bn (USD). Over the past 3-months alone, the performance of these ETFs has ranged from +42% to -50%. A major divergence over a short period. Other ETFs of note include Robotics, Artificial Intelligence and Cannabis. These strategies are often targeted at direct investors who may not fully understand the risks and volatility in the underlying portfolios.

3. **Rules-based decisions -** The availability of passive strategies such as value, growth, quality and yield have opened-up the ability to express active views via passive vehicles. But can a simple rules-based approach deliver? We have seen examples where they haven't, particularly in the 'income' style strategies which look to own high dividend yield stocks to provide income for investors. To deliver on the investment goal of income, the rules will typically look for historical dividends as well as forecast dividends. But what if something is changing?

    - In March 2015, an offshore high yield index provider incorrectly rebalanced its portfolio to Australian listed company Monadelphous Group. A large global ETF manager following the index started buying and ended up owning more than 20% of the company. The Monadelphous share price had rocketed to +50% and within the month, fell straight back down to its original price once the ETF provider had picked up the error and promptly sold its shares.

    - In March 2019, shares in Australian Fund Manager Perpetual soared over 12% on no new company news. Prompting speculation of a takeover. A substantial shareholder notice filed by a global ETF provider days later explained the sudden elevation of the share price, which subsequently fell back again. A $6 billion ETF had purchased US$100 million worth of Perpetual shares for its yield characteristics, without regard for the company's size or liquidity.

Companies are also being included in conflicting ETF strategies. For example, a US oil major, Exxon, has representation across Market Cap, Value, Growth, Dividend, Min Vol & Quality ETFs. Australian energy company AGL, is included across four different major ETF styles. How can a company be value, quality and growth? And are company management now incentivised to meet simple rules-based criteria of ETFs to generate passive flows into their firms? What is clear is that rules-based decisions can distort share prices well beyond the fundamentals of a business.

Conclusion

Passive investing continues to grow rapidly. Low cost, ease of access and innovation has driven the rise of passive. New innovations such as rules-based strategies and ETFs has seen passive flows increase further as investors implement active decisions through passive vehicles. However, history has shown that passive investing is not risk-free.

In our view, three key risks of passive investing include valuation distortions, unproven investment strategies and rules-based decisions. These risks are creating new opportunities for active managers to take advantage of mis-pricings across equity markets. **The key question is, which active managers are positioned to take advantage of these opportunities? Part 2 of our research, 'The future of active', is being released in December and aims to answer this important question.**