ROYAL LONDON POLICY PAPER 24

Could the passive investing pendulum swing too far?

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1. INTRODUCTION

The 'small print' of most advertisements for financial products reminds investors that 'the value of your investment may go down as well as up'. But over the long-term, assuming that the economy grows, investing your money in things like stocks and shares should result in an increase in the value of your investments.

One way to lock in to this growth potential is to invest 'passively'. The investor's money is invested on their behalf in a way which aims to match the performance of a basket of shares – perhaps the largest companies on the stock market (as measured by the FTSE 100 index) or all the shares on the market. These 'tracker' funds have become increasingly popular in recent years and are often available at very low cost.

Assuming that the tracker fund is successful in matching the performance of the index, then the saver will get a return slightly below the performance of the index once costs have been deducted.

An alternative approach is to invest 'actively', doing your research (or paying someone to do it for you) and carefully choosing which stocks in which to invest. This basket of investments would be kept under review and could be changed from time to time as new information becomes available. As might be expected, this is a more expensive process and the charges for actively invested funds can be significantly higher than those for passive investments. If they are successful, actively invested funds can outperform passive funds, even after the deduction of charges. But because of the additional cost involved, active funds need to achieve better returns before charges than passive funds in order to deliver the same outcome.

In recent years, active investment has come in for considerable criticism. Many asset managers running active funds have simply failed to deliver the additional performance to justify their higher charges, particularly on a consistent basis. In the worst cases, so-called active investors have been charging higher fees for active management but then quietly investing in a way that largely matches an index (so-called 'closet tracking'), resulting in the worst of all worlds for investors – active fees for passive performance.[1]

The result of this entirely justified challenge to active investors has been a flow of assets in the direction of passive funds. In addition, fierce competition between passive funds has driven down charges, making them still more attractive.

But what would happen if *all* investments were in passive funds? What would this mean for the functioning of the stock market and the governance of firms? How would new businesses raise investment funds if investors only wanted to invest in companies who were already listed on the stock market?

In this paper we examine the relative merits of active and passive investing and ask if there is still a role for active investing. We begin by setting out the advantages of passive funds and look at the reasons why they have grown in recent years. We then consider whether there is any limit to the expansion of passive funds and whether there are likely to be any problems if all or most investing took the form of passive investing. Finally we consider how and when active investing might be able to add value, and look at the appropriate balance between the two forms of investing.

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[1] The Financial Conduct Authority (FCA) has been particularly critical of the actions of 'closet trackers' as part of its Asset Management Market Study. It has already required asset managers to pay investors over £30m in compensation where they have paid excessive charges for what was essentially passive investing – see https://www.fca.org.uk/firms/authorised-and-recognised-funds/closet-trackers

2. THE CASE FOR PASSIVE INVESTING

What is an index and why would you want to replicate it?

Passive managers track an index - a group of securities compiled to reflect the available securities within a particular asset class and, consequently, to provide a benchmark for the indicative performance of that asset class.

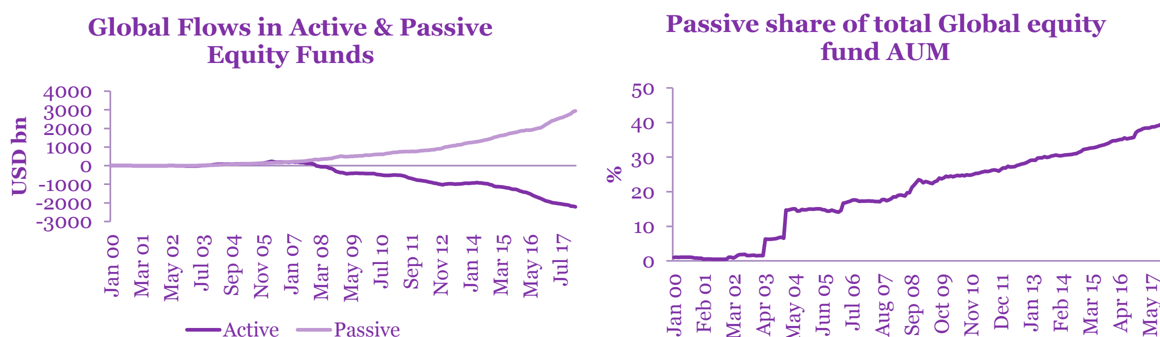
Index funds were devised to provide investors with cheap, diversified portfolios. They are, essentially, portfolios of stocks weighted according to the underlying index provider's methodology, usually by market capitalisation. Index funds hold the vast majority, if not all, of the associated index constituents.

By holding an index fund you are holding a unit of exposure (beta) to the underlying index and, by definition, no incremental outperformance potential (alpha). Passive management is essentially a logistical exercise and, consequently, a relatively cheaper alternative to active management.

Index funds have witnessed a surge in popularity over the past decade and assets have moved aggressively from active to passive products. Figure 1 shows that since the global financial crisis of 2008, equity funds have flowed heavily away from active and towards passive management. In terms of the overall balance of investments, passives have grown from a negligible share at the turn of the century to accounting for nearly half of all assets under management by 2017.

Figure 1:

a) Global flows since 2000 into active and passive equity funds, and
b) Share of global equity assets under management accounted for by passive investments

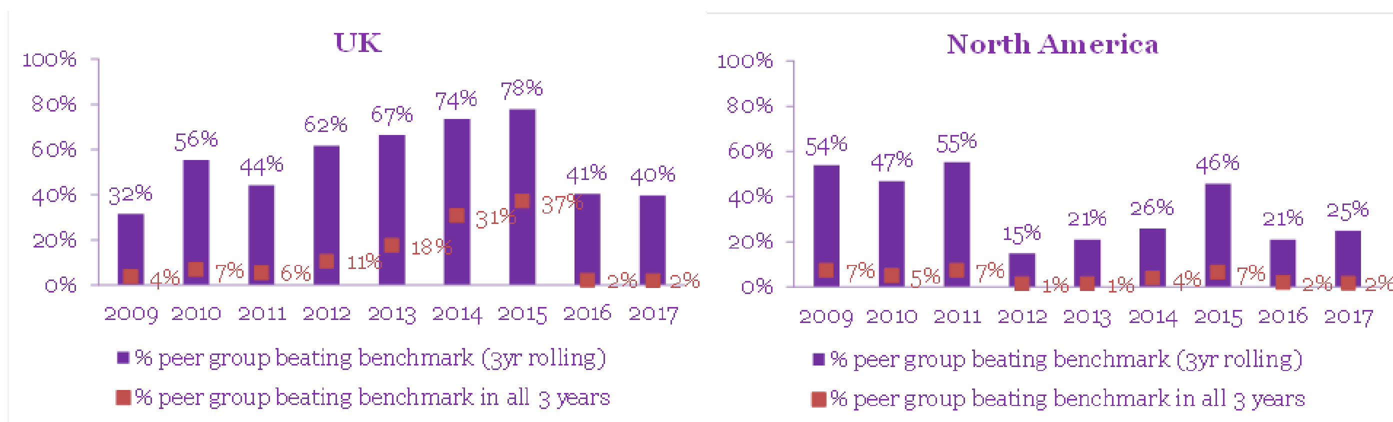


Source: Royal London Asset Management, Bernstein Research

This should not come as a surprise as this has coincided with significant fee compression in passive products and strong performance of the passive 'benchmark' versus more expensive, active alternatives. This trend has been reinforced by a restructuring of adviser remuneration away from commission, which has led to a greater focus on transparency and on fee levels.

Figure 2 provides data for the UK and for North America and shows what percentage of actively managed funds have outperformed the benchmark of passively invested funds over a rolling three year period and also in each of three consecutive years.

Figure 2: UK and North America: Percentage of funds which outperformed the benchmark a) on a rolling three year basis and b) in each of three consecutive years



Source: Royal London Asset Management, FTSE, Lipper. Note: peer group = relevant regional Investment Association all companies peer group

Figure 2 shows that in North America since 2012, active managers have underperformed their benchmark over any rolling three year period. It also shows that an extremely low proportion of active managers were able to outperform the passive benchmark in three consecutive years (shown by the orange rectangles). Just 25% of active managers have beaten the benchmark over the last three years and only 2% of active managers were able to beat the benchmark in each one of those three years.

This is slightly less of a concern in the UK given the UK benchmark (FTSE All Share) gives active managers more opportunity to add value by investing in smaller firms. The size premium is well documented in academia and investors are, generally,rewarded for taking small cap exposure over large. This is more feasible to implement within the FTSE All Share as there is a large tail of small cap stocks in the index that an active manager can invest in without going 'off benchmark'. Broad indices in the US, the MSCI US for example , do not offer such breadth across smaller caps. At the time of writing, the smallest stock in the FTSE All Share is ~£160mn whilst the smallest stock in the MSCI US is $7.5bn Even considering this, only 40% of managers have beaten the UK All Share benchmark over the past three years and, in line with the US, just 2% of managers have beaten the benchmark in each of these years.

A further trend in recent years has been a greater tendency for different equity markets to tend to move up or down largely in step with each other. This is because the impact of macro factors such as the state of the global economy and the level of interest rates has had a dominant effect on the level of equity markets relative to micro factors such as the performance of individual stocks. This has been particularly true for larger indices, particularly for those with active derivative markets, such as the FTSE 100 index, the S&P 500 and the Euro Stoxx 50. These are all markets where investors focused on macro trends rather than stock picking can hedge relatively easily. This has reduced the potential for outperformance on the back of stock selection.

To sum up, the flow of investment funds in recent years has been heavily towards passive funds. Competition between such funds has driven down costs enabling them to deliver improved performance net of charges. At the same time, active investors have found it increasingly difficult to beat passive benchmarks, especially on a consistent basis.

In the next section we consider how far this trend could go and whether we should be concerned if a much higher proportion of investment funds ended up being passively invested.

3. BUT WHAT IF ALL INVESTING WAS PASSIVE?

Current estimates suggest that fully passive index funds account for around one fifth of the US stock market. Estimates put this at 35-40% if one includes other systematic strategies and Exchange Traded Funds (ETFs)[2]. Given the trends identified in the last section, what would happen if the balance between active and passive investing continued to shift towards passive? In this section we consider the problems that could be caused if passive investing was the only, or dominant way in which funds were invested.

a) What would the fund market look like?

If all fund managers were simply trying to match an index then there would be nothing to differentiate between them other than price. Investors would have no alternative other than passive investing, and no-one could achieve better than 'average' returns before costs and 'slightly below average' returns after costs. But if investors are simply 'price takers', investing in companies regardless of their performance or conduct, there is a risk that this could in turn lead to poorer corporate performance and poorer long-term returns to the detriment of investors. We discuss this point more fully below.

b) What would it mean for diversification?

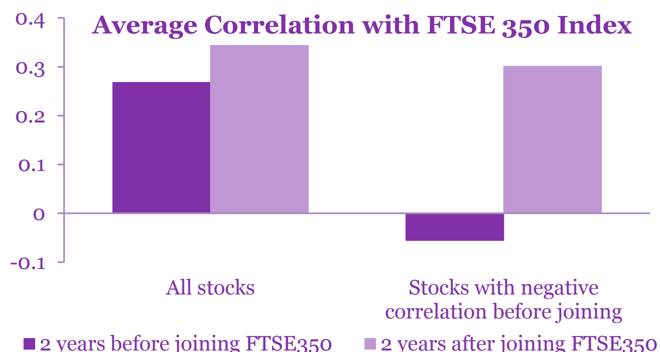
One of the few rules of investing of which most people are aware is that you 'don't put all your eggs in one basket'. Rather than invest in a single stock or a single asset class, investors generally spread their investments. Whilst this may dampen down the potential for spectacular gains, it also reduces the risk of significant losses. If investments are spread then although some may perform well and some less well, it is unlikely that they will all do well or badly at the same time.

This diversification is much harder to achieve in a world of passive investment. If investors are simply putting their money into the shares in an index and cannot invest outside the benchmark then this reduces the potential for diversification. Furthermore, there is evidence (see below) that when shares become part of an index such as the FTSE, they start to perform more in line with other shares inside the index, even if they did not do so before. This is because passive investors are forced to buy these shares regardless of performance.

Even stocks with negative correlation to the index before joining go on to have a strong positive correlation thereafter as shown in Figure 3.

[2] An ETF is an investment fund which can be traded on an exchange and which will often track an index. Such funds provide one way in which individual investors can invest their money so that it rises or falls broadly in line with market movements as a whole.

Figure 3. Correlation with movements in the FTSE 350 index -a) all stocks, b) stocks with negative correlation who go on to join the index



Source: Royal London Asset Management, FTSE, FactSet

Over the past five years the proportion of assets run passively has increased by a third. It is estimated that a further one third rise in passive share would increase average correlation amongst stocks by a further 15%.

c) The risk of being 'locked in' to failing stocks

Passive funds are unable to sell stocks in the benchmark. When a company issues a profit warning or significantly misses on earnings an active manager is able to sell out of their position. Whilst there is little systematic evidence on this point, there is an old stock market adage that profit warnings 'come in threes' – one is often followed by more over a period of time. This is because the first warning is often not the end of the story – there will likely have been a change in the market that management failed to anticipate that may have a longer term negative impact on earnings. This is an area where active managers have a clear advantage over passive. The box provides a case study of where an active manager was able to outperform a passive manager because of the ability to sell potentially under-performing stocks.

CASE STUDY – RLAM INVESTMENT IN 'MICRO FOCUS' DURING 2017/18

A recent example of where Royal London Asset Management has been able to take advantage of the freedom to sell stocks in an index was with their holdings in Micro Focus, a FTSE 100 software company.

In Q3 2017 Micro Focus acquired the former Autonomy business from Hewlett Packard, almost doubling its weight in the FTSE 100 and, consequently, forcing passive funds to buy more of the stock.

On 8th January 2018, Micro Focus reported disappointing results saying that synergies identified when they announced the deal was failing to meet their expectations. The stock fell 17% and, shortly afterwards, RLAM active funds sold their holdings.

A second profit warning followed on 19th March, causing the stock to fall a further 46%, at which point RLAM active funds bought back into the stock. Due to persistent inflows, passive funds were forced to add to their holdings between the two warnings.

The net result is a holding by passive funds now worth around 60% less than when Micro Focus undertook the acquisition. The obligation to hold funds – and even increase holdings – regardless of performance warnings represents a headwind for passive funds.

d) How would new firms raise money?

Another potential issue if investments were largely or wholly passively owned is how a new or growing business could raise money. At present there is a market for Initial Public Offerings (IPOs) where active investors are able to efficiently allocate capital and act as price setters. In the absence of active management who would allocate this capital and how would the market go about any rational price discovery? Private Equity may be able to fill some of the gaps but would be unlikely to assist with funding equity in the scale required by a Facebook, Alibaba or Aramco.

e) Stewardship and corporate governance

If everything was passive the industry would also face potential issues over stewardship. Many critics argue that passive managers may see research into company governance and engagement with boards as expensive and surplus to requirements. As passive investing grows, engagement with management may become less of a priority with a predominantly price sensitive client base, which could act to the detriment of the overall quality of corporate governance. After all, passive funds buy a stock because of its inclusion in an index and not because of their view on underlying fundamentals or company management.

From a public policy point of view, we need passive funds to do more to use their considerable size in being active when it comes to stewardship and it is welcome that the large passive houses have been increasing headcount in this area.[3] But if passive investing becomes dominant and competition is largely or solely on cost, budgets for this kind of research and engagement could easily find themselves being squeezed and there are already signs of this.

Without investors engaging with companies, holding managers to account and using the ultimate sanction of selling shares if necessary, the pressure on managers will be reduced and performance is likely to suffer as a result.

In summary, whilst there are obvious advantages to individual investors of putting their money in low cost funds which broadly track the performance of markets as a whole, from a public policy point of view there are clear risks if passive investing becomes too dominant. This could be to the detriment of individual investors whose investments will be less diversified and who may find that their shares perform less well in the long-term if there is no capacity to scrutinise corporates nor to sell the shares of under-performers.

But it could also be to the detriment of society as a whole if new firms struggle to raise funds because of the tide of money flowing into existing firms and the inability of investors to disinvest from poor performers.

In the next section we consider whether there are specific areas where active investing can add value, whilst recognising that in the recent past the additional cost of active investing has often proven hard to justify.

[3] There are passive funds which incorporate a mandate to scrutinise the environmental, social and governance (ESG) performance of firms. One example of this is the Royal London “Emerging Markets ESG Leaders fund”. A focus on ESG, and particularly governance, is paramount in Emerging Markets and leads to an emphasis on higher quality and less volatile sticks even within a broadly passive approach.

4. WHERE MIGHT ACTIVE INVESTING ADD VALUE?

Whilst passive funds benefit from being able to offer significantly lower fees, their increased prominence may have a detrimental effect on market structure and dynamics. It is important to consider the role active investors play in price discovery/market efficiency, efficient allocation of capital and in the stewardship of companies in which they invest. The governance of firms and their economic and social impact (ESG) is a growing area of interest for investors and something that active managers, unlike their passive counterparts, are more likely to be able to influence.

Active managers are able to integrate security specific information into their analysis and, consequently, take positions accordingly. Passive mangers have no interest in idiosyncratic stock returns (Alpha). They are, by definition, only concerned with delivering market returns (Beta) and, consequently, invest in all index constituents regardless of their valuation or corresponding fundamentals contributing to inefficient price discovery and the potential misallocation of capital. Although passive funds receive the same voting rights as active funds they cannot express discontent with management and corporate strategy by 'voting with their feet' and selling their holdings.

Ultimately, a key defence of active management comes down to its social function and its ability, versus passive investing, to allocate capital for the benefit of financial markets and society as a whole. Passive investment is paradigmatically opposed to this approach. Rather than looking at future dynamics in the economy, and allocating capital to underlying sectors and stocks accordingly, passive investing is inherently backward looking, acting as a 'price-taker' rather than contributing to price discovery and market efficiency.

Given that active managers have struggled to outperform passive managers in recent years, especially on a consistent basis, it would be hard to argue that passive investment does not have a place in an overall investment strategy. But is it also possible to identify types of market or situations in which active investment might be expected, prima facie, to offer an edge? That is the subject of this section.

a) Where the construction of the index creates a bias which may undermine performance[4]

The majority of this paper has focused on investment in equities as this will be more familiar to most readers. But passive investment can take place in any form of investment where there is a benchmark to follow.

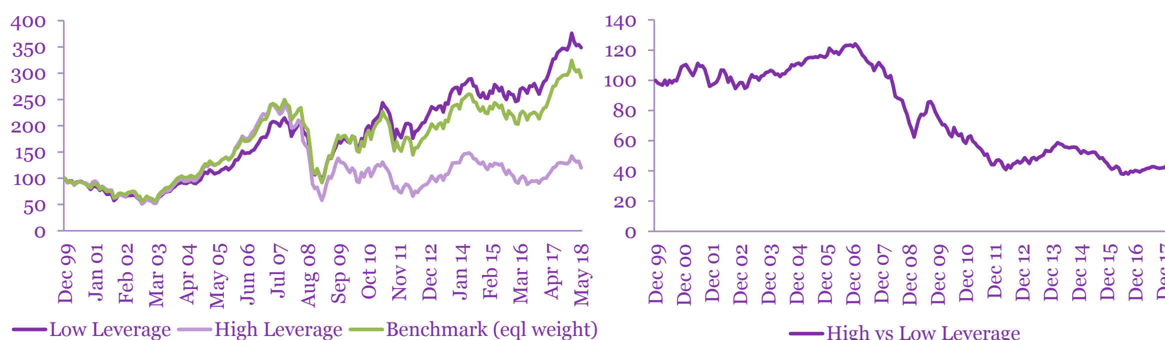
One important area of investment is in 'fixed income' assets such as corporate bonds. And there are reasons to think that passively tracking indices of corporate bonds could lead to under-performance.

The reason for this is the way in which indices of corporate bonds are constructed. Just as share indices are weighted by the size of companies, fixed income indices are generally weighted towards companies that issue the most debt. This biases fixed income indices towards higher leveraged companies. There is strong empirical evidence suggesting that investing in leveraged companies results in underperformance. Why

[4] Ezra and Warren (Journal of Portfolio Management, Summer 2010) identify three reasons where it makes sense to depart from a default passive index to an active investment. These are : a) When there isn't an index that can be replicated in a portfolio; b) when the weights used in an index aren't appropriate to deliver the required returns (eg when one deems the weighting scheme in the index inefficient) and c) When one believes that one can outperform a passive index (i.e. when one believes one has superior skill than the average investor)

would one want to invest in an index product that, by definition, has additional exposure to companies that issue the most debt?

Figure 4. Performance of high leverage and low leverage firms since 1999



Source: Royal London Asset Management, FTSE, FactSet

The left-hand side of Figure 4 tracks the performance of companies which issue relatively large amounts of debt and those with relatively small amounts of debt compared with a benchmark of all firms giving equal weight to each. The graph shows clearly that the shares of firms with low amounts of debt have significantly out-performed those of more heavily indebted companies. The right-hand side of the chart shows that if the relative value of such shares was indexed at 100 in 1999, the shares of highly leveraged firms are now only worth around 40% of those of less indebted firms.

a) When there's a market failure which provides opportunity to outperform the index

Economic theory would suggest that if markets work perfectly then the price of a share would reflect the expected future profits of a company. If the buyers and sellers in the market all have 'perfect knowledge' about the firm and an accurate understanding of its present and future performance, then there should be no potential for outperforming the market by holding some stocks and not others.

However, in practice, these conditions are unlikely to be met. For example, those who buy and sell shares will never have 'perfect knowledge' about the companies in which they invest nor about the markets in which those companies operate. In principle, an investor who knew more than average about firms or market sectors might have the opportunity to get a better-than-average return. The extreme example of this would – of course – be an 'insider trader' who used inside knowledge about the future to make investment choices before that knowledge became more widely known. But even in the absence of insider trading, an investor who, for example, undertakes research on companies and how they are being run might be able to select their investments in a more informed way and reap the benefits.

Active management involves investing in the same asset class but with the objective function of achieving a higher return than, as opposed to replicating, the index. This usually comes with increased research and resource requirements and higher implementation costs than a passive alternative which, by definition, result in higher fees.

Conventional wisdom suggests most investors are better off buying lower cost passive funds in developed markets as they are typically information-efficient with strong competition amongst asset managers, with risk budget better spent in less efficient markets. But active management may therefore add more value in less efficient markets or where the analysis required is more qualitative. At Royal London we believe that we

add value in these areas and, as a consequence, have active products in the form of Income, Small Cap and Sustainable funds in the UK with broader market exposure provided by a passive FTSE 350 fund.

CASE STUDY: CONSISTENT OUTPERFORMANCE OF PASSIVE BENCHMARKS

The Royal London global equity team uses active management to target higher levels of risk-adjusted return over time. Rather than invest in global equity indices, the team invests in a diversified portfolio of 30-45 stocks. The stocks selected are chosen using an investment process that seeks to identify companies with two attributes. The first is that they have superior shareholder wealth creation characteristics, the second is that they are undervalued by the market as a result of one or more market inefficiencies. The combination of focusing on superior shareholder wealth creators at better than average valuations seeks to outperform the index which is in effect the average of all the stocks in it. Whilst holding a subset of stocks increases the divergence from index returns in any time period, on a risk-adjusted basis their approach has persistently outperformed the benchmark and peer group over the past 15 years. This is delivered at an annual management charge of 0.6%.

b) When active investment reduces volatility

As noted in the previous section, those who invest passively in all of the shares in a benchmark are locked in to that basket of investments through the ups and downs of the economic cycle. The evidence suggests that stocks in an index have a tendency to move together, and the investor has no option to invest outside the index or pick stocks which may be less correlated with each other. Having the freedom to invest actively allows the investor to diversify and reduce the risk that his or her investments experience a roller coaster of returns.

5. CONCLUSIONS

Inigo Fraser-Jenkins[5], an equity strategist who has written extensively on the active versus passive debate, has this to say about the debate on active versus passive investing:

'Let's be clear up front. We are not saying that passive (investing) is a bad thing. Far from it. The growth of passive has delivered a major benefit to asset owners in lowering the cost of access to equity market exposure… Put another way, it allows asset owners to be clearer about exactly what it is they want to pay for.'

This would also be our view. There should be no presumption that active management will necessarily deliver better returns net of costs, and the onus is on active managers to demonstrate that they are delivering added value for those additional costs.

But we also think that there are dangers of going too far down a 'passive-only' route. From the point of view of the individual investor they are locked in to shares which may be poorly performing and they can face greater volatility if all of their investments move 'as a pack'. In addition, if large passive asset managers are seeking to cut costs by reducing engagement with firms, the performance of those firms may ultimately suffer.

From the point of view of the economy as a whole, active investors deliver spin-off benefits. They are a source of capital for start-up businesses not yet included in the main markets and their buying, selling and engaging behaviour can help drive up standards of corporate governance and performance. There is no doubt that UK plc would suffer if active asset managers were driven to the periphery of investment decisions.

In our view there is no right or wrong answer to the active/passive debate and it is likely that a mix of both is required and that this mix will vary from client to client. Indeed, an effective asset manager will 'actively' choose where to passively track markets and where active management can add value net of costs. As such, at Royal London we use a combination of both active and passive investing to combine the important elements of a low cost passive approach that can deliver broad market coverage with the use of active strategies that can deliver additional value by exploiting market inefficiencies, allocate capital to businesses that can create additional value and ensure that businesses invest responsibly. The lower costs associated with passive investing also have the benefit of allowing us to pay a premium elsewhere for active management where we think it is justified.

[5] Inigo Fraser Jenkins is Head of Global Quantitative and European Equity Strategy at Sanford C Bernstein

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