Investing in funds

Rise of passive funds is rebooting active management

Create-Research's Amin Rajan says these two investment strategies are complementary

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Active managers are coming out of the doldrums at long last, but few expect a return to the good old days.

Actives and passives may well be entering an era of coexistence, due as much to the reappearance of old cyclical forces as to the arrival of new structural ones, with the headlong rise of passives in this decade.

This rise has inevitably invoked depressing forecasts about active investing, mostly based on recency bias: the tendency to project the here and now into the future unconditionally. The implied doom and gloom mistakenly assumes that actives and passives lead separate existences. The reality is more nuanced, according to a report launched by Create Research this week.*

Like yin and yang in Chinese philosophy, the two styles are diametric opposites, yet are complementary due to the changing level of market efficiency over a cycle.

As active managers seek to buy underpriced and sell overpriced stocks, price anomalies are reduced and markets become more efficient, making passives more attractive. After all, passives thrive when no one has the information edge.

As more money flows into passives, stocks are bought because they are in an index, not because of their intrinsic merit. Valuations become distorted, as new information becomes available. That opens the door for actives.

In the past, this cyclical pattern had a habit of bringing both styles back down to earth due to the power of mean reversion: what goes up must come down and vice versa.

For example, having averaged 16 times cyclically adjusted earnings historically, the S&P 500 index soared to 44 times in 2000, reaching its worst ever point of overvaluation. It duly retreated into self-healing mode in the last decade, when it was consistently outperformed by the majority of active managers.

In this decade, the tables have turned. The main reason is the near-$16tn of liquidity pumped into markets by central banks after the 2008 crisis. As a side-effect, asset prices have been over-inflated, benefiting the good, the bad and the ugly indiscriminately. Value investing has been sidelined.

However, the latest data from Morningstar, the research provider, suggest that actives may well be regaining their mojo. Because current equity valuations are so far removed from their fundamentals, the pendulum may well swing back in favour of actives before long. But the timing is hard to predict. As John Maynard Keynes, the economist, once observed: “Markets can remain irrational longer than investors can remain solvent.”

Even so, it is unlikely that the pendulum will swing fully away from passives, because their structural advantages have become glaringly evident with the growing separation of alpha and beta.

Passives will always remain attractive for those who want low-cost market beta

MARTIN GILBERT, STANDARD LIFE ABERDEEN

"Passives will always remain attractive for those who want low-cost market beta," says Martin Gilbert, co-chief executive of Standard Life Aberdeen, the fund house. Regulators in the UK and the US couldn't agree more.

Cap-weighted indices are cheap, transparent and require minimal governance, offering a set-and-forget autopilot option. Exchange traded funds, for their part, enable investors to slice and dice the investment universe to pursue specific themes over a market cycle, while offering intraday liquidity.

But all that glitters is not gold. Passives have their own limitations. In cap-weighted indices, great companies are included in the same basket as mediocre ones, due to bulk buying. These indices could make booms and busts more likely owing to their inherent tendency to buy high and sell low when momentum is working.

ETFs, too, have caused concerns because of the extraordinary level of their daily trading that hampers the two traditional functions of financial markets: price discovery and efficient allocation of capital. Hence, the real test of passive investing will come when they are judged not by inflows while markets are riding high but by their resilience when the inevitable downturn comes.

Investors have wised up, after a run of sub-par performance from active managers in this decade. The burden of proof has shifted for them. To their credit, they now recognise that the rise of low-cost passives is a game changer that is intensifying price competition, margin compression and industry consolidation.

"Active managers need to craft a new narrative on what they stand for and what they can deliver," says Richard Wilson, chief executive of BMO Global Asset Management.

The winds of change are evident. Active managers are now taking steps to deliver better returns net of fees and charges. They reflect the new reality: as the fund industry is moving from being supply led to being demand led, a trusted brand only means one thing: a promise kept.

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*Active investing: shaping its future in a disruptive environment