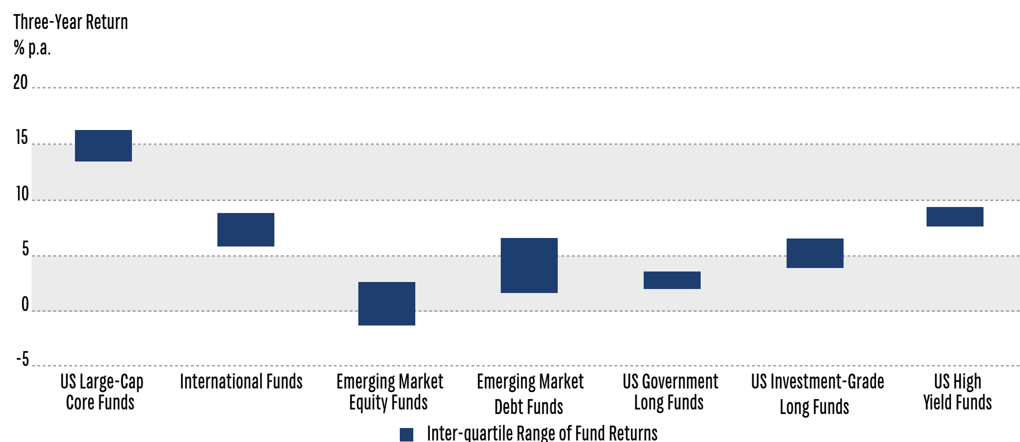
The hidden risks of going passive

Passive management is often seen as a low cost, low governance way to invest. While this may be true in a narrow sense, we think it would be a mistake to believe that it is a low risk route to success or that it offers a 'set-and-forget' approach. We would argue that the most important investment decisions are unavoidably active and that there are hidden risks to index-based investment approaches. Moreover, there is evidence that some active managers can add value. This article looks at these and other issues that investors need to consider when deciding whether or not to go passive.

The importance of asset allocation

First and foremost, it is important to remember that one of the biggest decisions any investor makes is how they allocate their assets. Even the best active manager in one asset class will often underperform the worst asset manager in another.
In Figure 1, the asset allocation decision is demonstrably more significant than the active-passive decision.

Figure 1: Asset allocation matters: three-year returns of active funds using different asset classes



Source: S&P Indices Versus Active Funds Scorecard (SPIVA) Mid-Year 2014, and Schroders, as at 30 June 2014.

Whether and how much to allocate to different asset classes is therefore a decision of paramount importance. It is also inescapably active – it is impossible to make a 'passive' asset allocation decision. However they manage their portfolios, investors cannot avoid choosing which broad categories of assets to use: equities, bonds, property, alternatives, etc. Once that course has been charted, the investor needs to decide whether to use active or passive management to gain access to the assets they have chosen.

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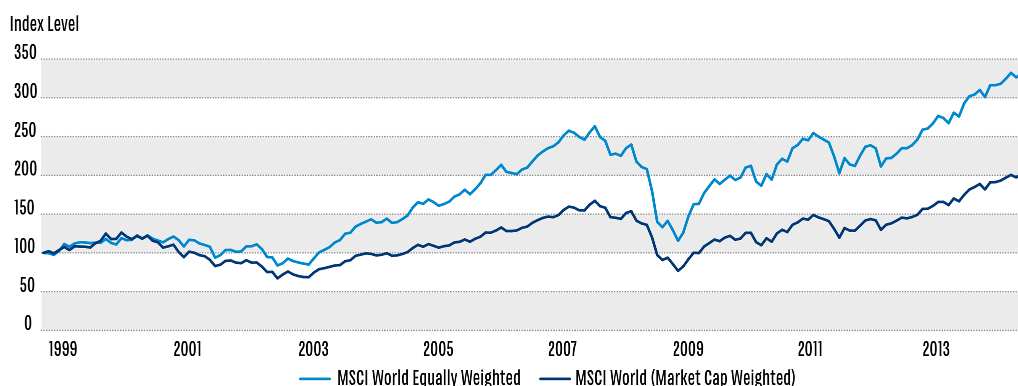
Untoward valuation biases

Investing using passive indices can certainly have benefits, but it also carries its own risks. For instance, traditional equity indices weight stocks by market capitalisation, so that bigger companies dominate. At the end of September 2014, three-quarters of the total value of the MSCI World Index – a benchmark widely followed by passive investors – was accounted for by very large-cap stocks valued at more than $20 billion.

One of the problems with this approach is that it emphasises yesterday's winners. These are the biggest stocks which performed well historically, but are now more prone to underperform as smaller stocks erode their market dominance. This is evident when a traditional index, such as the MSCI World, is compared with an index without the market cap bias, such as the MSCI World Equally Weighted Index. The cap-weighted index lags significantly, as seen in Figure 2.

Figure 2: A market cap bias can weigh on returns



Both indices are shown rebased to 100 as at 31 December 1998; in US dollars, with net dividends reinvested. Source: MSCI Barra, Schroders, as at 30 September 2014.

One of the reasons for the underperformance of market cap-weighted indices is that they can force investors to buy stocks with expensive valuations and sell cheap ones, in other words, buy high and sell low. This is contrary to many well-tried investment strategies, such as those used by the celebrated investors Benjamin Graham and Warren Buffett. Their approach has been to buy low-valued stocks, on measures such as price-earnings ratios, and sell high.

As well as tending to favour highly valued and expensive stocks, indices can be biased towards stocks that are judged low quality on measures such as stability of earnings growth. Both types of stock – whether expensively valued or poor quality – are likely to prove a drag on long-term returns. In contrast, stocks seen as being cheap or high quality tend to outperform traditional benchmarks. So active managers that have the ability to select from these parts of the market may be expected to outperform over the long term[1].

[1] See *Triumph of the Optimists: 101 Years of Global Investment Returns*, Elroy Dimson, Paul Marsh and Mike Staunton, 2002, and *Investing on hope? Small Cap and Growth Investing*, Aswath Damodaran, New York University Stern School of Business.

Restricted choice and concentration risks

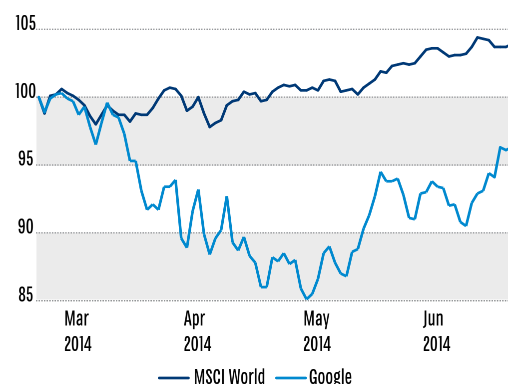
Another problem that passive investors need to overcome is lack of breadth. An index-bound investor unnecessarily restricts their investment choices. For instance, while the MSCI World Index is composed of over 1,600 stocks, we calculate that the universe of global stocks with sufficient investable liquidity comes to more than 15,000. Moreover, as we have suggested, index investors further narrow their choices by their bias towards big companies. There is a huge range of mid-, small-and micro-cap stocks beyond the reach of the index which have all been shown to outperform large cap over the long term[1].

This so-called concentration risk is evident in the current market. At the end of February 2014, just over 9% of the value of the MSCI World Index – tracked by many passive funds – was represented by the top 10 stocks, or less than 1% of the total by number. This means that there is considerable concentration risk for anyone buying an index tracking fund. Moreover, three of the four largest stocks were in the IT sector: Apple, Google and Microsoft. The other was Exxon Mobil, which is in the energy sector. Since February, Google has significantly underperformed, dragging down the performance of the whole market cap-weighted index (Figure 3). Indeed, the lag has been such that Google is, at the time of writing, no longer among the 10 largest stocks in the MSCI World Index.

Figure 3: The MSCI World Index is vulnerable to underperformance by its leading constituents

Leading Index Stocks, February 2014

Position	Stock	Weight
1	Apple	1.5%
2	Exxon Mobil	1.3%
3	Google	1.0%
4	Microsoft	0.9%
5	Johnson & Johnson	0.8%



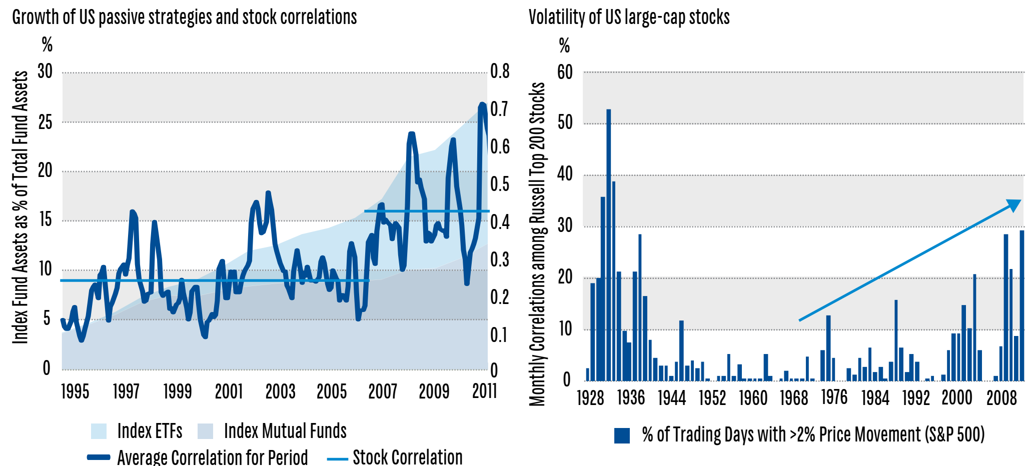
Rebased to 100 as at 28 February 2014. Source: Bloomberg, MSCI Barra and Schroders. Chart data as at 30 June 2014.

Systemic risks

Arguably more serious for passive investors is the unintended systemic risks to which they are exposed. This results from the process of 'price discovery': the way the market sets prices. Active managers are often seen as 'price makers', directing capital towards healthy companies and away from poorer ones. By contrast, passive managers who are not able to distinguish between good and bad are often known as 'price takers'.

This price taking may lead to unintended consequences. Fidelity Investments, the fund management group, has mapped the growth of exchange traded funds (ETFs). From 4% of US equity index funds in 1995, they had jumped to 27% by 2011. Over the same period, stock correlations – the propensity for share prices to move together – have grown by a similar amount (Figure 4, left chart). This growth has coincided with a sharp rise in the volatility of large-capitalisation stocks in the US market (Figure 4, right chart). The implication is that passive funds may have contributed to this volatility by trading the same index stocks at similar times.

Figure 4: Growth of passive strategies has coincided with increased correlations and volatility



Left chart: Source: Investment Company Institute, Simfund, Haver Analytics, Fidelity Investments as at 31 December 2011. Right chart: S&P 500 Index representative of US large-cap stocks; Source: Bloomberg, Fidelity Investments and Standard & Poor's, as at 31 December 2011.

All this has come at a time when global indices have become more synchronised. An index that has become more volatile in one region is more likely to fall at the same time as an index–based in another region. So an investor who had chosen to invest in passive funds to, say, avoid the idiosyncratic risks of small companies may have simply replaced one risk with an even greater, systemic risk.

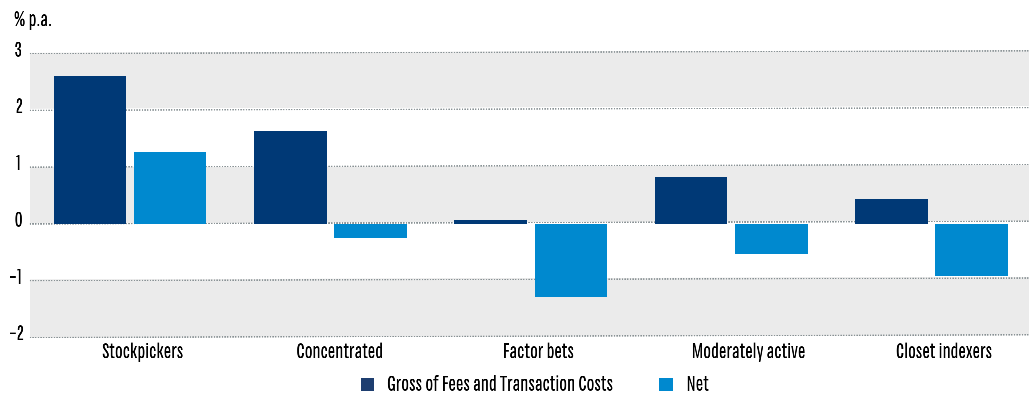
Why active share matters

Despite its manifest drawbacks, investors may feel that they should consider passive management if they cannot find an active manager who can outperform over the long term. Certainly, research has contested whether active managers can demonstrate such an ability. But one recent study[2] by Antti Petajisto, whilst a finance professor at the NYU Stern School of Business, has found that, on average, US active equity managers do have the ability to outperform. However, this outperformance is often eroded by fees and transaction costs.

Interestingly though, one type of manager was found to be more likely to outperform net of these costs: 'stockpickers' whose portfolios diverged markedly from the index, otherwise known as having a high active share. This was all the more notable given that the US equity market is considered to be the most efficient of world markets and the hardest to outperform. The outperformance by different types of active managers over 20 years is shown in Figure 5, with the 'stockpickers' group clearly leading in terms of both gross and net performance. This group took positions that were significantly different from the benchmark, yet their risk relative to the benchmark was lower than the concentrated managers group. The study therefore reaffirmed the long-term case for active management.

[2] 'Active Share and Mutual Fund Performance', Antti Petajisto, *Financial Analysts Journal* 2013, volume 69, number 4.

Figure 5: Not all active managers are alike: outperformance of US equity managers, 1990 to 2009



The chart shows the annualised equal-weighted benchmark adjusted performance of US all-equity mutual funds, excluding index funds, sector funds, and funds with less than $10 million in assets. Source: 'Active Share and Mutual Fund Performance', Antti Petajisto, July 2013 (http://www.petajisto.net).

Conclusions

We believe that it is hard to escape making active decisions when setting investment strategy. There can be no such thing as a passive asset allocation policy, yet the asset allocation adopted can make a crucial difference to returns.

Once that decision has been made, there may be reasons for adopting passive investment approaches, but investors should realise that they may face unforeseen risks. These include undesirable concentrations of stocks, systemic risk and buying at too high valuations. Investing passively should not be seen as a low governance 'set-and-forget' option.

While it is no panacea, active management can overcome some of these issues. There is also evidence that certain active fund managers often outperform over the long term. These are managers with a high active share.

We believe that, whatever decisions they finally take, investors need to understand the issues we have raised and consider them thoroughly. Only then can they be satisfied that they have chosen the best options for their needs and circumstances.

Alistair Jones, Strategic Solutions

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