# Passive investing - reshaping the investment landscape

Professor Amin Rajan | Create-Research | 26 June 2018

Game changer or new danger? That's the question behind the spectacular rise of passive funds throughout this decade.

Their advocates see this trend as being as immutable as the momentum of a supertanker. According to our institutional survey respondents, passives have delivered good returns net of fees.

Their detractors retort that the rise of passives is due to a one-off boost from unconventional monetary policies in America, Europe and Japan. They also question what systemic dangers may be lurking in the background with this relentless concentration of assets in monolithic indices on autopilot.

Thus far, the debate has been emotional and polarising, generating more heat than light and has suffered from:

- recency bias, which puts too much emphasis on recent trends to the exclusion of historical experience; and,
- saliency bias, which assigns too much weight to the information that is predominantly on display to the exclusion of contrary opinion.

It is essential to develop a clear-eyed view by surveying the actual experiences of long-term investors. Like its physical counterpart, the investment universe is cyclical and adaptive. Styles go in and out of fashion. A time perspective is essential.

CREATE-RESEARCH conducted a global survey of 153 pension plans in 25 countries (including Australia) with a total AuM of €2.9 trillion, about their use of passive investing in portfolios. The survey addressed four pertinent questions:

- What is the current share of passives in investment portfolios, and what benefits have these funds delivered thus far?
- Are passives and actives competitive or complementary in the overall portfolio, and what is the underlying rationale?
- How are the respective roles of passives and actives in asset allocation likely to change over the rest of this decade, and what will their drivers be?
- What innovations will be required in passives to enhance their resilience?

The survey was augmented with structured interviews with senior executives in 30 plans. All the information in the report is based solely on the survey and interviews.

For ease of reading, the terms "passives" and "actives" are used throughout this report instead of longer titles such as "passive funds" and "active funds".

SURVEY HIGHLIGHTS

- With fees becoming the North Star of investing, passives are reshaping the investment universe (58%).
- Their rise is a foundational change in the way pension plans now manage their portfolios, blending actives and passives, knowing that both are needed (60%).
- This broader diversification aims to not only minimise risks but also maximise returns to create an all-weather, buy-and-hold portfolio (51%).
- Passives are not only becoming a core asset class, but are also being used to access specialist asset classes, secular investment themes and cyclical risk factors (48%).
- Passives have benefitted significantly from the ultra-loose monetary policies of central banks, which have created epochal challenges for actives to up their game (54%).
- The unwinding of these policies is expected to have some effect on passives, more likely a slowdown in growth than a sharp reversal in their inflows (42%).
- Far from being polar extremes, actives and passives are complementary. Each relies on the other to survive and thrive, like yin and yang in Chinese philosophy (60%).
- Another test for passives will be when they are judged not on their current inflows but on their resilience when the inevitable correction comes (55%).
- For now, the real debate is not about actives vs. passives but about how to drive out mediocrity in the investment landscape. The rise of passives has kick-started that process (58%).

Passives are now widely used by survey respondents, with 66% seeing them as a mature part of their portfolio, and a further 15% now in the implementation phase. Amongst the rest, 3% are close to decision making, and the remaining 16% are still in the awareness-raising phase. Passives have been implemented via three vehicles: traditional indexed funds used by 48% of respondents; segregated accounts used by 38%; and, ETFs used by 23%. Thus, passives are already mainstream for the majority of pension plans. Two drivers have influenced this outcome. According to our survey respondents, passives have, on average, delivered superior results net of fees compared with actives in this decade. Passives have also experienced a strong boost from certain dramatic upheavals in the investment landscape over the past 18 years.

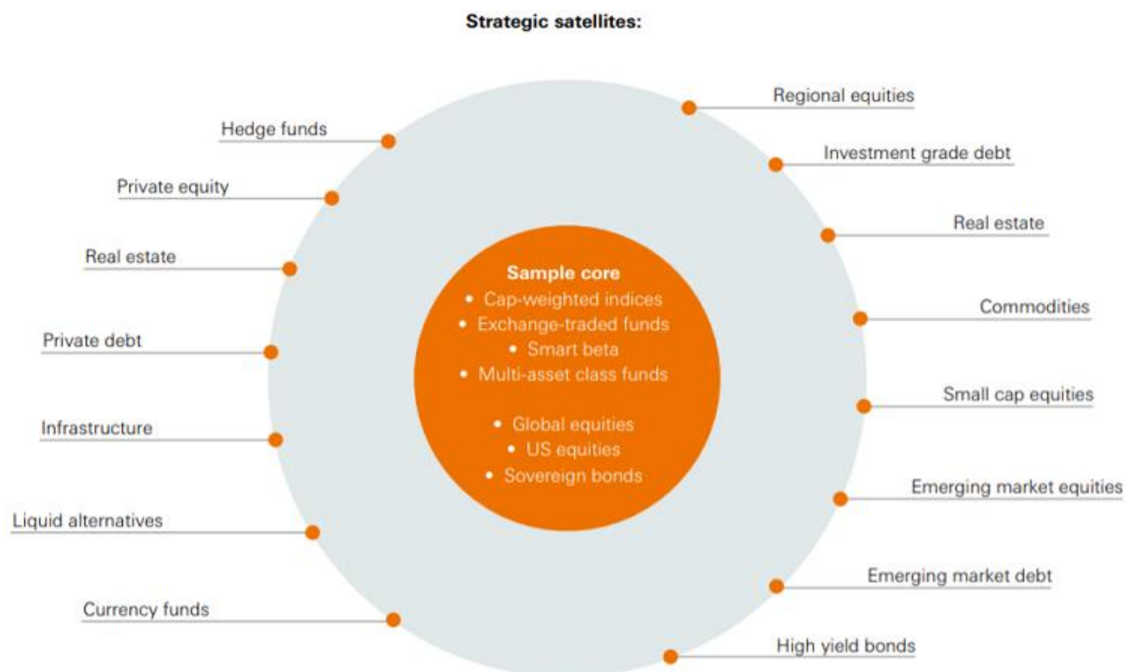
## KEY FINDING 4: PASSIVES WILL MOVE CENTRE STAGE IN THE CORE-SATELLITE MODEL

Like digital brands, passives will continue to benefit from the 'network' effect, in which a product is perceived as more worthwhile the more people use it. The classic example is the telephone - a growing user base enhances its value to each subscriber.

The network effect also changes the industry dynamics, turning passives into the mainstream. As the amount of assets in ETFs increases, so does their ability to innovate and move around exposures rapidly. They are viewed as uniquely suited to the environment of this decade and are used and traded by an ever-growing band of investors. Of course, much depends upon how they'll fare in future market corrections. Apart from cap-weighted indices, none of the other passives have been significantly stress-tested by time or events.

For now, the rise of passives is recalibrating the traditional core-satellite model (see Figure below). At the start of this decade, the core was dominated by large cap equities and sovereign bonds, as well as by regional equities and investment grade bonds. Growth in passives, however, has since catapulted them into the core portfolio, alongside global equities, US equities and sovereign bonds.

Figure: Core-satellite model - passives will come to dominate the inner core




Source: CREATE-Research Survey 2018

Reportedly, out of the seven most heavily traded stocks today, five are ETFs. Ever more asset classes have been shunted to satellite status as part of the alpha-beta separation. The core is dominated by items trading in deep, liquid markets, the satellites by items trading in less liquid (or illiquid) markets.

The precise designation of the asset classes in the above Figure is a matter of debate. The substantive point is that the current index revolution is recalibrating time-honoured investment approaches and pushing passives centre stage – at least for now. At the same time, actives are being increasingly chosen for asset classes amenable to alpha generation.

For passives to retain and enhance their relevance, however, it is essential for the next wave of innovation to secure improvements in three areas

- 48% of respondents want to see improvements in fee models, as rising volume generates economies of scale. This observation applies especially to smart beta whose fees now sit somewhere halfway between pure passives and actives.
- 47% of respondents want to see improvements that enhance the risk-return trade-off of all factor-based strategies, especially in the discovery, choice, timing and weighting of factors over different phases of the market cycle.

- 39% want three improvements in multi-asset strategies that blend actives and passives.

Specifically, they want to see fees charged on net performance that reduce the 'netting risk', a deeper understanding of the correlation between component styles and a more effective blending of high conviction and rules-based styles.

However, these suggestions do not detract from the three overriding messages from the survey.

- First, low fees are now seen as a key source of value creation given that QE has borrowed against future returns.
- Second, prudent diversification favours both actives and passives.
- Third, the separation of alpha and beta is now an irreversible structural feature of pension investing.

The above is an excerpt from the full 44-page report. To access the full report, click here.

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Professor Amin Rajan is the CEO of CREATE-Research, a network of prominent researchers undertaking high level advisory assignments for governments, global banks, fund managers, multinational companies and international bodies.

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