Is Active Investing Making a Comeback?

The debate on passive versus active management has been ongoing for multiple decades since the first index investment trust was introduced in the 1970s. Subsequently, the launch of the first S&P 500 exchange-traded fund (ETF) in 1993 revolutionized the asset management industry as investors were able to buy and sell hundreds of stocks through a single publicly traded share. Since then, driven by ease of investing and lower costs relative to traditional mutual funds, passive strategies, which include index mutual funds and ETF's have gained market share at the cost of active funds. The availability of cheap money following the Global Financial Crisis in 2008, added further fuel to the trend with current assets in passive funds on par with active strategies globally.

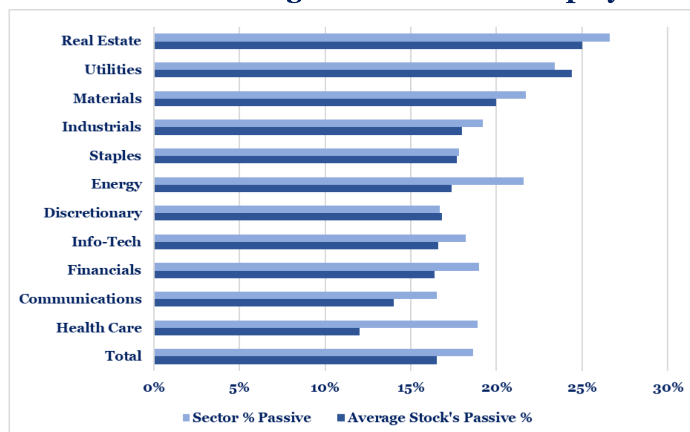
While passive investing is here to stay, we believe that the pendulum has swung too far in favor of passive and we see active management regaining some lost ground, especially in the current environment of higher interest rates, higher inflation and macro uncertainty.

Crowding Effect

As passive funds have gained in popularity, the number of ETFs has ballooned. According to Statista, there were 8,754 ETFs globally in 2022 compared to 276 in 2003. At the same time, the number of indices has also grown at a rapid pace. There were 3.3 million different indices in the first quarter of 2022, according to the Index Industry Association. This was more than 56 times the total number of listed companies globally, which was at 58,200. Passive funds are by construction built to mimic the performance of a broader index, so what does this mean for passive investing?

There are implications for passive investing because most indices use market capitalization to weight the constituents. Hence, by default, passive investing could lead to crowding in some large cap stocks that are more likely to be included in the more popular indices. For example, according to ETF.com, Apple is currently held in 420 separate ETFs while more than 300 have LVMH in the fund. According to Bloomberg Intelligence, the average publicly traded US company held by passive funds has tripled over a decade to 19%. On a sector basis, passive ownership ranges from 17% to 27% with the highest passive ownership in real estate (Exhibit 1). Similarly, BlackRock estimates that about 18% of the global stock market is owned by index-tracking investors.

Exhibit 1. Total and Average Passive Ownership by Sector: US



Source: Bloomberg

We believe that as trading in passive investing is driven by index changes or investor inflows and outflows, panic selling can lead to distortions in the pricing of individual securities. While active strategies can monitor and build a portfolio to minimize the impact of crowding by underweighting crowded securities, passive strategies perpetuate crowding behavior as index inclusion is the sole reason for ownership.

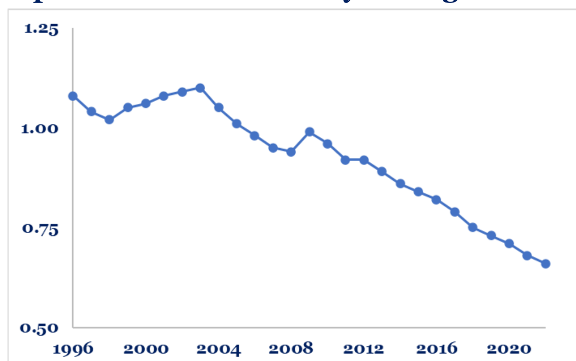
Property of Haven Global Partners. All Rights Reserved.

There are other studies that find that passive ownership could be even higher. Based on trading data from end-of-day indexers who are benchmarked to either the S&P500 or Russell 1000/2000, research by Chinco and Sammon suggests that passive ownership of the US market could be as high as 38%. A recent study by MAN Institute finds that only one out of every three dollars held by institutions deviated from a cap-weighted benchmark suggesting peak passive investing.

Fee Compression

Rising demand for low-cost passive funds has put pressure on fees for actively managed funds and we believe as fees have come down, active strategies have less of a cost disadvantage than in the past. Exhibit 2 shows the long-term fee compression in actively managed mutual funds according to the Investment Company Institute. In 1996, active managers in US public equities could command fees of 1.08% on an asset-weighted average. By 2022, this had declined to 0.66%. There has been a similar downward pressure on fees for institutional funds. According to Investment Metrics, active management fees declined 4% in 2021 and decreased further in 2022. In the fourth quarter of 2021, fees for US large cap managers were 55.6 basis points on average while they were 65 basis points for non-U.S. large-cap managers.

Exhibit 2. Expense Ratios of Actively Managed US Mutual Funds



Sources: Investment Company Institute, Lipper and Morningstar

As fees on active funds have come down, the hurdle rate for active managers to outperform has also fallen since fees detract from performance. This also means that the cost advantage of index funds looks less attractive, especially in comparison to those active managers who are able to generate alpha.

End of Low Interest Rate Era

As interest rates have climbed to a 16-year high, we believe that it is safe to say that the decade of cheap money is behind us – at least for now. The current environment is marked by macro uncertainty as the Federal Reserve has raised interest rates at the fastest pace since the Volcker era in the 1980s. Over the 13-month period from March 2022, the Federal Funds target rate has increased from 0.25% to 5.25%. Meanwhile, the rate of inflation is still hovering near 5% in the US, 7% in the Eurozone and 3.2% in Japan. The higher rates have started to have an impact on real economies as several banks have collapsed in the US and Europe.

We believe there are several implications for passive investing strategies in the current macro environment of higher interest rates ushered in by the Federal Reserve's attempt to tame inflation. First, by design the most popular passive strategies have higher exposure to stocks that have outperformed since those are also the stocks that are more likely to have grown in market capitalization and thus have a higher weight in the index.

Secondly, most of the larger companies currently in the popular indices are growth stocks that have benefitted from a low interest rate environment. All things being equal, rising rates tend to weigh on stock valuations, as they can prove to be a drag on corporate profits. Referring to the current resilience in the stock market as an echo bubble, investor Ruchir Sharma

 Property of Haven Global Partners. All Rights Reserved.

states that "the echoes gradually fade away, until serial disappointments kill the faith. Eventually, as the echo fades, new money will more likely be made in sectors and stocks that were not caught up in the bubble of the past decade." While active managers have the ability to be nimble in the current environment of macro uncertainty, passive strategies are static.

Third, as investors have more options to make higher returns elsewhere than just passively tracking the broader market there could be capital outflows into other asset classes. For example, Apple just announced that its card holders in the US can open a savings account and earn 4.5% interest rate! This is where the ease of passive investing could actually be a negative as investors can seamlessly move money elsewhere.

Recognizing the current macro uncertainty, Future Fund – Australia's sovereign wealth fund - that made a bold move six years ago to transfer its entire equity exposure to low-cost index tracking strategies stated recently at the Australian Financial Review Alpha Live Summit that the sovereign wealth fund was once again backing stock pickers and was shifting towards investments that rely on investor skill rather than market risk.

Similarly, according to Bloomberg Intelligence, active funds have attracted about 30% of the total flows to ETFs so far in 2023, although such funds make up only 6% of the total $7tn ETF market. We believe that this could be the start of a new trend underscoring the appeal of active strategies after years of growth in passive strategies.

Property of Haven Global Partners. All Rights Reserved.