Providence
Independent Investment Advisory

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The Rise of Passive Investing: Fee Saving or Increasing Risk?

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Active Versus Passive Funds

At various times in investment cycles the familiar theme of active management versus passive management gains the attention of the media and investment commentators.

The perennial argument of whether active managers can outperform the index usually reappears towards the top of these cycles. This is a result of active managers underperforming their relevant benchmarks when markets are driven by momentum and also the fear of missing out on a rising market. We are once again at this juncture after the recent poor relative performance of *the average* active fund manager over their relevant index.

Various individuals or groups with a vested interest will espouse the virtues of each strategy to further their cause. As always, statistics can be manipulated to provide the desired confirmation of viewpoint.

Part of the wave of funds rolling into passive investments is without doubt a structural change and evidenced by the way that assets are allocated now for many, usually low-balance, investors. This move is in part driven not only by the ease of allocating money to any number of passive strategies, but also by the desire (of advisers and their clients) to keep fees low. Gone are the days of portfolios being churned from one listed stock to another. Low-cost Exchange Traded Funds (ETFs) are very much an incentive for many advisers to keep their fees to clients low. Couple this with the emergence of robo-advice (a client essentially inputs information into a system that spits out an asset allocation for them), and the result is a wave of funds moving into the ETF space.

At Providence, we are agnostic to the various strategies. Our goal is to find the most appropriate return for the risk undertaken after all fees.

As investors move away from active managers, their stock holdings will be under pressure as money moves into index funds wherein the largest stocks become larger irrespective of fundamentals. This becomes self-fulfilling until it doesn't, and when this happens index investors lose the same amount as the overvalued underlying market.

The Use of Exchange Traded Funds (ETFs)

There is a new dynamic, which we believe can supercharge potential future drawdowns - the exorbitated rise of Exchange Traded Funds (ETFs).

ETFs are index funds listed on the exchange that replicate a nominated benchmark or index. Proponents of ETFs espouse the attractiveness of lower fees for exposure to equity markets/stocks/sectors/thematic investing as an alternative to active management via the traditional path of investing with a managed fund. ETFs are changing the landscape and the flow of funds in key developed markets. As they can be traded on the stock exchange, there is also the attraction or potential illusion of readily available liquidity.

An ETF is a pooled investment vehicle with shares that trade throughout the day. The ETF Manager appoints an Authorised Participant who is responsible for recreating the relevant index through the physical holdings and packaging them up into the ETF. This is then listed on the stock exchange and should trade around its underlying net asset value.

In recent years, the explosion of ETFs on offer globally (no less than 150 on issue on the ASX) has seen a flurry of both retail and wholesale investor capital migrate away from the active funds industry and into ETFs in most developed markets. Global ETFs have grown from US$715 billion in 2008 to over US$3 trillion currently and account for over 30% of the daily volume in the US equity market.

Concentration of funds management in Australia is another dynamic that has been fuelled by the dominance in recent years of passive investing. The chart below highlights how concentrated the top 10 fund managers are and what percentage of the funds management industry they represent. Importantly, this also highlights the dominance of passive money within the top 10 funds management players.

Figure 1: Top 10 managers account for 57.2% of the funds management industry in Australia

Source: Ellerston Capital, Morningstar (data as at 31 May 2017)

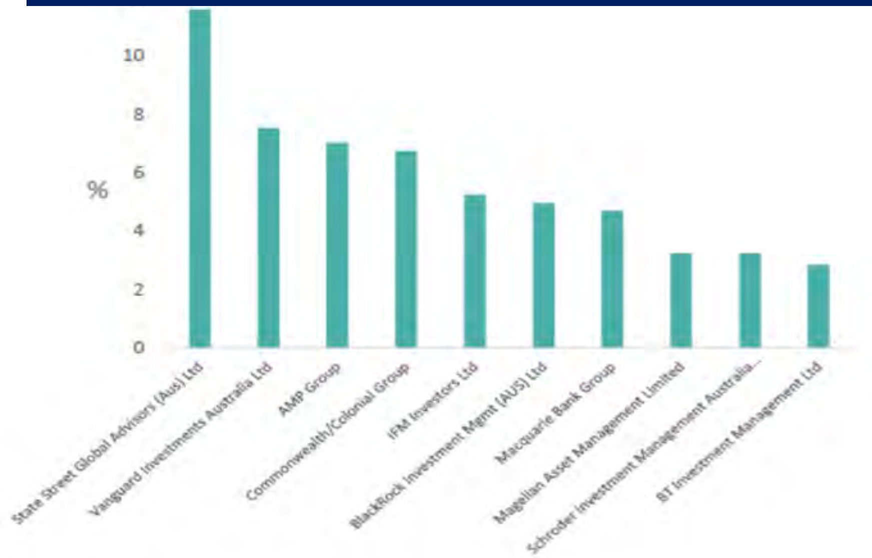


Figure 2: ETFs as a percentage of overall US trading (% of all US volume)

Source: Credit Suisse Trading Strategy, Financial Times

ETFs now account for about 30% of all US trading by value and 23% by share volume.

This is without doubt impacting the way that companies are being valued in the market globally and how capital is invested. Given that, in many instances, ETFs are essentially replicating an index, the discretion about what stocks to own or not in a portfolio is distorted as every stock is essentially replicated within the ETF irrespective of that individual company's profitability, management performance and financial stature. In some instances, this is creating some hyper-volatility on a company-by-company basis. Active fund managers discriminate stocks based on their own internal analysis, but ETFs do not; they replicate a given index. It is no coincidence that stocks are now far more volatile on the day that any negative news is announced, as it is often the case that they were already mispriced, especially in a rising market, due to the momentum of passive investments.

Many argue that ETFs provide a similar exposure to that of active funds and in many cases, those in favour of ETFs highlight their performance versus that of many mainstream managed funds.

While sometimes this is indeed correct, as ETFs have outperformed quite a number of managed funds in recent years, it is worth considering the following:

1. Have we come to a point where the rise and rise of ETFs is now impeding efficient allocation of capital? Academics would argue that an 'efficient market' is one where all information is known about a market or company insofar that a current price reflects that company's current value based on all available information known by the entire market at that time. ASX rule 3.1 adds to this argument through the notion of continuous disclosure. Yet the global equities industry has a vast array of managed fund organisations who make it their life's work to beat this efficient market theory by in-depth, bottom-up and top-down analysis to discover mispriced opportunities in the market every day.

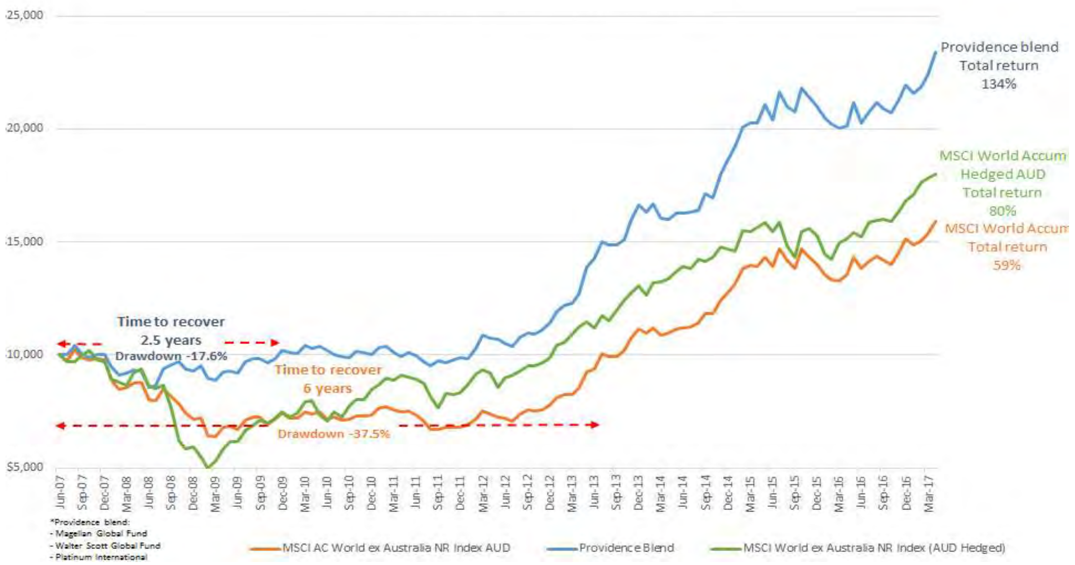
2. The active funds industry is and has always been based on the notion that stocks are not always efficiently priced and therein lies the opportunity, or highlights stocks in which to avoid investing. The sheer volume of funds directed to passive index funds (ETFs) has in many instances distorted the valuation of many companies listed on the ASX and other global bourses. Aided by a bull market, this in turn has had a bearing more recently on the performance of many managed funds. Momentum has a way of taking over the music at the party - not always to everyone's liking.

3. We would argue that ETFs are possibly another cycle – or bubble - and a managed fund or funds for long-term, patient investors keen to preserve their capital, should not be measured purely on one year of performance. Tenure of an investment team, adhering to their stated investment style/process and long-term performance is far more important to us at Providence in our due-diligence process than measuring a fund manager on short-term performance, especially against a passive fund that has had a wall of momentum behind it.

4. At Providence, we recently reviewed our international fund managers, paying particular attention to how they performed during significant pullbacks in markets over the last 15 years, in order to capture cycles. In the last five market corrections, including the GFC, the average drawdown from our international fund managers with whom we have client funds deployed was -8% versus the average drawdown of the MSCI World Ex-Australia Total Return Index of -14.1% over the same periods, which is their benchmark. The chart below depicts the recovery of those same fund-managers during the GFC relative to their benchmark. This is where the craft of active managers comes into the fray.

Figure 3: Blend of international active managers* vs. MSCI World Index during correction

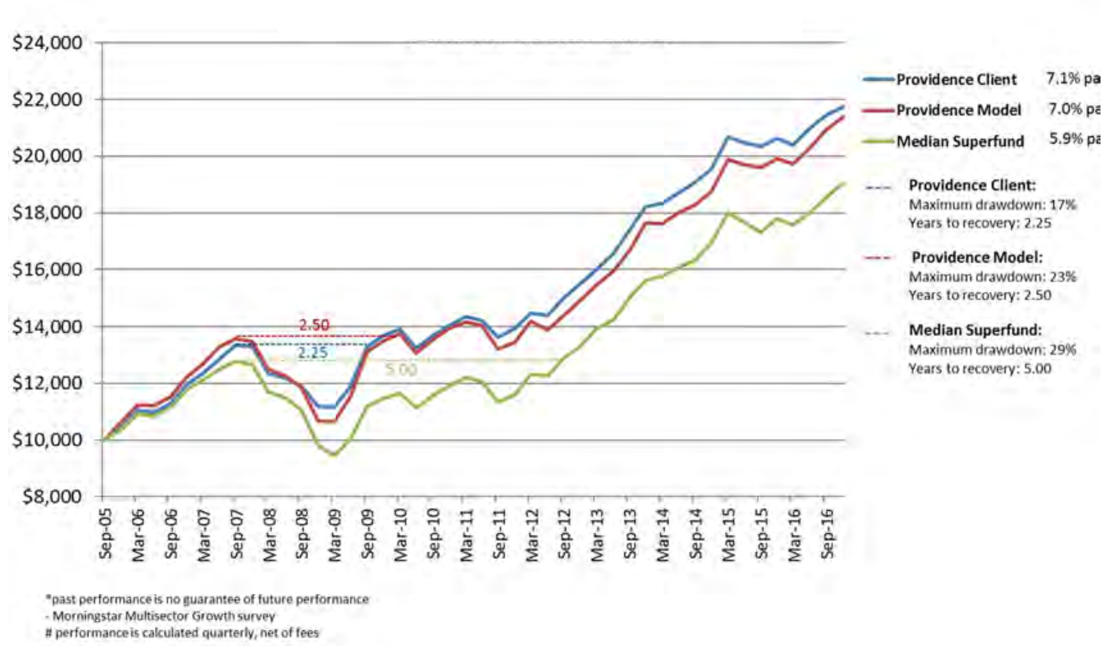
Source: Providence, Morningstar



We also highlight the performance of our own Providence model portfolio over the same period in the chart below. The importance of a balanced portfolio and appropriate asset allocation, providing a broad exposure to asset classes as set by our Investment Committee, is evidenced in this same chart. The time to recovery post-GFC of the highlighted Providence portfolios versus the median superfund was broadly half the duration of recovery of the median superfund.

Figure 4: Investment performance after all fees – Growth of $10,000 from Sep 05 to Dec 16

Source: Providence, Morningstar



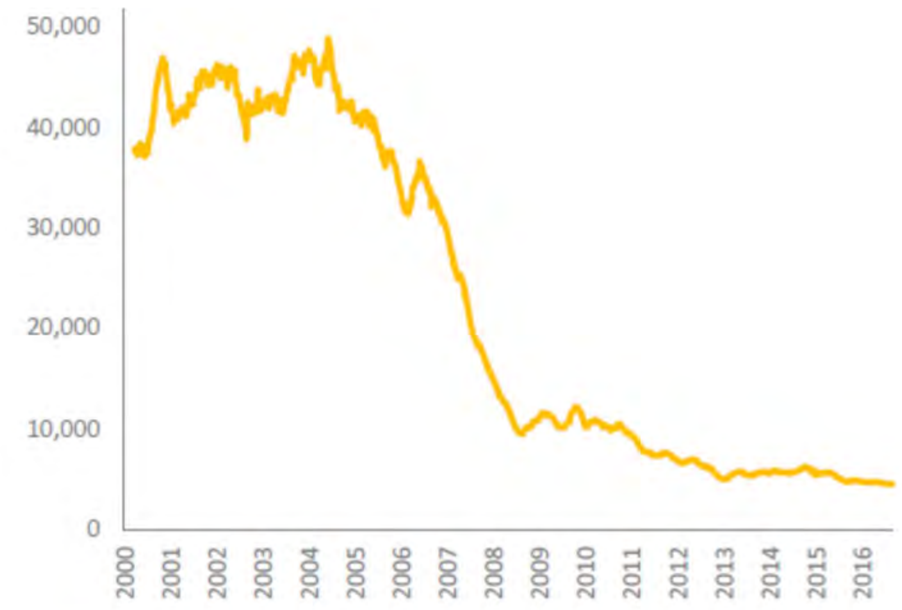
5. There is the assumption that ETFs are always liquid and trade at the underlying net asset value. This is true when the market is trading efficiently. However, given that ETFs rely on authorised participants to recreate the index, if there is any dislocation, this can result in ETFs trading at a large discount to their underlying Net Asset Value (NAV). On Monday August 24, 2015, the S&P 500 opened down 5.2% in the first five minutes of trading. The carnage was felt to a greater degree in some ETFs with multiple ETFs declining by around 20%.

   a. This was further shown by an article in the AFR in June highlighting robo-adviser Stockspot's analysis of the 155 listed ETFs in Australia[1]. Of those 155 ETFs analysed, only 36 earned four or five stars out of five, with 37 achieving one or no stars. One of the principal rating tools used in this analysis related to liquidity, which was a requirement of an average daily volume greater than $500,000. While a good yardstick, that still is very thin volume when everyone is heading for the same door.

b. To expand on this point a little further, the chart below shows clearly how the turnover in the Australian market has changed. While the total daily dollar volume turnover in the Australian market has not altered that much over the last decade, the average trade value has plummeted. This is a result of an explosion of smaller dollar value trading influenced by passive investing and algorithmic trading, further impacting the overall efficiency of the market.

Figure 5: Average trade value

Source: Ellerston Capital



6. Capital preservation in tough markets is far more important to us than short-term performance in a momentum-driven market. If an index goes down 10%, for example, so do index ETFs. This is when active management, we believe, can add value.

7. Most industry pundits would argue that many developed markets around the globe are fully valued**.** The US market currently has the S&P 500 trading on a cyclically-adjusted (Shiller) PE ratio of 28.9x, which has only been higher twice before: 44x in 1999 and 30x just prior to Black Tuesday. While that does not necessarily mean that we are poised for a major correction, it does highlight that index investing (via ETFs) has quite possibly been an easy one-way bet…for now.

It is perhaps no coincidence that much of the performance of the S&P/ASX 200 has been concentrated on the big end of town, by way of market cap, as ETF generated funds merely go about the process of replicating their chosen index. The big get bigger. There is now an abundance of ETF options to suit all sorts of investor whims, most of which only add to the investor appeal of having a punt on a certain theme, sector or industry.

Why this becomes important for the deployment of capital can be explained in the following manner:

- More volatile markets tend to play into the hands of active managers as they can appropriately position the portfolio rather than hug an index.
- They can identify expensive and cheap investments to manage the portfolio exposure and performance.
- They can position the portfolio for loss minimisation, even if for relatively short periods of time.
- In a falling market, you are losing money. Outside of cashing out, you want to minimise this capital destruction as best you can.

Passive options tend to perform well in a low-volatility environment such as the one we are in now and have been in for a while. A rising tide lifts all boats, if you will.

With passive investing, we wonder if the investor fully appreciates in what they are really investing and some of the inherent risks, perhaps hidden now in a rising market but there all the same, especially for some of the more creative ETFs on offer. There is now a three-times levered ETF in the market i.e. 300% gearing!

The ASX's own website, amongst others, highlights the following risks with relation to ETFs:

- Lack of liquidity may make it difficult to buy or sell exchange traded products in certain circumstances.
- Exchange rate fluctuations for global ETFs.
- Use of derivatives and counterparty risk – ETPs that use derivatives could cause ETPs to incur losses.
- Specific risks for single asset ETPs.
- Liquidity – single asset products may be more susceptible to liquidity risk.

Liquidity may ultimately be the trap that catches investors off guard. This is arguably more relevant for the more obscure ETFs that are readily available but very important all the same. In one example, we recently had a look at the liquidity of a more 'advanced' ETF that measures stocks with a little more rigour than just tracking a particular index - emulating a fund manager of sorts. The recent performance of this ETF may well have been quite solid (+15.6% FYTD); however, the point we would highlight was its lack of liquidity. Perhaps this is not a problem when markets are calm and rising, but what if they are not? In this instance, the average daily dollar volume of this ETF over the last ten months was $550,000 per day, in total. Try getting out of that in a hurry.

Conclusion

We agree that the *average* active fund manager underperforms the index over time, but who wants to be invested in the average? We believe by careful due diligence and a focus on what part of the cycle we are entering, investment advisors can identify those active fund managers that will outperform an index. We believe this is particularly the case during a sharp market correction.

Index funds can play a role in portfolios as a low-cost beta allocation, but we need to keep a watchful eye on the valuations of the index.

Are ETFs the next financial weapons of mass dislocation or efficient fee-saving investment vehicles? This may be too strong a view; however, care needs to be taken in understanding the structure of the ETFs, and there needs to be an awareness that the efficient pricing of these instruments is reliant on a third party to make the markets, and at times there could be a mismatch in liquidity.

At Providence, our stance is long-term investing for performance and capital preservation. In our view, that ethos and asset allocation (AA) are the biggest determinants of performance rather than following the latest trend.

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