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Passive Investing—A Great Idea Gone Bad

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DISCLAIMER: This article is for informational purposes and is not intended as an investment recommendation. It is likely that if the author turns out to be wrong, he hopes that you will forget about this article. If he turns out to be correct, keep an eye out for future advertisements for his new hedge fund.

The acceptance of passive investing has grown in fits and starts over most of the last 40 years. However, in the last few years, passive investing has become very mainstream and has had phenomenal growth—with both retail and institutional investors pouring in. The story of Vanguard Funds illustrates this growth.

In 1976, Vanguard Funds launched their first index mutual fund. While they offered up to $100 million to prospective investors, they saw very little interest and their total initial subscription was a disappointing $11 million. Fast forward to 2017 and Vanguard, now synonymous with passive investing, is the largest mutual fund company in the world with over $4 trillion in assets.

Here are a couple more stats on Vanguard according to the New York Times:

- On some days they invest up to $2 billion of new money—which is almost 200-times their total initial subscription back in 1976!
- They achieved mutual fund inflows of $823 billion over the last three years compared to only $97 billion for the rest of the entire mutual fund industry.

The benefits of passive investing are now clear to many people—it's a low cost, broadly diversified, and tax efficient way to get exposure to financial markets.

Opposite to this growth in passive investing, active investing has diminished in use and reputation. This decline in active investing is highlighted by the once glorious hedge fund industry becoming a pariah to many large institutional investors.

As I write this in early June, I see many people characterizing the growth of passive investing as mainly a battle between passive and active. Some view this battle as passive rightfully gaining an upper hand on active investing. Others view it as temporary with a resurgence of active investing soon at hand.

My interpretation of this growth in passive investing is a bit different from most and likely a bit controversial. It appears to me that this recent surge in passive investing is really just the chasing of recent favorable financial market gains, particularly equity market gains. I see more and more people jumping on the passive investing bandwagon in what seems to me to just be a way to rationalize their extrapolation of past market returns. This return-chasing behavior is quite normal in the history of financial markets, and I think that passive investing is just the vehicle of choice at this moment in time. It's the cheapest and most efficient way to chase.

THE MARKET ECOSYSTEM

Financial markets are essentially a complex ecosystem of different types of investment participants applying different strategies over different time horizons. Over time, different strategies ebb and flow and pick up more adherents at the expense of other strategies. There is passive versus active, value versus growth, short-term trading versus long-term investing, and so on.

In addition to these shifting currents, you can have the amplifying effects of positive feedback loops. That is, the early successes of a particular strategy further perpetuates that strategy by bringing in more followers resulting in more buying of those investments that the strategy seeks out, and so on. Financial market history shows this can go on longer than you can imagine.

One example of this ebb and flow of investing strategies from the recent past was the significant swing towards value investing in the years after the bursting of the tech bubble. At the turn of the millennium, with the tech bubble in full force, value investing was dismissed as being out of touch with the new economy. But 6 years later, after a period of magnificent returns for the value approach and a lean period for growth investing, value investing was viewed by many as the best approach to success in financial markets.

One anecdote I have of this time was in 2006 when I overheard a conversation between a small mutual fund company CEO and his colleagues. He was explaining that his star value fund manager, who had generated excellent 5-year returns, was about to retire and the CEO was begging the manager to stick around for one more year. He then explained to his colleagues he wanted the manager to stay not because of the great returns, but rather because the value fund was experiencing dramatic inflows at the time and the CEO wanted those flows to continue for at least a bit longer.

Value investing's period of success ultimately led to many value-oriented funds being the hardest hit for outflows in the financial crisis of 2008–2009. The dramatic inflows to value funds were likely a sign that investors were chasing the great returns of the strategy and not a sign of value investing's intrinsic value. (Pun intended.)

Currently, some point to the recent spectacular fund flows into passive investing as a signal that people are becoming more rational by focusing on the efficiency of index investing. However, I think it's more likely that the fund flows are a symptom of recent positive returns fueling more followers of passive investing. For now, the strategy seems to be benefitting from positive feedback within the market ecosystem.

RETURN-SEEKING VERSUS LOSS-AVOIDANCE

Currently, many investment commentators view the current growth in passive investing as mainly a passive versus active debate. While I think that is part of the current ecosystem ebb, I think it is much more than that—specifically, it seems to signal much less concern for risk.

In addition to the varying shifts in different investment strategies in the financial market ecosystem, there is a larger, overriding component. That component is the dichotomy between seeking returns and avoiding losses. Regardless of the strategy used, market participants can be at varying degrees of focusing on the returns they can achieve and their concern for future losses.

A short book written over a hundred years ago illustrates this phenomenon well. *One-Way Pockets* was the work of a man who carefully studied the brokerage records of his investment firm's clients. After a solid bear market, clients seemed much more concerned with risk management. Typically, they would be careful in setting stop-losses on any trade or quick to sell on downturns. Over time, the ups and downs of a bull market seemed to condition the clients to worry less about risk and focus more on returns. As the bull market matured and entered its late stages, the stop-losses were rarely put in place and the purchase of the best-performing stocks were aggressively pursued. As a new bear market unfolded, the market seemed to condition a return to loss-avoidance and so on it went.

I think this kind of return-focused behavior (and less focus on risk) is evident now in an unusual way—the growth in the use of passive funds by large institutional investors has come at the expense of hedge funds. While it seems that history would imply that an **increase** in the use of hedge funds would signal return-seeking, I believe things have changed a bit in the last 10 years in the hedge fund industry.

My sense is that many of the extreme risk-taking hedge funds got wiped out in the financial crisis of 2008–2009. In response, the hedge fund industry (which was at that time trying to meet a demand for **less** risk-taking) became much more focused on

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long-short strategies (i.e., market neutral strategies). As the bull market in both equities and bonds progressed, the returns on these long-short strategies significantly lagged the major indexes. It appears to me that many large institutional investors soon started to focus more on return (by pursuing fully long passive strategies) and have now become less concerned with risk (by eschewing long-short hedge funds).

This lower concern for risk likely signals we are in the very late stages of the bull markets in both equities and bonds. In addition, my best guess is that the future unwind of this lower concern for risk will hurt both passive and active management long-only strategies.

CONCLUSION

Passive investing has become a very dominant investing approach in the last few years. It would be nice if this was because investors are becoming more rational, but I see it as much more about return-chasing and a significant decrease in concerns about market risk. I am not trying to diminish the many positive qualities of passive indexing. Rather, I think that the significant number of indexers-come-lately are signalling that the recent bull market is in its very late stages.

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