LGT Vestra Snapshot

The perils of passive investing

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Huge swathes of investor capital has been allocated to passive strategies over the past decade as investors have feasted on the abundance of liquidity provided by central banks and the continual desire for products with lower fees. In fact, according to JP Morgan, ETFs now account for 24% of all trading volumes in the United States and 90% of trading volume is now driven by 'non-human' or 'non-discretionary' investors such as High Frequency traders, ETFs, trackers, algorithmic trading strategies, rules based quant, etc. But why does this obsession with ETFs matter?

Performance for one hasn't been as strong as you may imagine, particularly when you compare traditional investment funds with ETFs. The founder of Vanguard, Jack Bogle, recently shared his analysis of dollar-weighted investor returns with the investment magazine Barron's. The research shows that from 2005 to 2017, the average investor returns from "Traditional Index Funds" was 8.4% whereas for ETFs, it was 5.5%. If ETF performance is so much worse than Traditional Index Funds then one might ask – "what is the point"?

Volatility exacerbated

One of the fundamental issue for investors is that passive investing is indiscriminate and as such there is no price discovery mechanism relating to the underlying equity. The advent of products such as Smart Beta ETFs that allow investors to invest in a specific sector or style, means that when markets are going up then money flows freely into assets that are trading at expensive multiples, and when markets correct, investors (often retail) withdraw their money and sell at the bottom creating a cascade effect. This means that looking forwards bubbles could be bigger, and troughs could be deeper, at least temporarily.

The liquidity lobster trap

Another issue that we have warned about in previous work is the liquidity mismatch that could impact investors in the event of a market stress event. Firstly, ETFs are vehicles that are priced and trade continuously yet invest in assets that often cannot provide daily liquidity. Investing in assets with poor liquidity can be like a lobster trap; very easy to get into but impossible to get out when you need to. History has shown us that liquidity in the fixed income space in particular can dry up (as witnessed during the Global Financial Crisis), particularly non-standard investments such as emerging market debt. Secondly, investors holding synthetic ETFs may find that the return profile of the ETF is somewhat different to the underlying index.

As central banks begin to batten down the hatches and embark on part two of the money experiment (Quantitative Tightening) we expect to see an increase in volatility and as such we believe that it is prudent to invest in active managers and at the very least hold assets that you understand and have ample liquidity. As such, in the MPS portfolios, we only hold funds that we have researched, and we try to avoid investments that may have a liquidity issue such as open-ended property vehicles in 2016.

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