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Is Indexing Getting Too Popular? (Continued...)

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(Author's Note: Ballentine Partners published an article in May 2017 ("Is Indexing Getting Too Popular?") discussing the growth of indexed investment vehicles and their impact on market behavior. This is an update to that research.)

As committed believers in low-cost, tax-efficient investment strategies, Ballentine Partners has looked upon the growth of passively managed investment vehicles with some satisfaction along with a degree of concern. As indexing continues to garner a larger share of investor assets, some observers worry that we are approaching a natural limit in the proportion of common stocks that can be indexed. After all, if indexing means owning stocks without regard to their fundamental outlook or market valuation, what is the incentive to seek out companies with superior characteristics that will cause their stocks to rise faster than the market?

The growth of passive management in the last decade is well-documented. (For purposes of this article, passive management refers to both US mutual fund and exchange traded funds (ETFs) that attempt to replicate an unmanaged index of securities organized under a common theme, such as capitalization-weighting.) It is estimated that passive strategies now account for approximately 43 percent of total US equity fund assets.[1] Ned Davis Research estimates that domestic equity passively managed vehicles have amassed a cumulative net inflow of $1.3 trillion since 2006 while actively managed funds have experienced a net *outflow* of nearly $1.1 trillion.

The main reason for this enormous shift is obvious: investment performance. Using 5 year returns as a yardstick, only 15.7 percent of US large cap managers outperformed their benchmark, according to S&P Dow Jones Indices (SPIVA). Across all domestic sizes (large/mid/small) and styles (growth/value), only one category (multi-cap value) had more than 20 percent of managers that outperformed their benchmark. This data is very consistent throughout time. These returns are presented before taxes, so a pure apples-to-apples comparison would make active managers look even worse.

The other reasons for the growth of indexing include: ease of trading, ability to shift portfolio allocations quickly, transparency into underlying holdings, and low and declining costs. (Fidelity just introduced two new ETFs with *zero* management fees.)

Is there any reason to believe that the performance advantage of passive strategies may dissipate over time? There are certainly shorter time periods in which a majority of active managers have beaten their benchmarks. Since active managers usually hold a portion of assets in cash (either for tactical reasons or to handle redemptions), they have an inherent advantage during periods of severe market weakness. But as a group, active managers have failed to maintain their advantage as markets recover.

Active managers argue that their time to demonstrate added value is when correlations among stocks are falling, since it allows for a clearer differentiation between winners and losers. In fact, correlations among S&P 500 stocks

[1] *BIS Quarterly Review, March 2018*

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have generally been falling since 2013[2], but the percentage of active managers beating their benchmarks has not increased.

Another criticism leveled at passive management is its tendency to allocate an ever-greater share of new dollars into the largest components in the index, creating a virtuous circle of higher share prices and more dollars flowing to the biggest names. In fact, the weight of the top 10 largest stocks in the S&P 500 as a percentage of the total index market capitalization is currently about 22 percent, near its 47-year average of 22.7 percent[3]. This percentage peaked in 1975 at 34 percent, before indexing was created!

Among the important roles that active managers fulfill is to allocate capital to those companies who can use it most efficiently, and to influence corporate managements to make better decisions through ownership of their shares. While passive strategies arguably fail on the first objective, they can exert material influence on corporate behavior through their role in voting company shares. Indeed, the concentration of passive assets among just four large managers (Blackrock, Vanguard, Fidelity, and State Street) provides them with extraordinary power and influence over corporate America.

As one might expect, the debate over the importance of passive management is neatly aligned with the incentives of the participants. Burton Malkiel, the passive management disciple and legendary author of *A Random Walk Down Wall Street*, believes that problems won't occur until indexing represents 95 percent of the US stock market. Until then, he believes, passive should win the day. Despite the relatively large percentage of fund assets that are managed passively, indexing still represents only about 15 percent of total outstanding US equity securities[4]. (This number includes individual securities held in brokerage accounts, and not in fund vehicles). So if Malkiel is right, we have a very long way to go.

As we have argued, there should be a self-correcting mechanism in the market to limit the growth of passive management. That is, when company fundamentals are so detached from stock prices, active managers should be able to exploit that disparity by selling expensive stocks and buying cheap ones. That should result in a sustained period of active management outperformance, leading to a rebalancing toward more active strategies. Based on the available data, we are not there yet. We continue to view passive management as the superior choice for taxable investors in those asset classes where the markets are efficient and information spreads quickly.

[2, 3] *Ned Davis Research*
[4] *BIS Quarterly Review, March 2018*

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Bruce is a Partner and Director of Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.

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