the advisor

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Passive Risk

"Crises take longer to arrive than you can possibly imagine, but when they do come, they happen faster than you can possibly imagine." Rudiger Dornbusch 1942 -2002

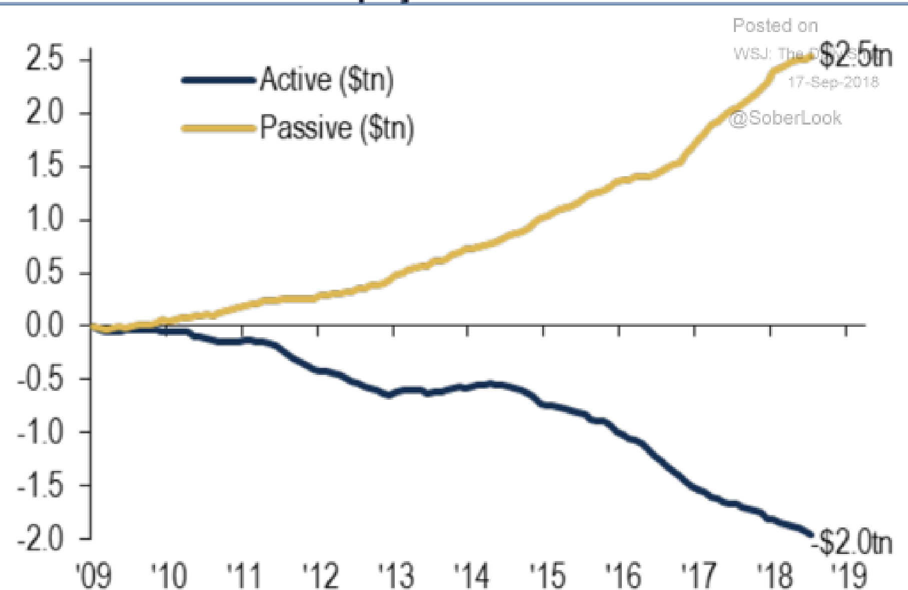
One of the great financial innovations of the past forty years has been the index fund, a form of passive investing. One cannot invest in an index but one can invest in an index mutual fund or exchange traded fund (ETF) that tracks an underlying benchmark; a representative basket of securities is purchased and held by the fund. The associated costs of operating these funds is minimal and the savings are passed along to the investor. It is a simple and cost-effective way of mimicking the performance returns offered by an index.

Jack Bogle of Vanguard Funds introduced the first index fund in 1975. Bogle insisted that passive investing is superior to active fund investing because of lower fees and because active managers can't "beat the market." Bogle urged investors to buy and hold passive funds and ignore market ups and downs. Investors who have bought and held passive ETFs that track America's main indices have done extraordinarily well. It's been an incredibly successful innovation and today investors have a cornucopia of passive index funds and ETFs from which to choose.

Unlike passive investing, active investing requires due diligence and research on the fundamentals of the underlying securities and then taking positions according to the investor's convictions. Active investors depend on bid (buy) and ask (sell) prices in order to make their investment decision. The narrower the bid-ask spread, the greater the liquidity of that security. This is the essence of price discovery in the securities markets.

With passive investing, fundamentals are irrelevant so prices are driven by "capital flows". Capital flows into securities for no reason other than the fact that they are highly liquid members of an index, and those capital flows chase the hottest securities (think FANG stocks: Facebook, Amazon, Netflix & Alphabet's Google). As long as the flows are positive, prices go up. A passive investor simply buys an index ETF then sits back and waits. Since markets go up most of the time, a passive investor makes money most of the time but contributes nothing to price discovery. In a world in which most managed money is handled by active investors, the passive investor can do just fine. Passive investors pay lower fees while they get to enjoy the price discovery and liquidity provided by the active investors. Passive investors are, however, free riding on the work of active investors.[1]

Since 2009, the number of passive fund investors has been expanding rapidly while the number of active fund investors has been declining remorselessly. The chart on this page shows what has been happening. Over $2.5 trillion of equity investment has been added to passive-strategy funds, while $2.0 trillion has been withdrawn from active-strategy



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(Passive Risk cont'd)

funds. Starting this year, over 50% of the assets under management in the U.S. will be passively managed according to Bernstein Research. This means more investors are free riding on the research of fewer and fewer active investors.[2]

What will happen when passive investors become the majority?

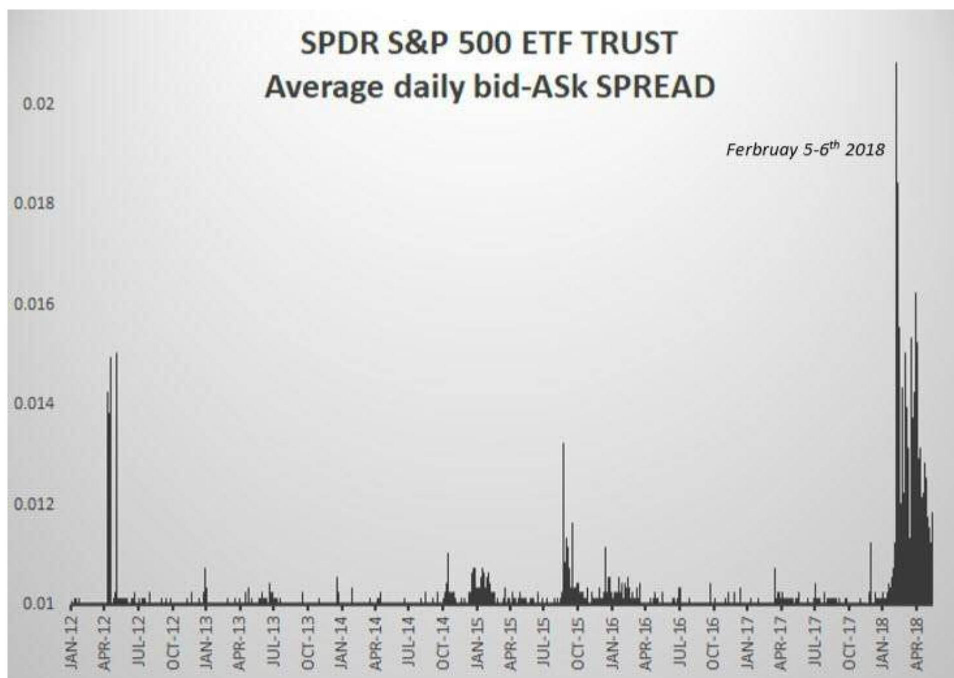
One of the hedge fund industry's leading experts on volatility is worried about this development. Christopher Cole's research suggests that passive investing is "… just a crowded 'liquidity momentum' trade and its outperformance compared to active managers may be self-fulfilling and ultimately de-stabilizing in the long run. When passive investing becomes dominant 'excess returns' are actually diminished and volatility should rise. What they claim as being low cost, actually comes at great expense in the long-run. What they think of as diversification is actually dangerous herding."[3]

As a case in point: in February of this year, a routine decline in equities caused a spike in volatility. Think of volatility as 'fear'. This spike in volatility lead to a liquidity squeeze in the retail-dominated short volatility space (where investors sold volatility derivatives in order to keep a premium, earning a decent yield in yield-starved market). Popular short volatility ETFs (such as "XIV") were wiped out and many strategies that had consistently made money from low volatility lost years of profits *in an hour*.

According to Cole, the volatility spike in February is widely misunderstood. It was not a 'volatility event' but instead a 'liquidity crisis'.

One of the most successful ETFs is the SPDR S&P500 ("SPY") which passively tracks the S&P 500. It is one of the most liquid exchange traded funds in the world with a capitalisation of over US$260 billion. "Normally this ETF trades very tightly with an average bid-ask spread of only 1 cent. On February 5-6th the average spread blew out to historical highs of over 2 cents wide, representing a 28 standard deviation move."[4] See chart this page.

The move in the derivative space was even more shocking causing derivative desks at some major banks to refuse to provide quotes. *Liquidity evaporated*. And this during a "routine decline" in the equity markets. What will happen during a period of actual systemic stress?[5]



When sentiment finally turns, the risk of this situation will become plain. Active investors are the ones who stabilize the market when it's under stress. If markets are declining rapidly, active investors who see value may step in to bid. If markets are soaring in an unsustainable fashion, active investors may take profits and move to the sidelines. It's the active investors who act as a dampener to the upside and a supporter to the downside. Active investors are the providers of liquidity.

When - not if - the market goes down, passive fund managers will be forced to sell securities in order to track the index. This selling will force the market down further which will beget more selling by passive managers. Prices will 'gap' down just as passive investors are looking for active investors to step in and bid.

There might not be enough active investors left to make a difference. With fewer bids, there is less liquidity. With less liquidity there is increased downside volatility. This dynamic will feed on itself and only accelerate as markets fail.

Too late, the very success of passive investing will have become problematic.

Sources:

1. James Rickards, "Free-Riding Investors Set Up Markets for a Major Collapse", Daily Reckoning, 24 Sept. 2018
2. Ibid
3. Christopher Cole, "What is Water in Markets?", Artemis Capital Management LP, July 2018
4. Ibid
5. Ibid
6. Chart previous page, James Rickards, "Free-Riding Investors Set Up Markets for a Major Collapse", Daily Reckoning, 24 Sept. 2018
7. Chart this page, Christopher Cole, "What is Water in Markets?", Artemis Capital Management LP, July 2018

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