Passively Active: An Alternative to Cap-Weighted Passive Investing

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Active and passive investment strategies are regularly pitted against each other. But is there a third path which can incorporate the best of both?

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Introduction

Much has been written about the rise of passive investing (including by yours truly **here** and **here**[1]). There is a lot to love about the approach, not least the suffering it causes us overpaid active managers. So maybe if we can't beat them, we should join them? We believe it's not an either/or and there is a third path via which allocators and managers can access the best of both worlds.

A lot to love about a passive approach

Let us begin by again reviewing the pros and cons of passive investing. Most of the pros are fairly well known which is one reason why passive has become so darn popular. Passive is generally very cheap, with low turnover and transaction costs, is highly transparent, and most importantly, has generally outperformed the aggregate experience of active managers[2]. Often equity investing is referred to as a zero sum game, and active managers must therefore underperform after fees and transaction costs. The onus has thus shifted to the active manager to justify their value-add, and this is a great thing for allocators!

Passive has another potential advantage: it is implicitly built to capture the positive skew of equity returns. Over very short-term time periods, stock returns are fairly normally distributed, with fat tails; over a longer-time period, stock returns are very positively skewed. A stock can only fall 100%, but it can rise much more than that. According to research from the W. P. Carey School of Business, from 1926 through 2022, 20 stocks accounted for 19.4% of all wealth creation in US equities while 528 stocks accounted for 90% of all wealth creation[3]. So while we rue the current concentration of equity markets globally, and today we appear to be at an extreme (especially in the US), it is the norm that a minority of companies end up creating most of the wealth. Active managers, in an attempt to "beat" their benchmark, will trade to capture alpha opportunities and manage risk within their portfolios. And that can include adding to high conviction positions on weakness or trimming strong performers with less perceived upside. In **Rebalancing Risk**[4], the authors argue that (in a different setting) rebalancing "induces negative convexity by magnifying drawdowns when there are pronounced divergences in asset returns". This is a feature that most passive benchmarks need not concern themselves with.

Passive investing generally assumes the market is efficiently priced. If there are securities that are grossly over- or undervalued, a passive allocation will buy too much of the overvalued security and too little of the undervalued security.

And the cons…

The cons of passive investing are not quite as clear. Certainly, indices can and do become concentrated, and one could debate whether this is a feature or a bug. Passively holding the Nikkei 225 Index at the start of 1980 or the Nasdaq Composite Index at the start of 1991 would have been hugely profitable; holding them in 1990 or 2000, respectively, would have been extraordinarily painful. Passive investing generally assumes the market is efficiently priced. If there are securities that are grossly over- or undervalued, a passive allocation will buy too much of the overvalued security and too little of the undervalued security. It could be said that passive investing is more likely to have a momentum tilt to it, at the expense of valuation, and how you feel about that likely influences your view on the attractiveness of passive.

There are some more controversial views about passive investing, with Bernstein writing that "passive investing is worse than Marxism" back in 2016.[5] The author argues that a world where passive investing comes to dominate is a world where capital allocation is at best haphazard. The point of functioning capital markets is to allocate capital, and at least with Marxism there is a plan in place. If passive takes over, and there is not sufficient price discovery, how is capital being allocated? Imagine going to the grocery store and buying a small slice of everything. Imagine thinking about making a charitable contribution and giving a small amount to all possible charities weighted by some notion of size. For individual investors to be passive makes a lot of sense. But an entirely passive market would be… odd.

1. US Equities: Approaching Peak Passive and the Implications for Active | Man Institute | Man Group; Active, Passive, Retail, ESG and Value; Oh My! | Man Institute | Man Group. **2.** Source: Morningstar. This does vary by region, with the argument most convincing in relation to US equities. Note also for the purposes of this paper, we mean passive to be capitalisation-weighted approaches, not alternatives like equal or fundamentally-weighted. **3.** https://wpcarey.asu.edu/department-finance/faculty-research/do-stocks-outperform-treasury-bills **4.** Rebalancing Risk by Nicolas Granger, Douglas Greenig, Campbell R. Harvey, Sandy Rattray, David Zou :: SSRN **5.** Bernstein. The Silent Road to Serfdom: Why Passive Investing is Worse Than Marxism. Fraser-Jenkins et al 2016.

Others have worried about the implications of concentrated, passive voting interests and the impact of investors holding everything. Matt Levine frequently writes about this by asking if index funds should be illegal. The argument is loosely around collusion; if companies have the same owners, there is less incentive for said companies to compete, and indeed there is a subtle incentive to maximise profits of all companies. So if company A could compete more aggressively with company B, the joint owners will ask what the impact would be on total profits, as they have claims on both. This is an interesting theoretical argument, although in practice, probably not much of a concern. That being said, what happens when the collective market is held in roughly equal proportions by a majority of investors? We worry about monopoly power if one company dominates an industry, but what if one industry is collectively owned by the same group of investors?

We estimate that roughly $2 out of $3 in the US is passively allocated.

How much passive is too much passive?

We estimate that roughly $2 out of $3 in the US is passively allocated.[6] This is not to say that passive investors are two-thirds of the US market, but rather the combination of passive owners and benchmark-oriented optimisations has led to this outcome. Unfortunately, we have found it impossible to estimate the equivalent number outside of the US. We believe passive has grown everywhere, but likely lacks the influence outside the US that it enjoys within it. What is the upper limit to passive investing? And are we anywhere near this threshold?

The reality is you only need one active investor in the market. Now this may not be a well-functioning market, but it would work in that the sole active investor would essentially determine the value of each stock when a passive investor decided to buy or sell their index. This sole active investor would wield an incredible amount of power and be responsible for determining the value of each individual security. Of course, this is an absurd extreme, and does not represent a viable outcome for an equilibrium between passive and active investors.

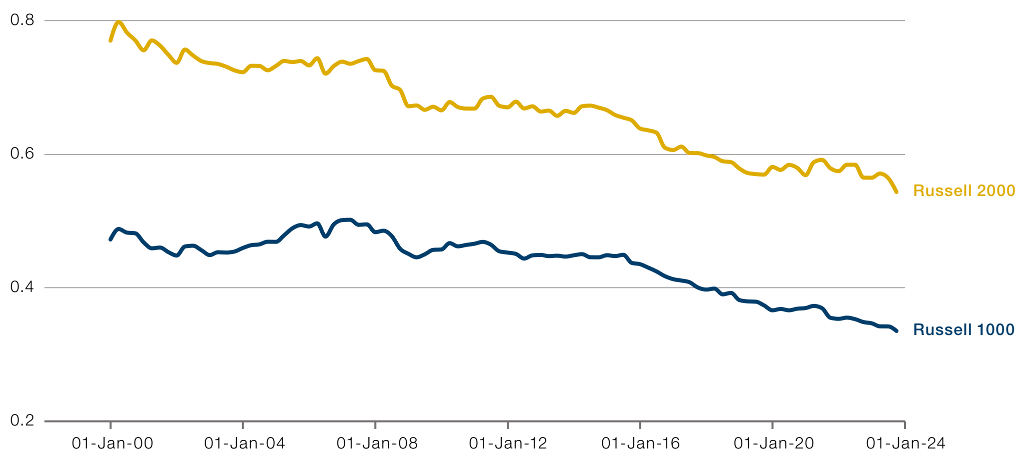
It is impossible to know what the "right" amount of passive is. Indeed, it is likely a moving target that is dependent on several factors. Historically there has been too much active investing with too high turnover at too high fees. Ultimately, though, this is a healthy competition between active and passive strategies. Three angles of that competition are (a) net-of-fee returns, (b) risk, and (c) other motivations of the allocator. Passive strategies have forced active managers to reduce their fees, which is a good thing (for allocators, not investment managers!). Both passive and active managers have the ability to cater to other motivations of an allocator (e.g. ESG concerns), although the relative viability of each approach depends on the beliefs of said allocator.

A question worth asking aloud is whether equity markets could function efficiently *without* active managers.

A question worth asking aloud is whether equity markets could function efficiently *without* active managers, and I think the answer is obviously not! So if we can all agree that active management is necessary, then the important question is how much do we need *and who should subsidise* price discovery? Fifty years ago, index funds were just about to be introduced to the masses. Prior to that, it is not clear that portfolio managers or investors thought much at all about benchmarking. Today, we claim that $2 out of $3 in US large cap equities is passively allocated – either directly via index funds or through benchmark-centric optimisation. The move into passive allocations can be seen in Figure 1.

6. US Equities: Approaching Peak Passive and the Implications for Active | Man Institute | Man Group

Figure 1. Estimated asset-weighted active share within Russell 1000 & Russell 2000



Source: Bloomberg, Man Numeric.

What if we could design an active strategy that sought to capitalise on the benefits of passive investing without incorporating some of the potential negatives?

That is an incredibly significant shift over the last fifty years, and though there is nothing preventing that passive allocation from rising further, we again believe we are approaching an upper limit. In the US, one might say passive investing has already won, and many allocators now have little to no incentive to even consider active strategies.

At this point, we have not really answered the original question: how much passive is too much passive? But what if we could design an active strategy that sought to capitalise on the benefits of passive investing without incorporating some of the potential negatives?

The best of both: Passively active strategies

To recap, passive strategies benefit from (a) low fees, (b) low turnover and transaction costs (generally), and (c) letting winners ride and not reinvesting in losers[7]. But they are not particularly discriminating, and inflows and outflows are executed in a market-cap weighted fashion. And because passive managers have consistently grown market share over the last few decades, we are talking about consistent net inflows. If a stock becomes overvalued, every incremental dollar into the index fund buys too much of it, and potentially exacerbates the problem.

One solution would be to implement a buy-and-hold strategy, using a ranking system to identify very attractive names. Depending on the ranking system, the attractiveness of particular stocks will vary over time, so it is important that the ranking system is somewhat stable over time. If you buy a particular stock, your intent is to *invest* in the stock and not to *trade* it. And if the name eventually becomes particularly unattractive (ideally several years later), you could remove it from the portfolio and invest in another very attractive name. For those who follow Warren Buffet, his approach is simultaneously passive and active, and maybe we can move from an *either active or passive* world to developing strategies that seek to capture the best of both worlds.

The fact that the markets seem to be incredibly short-termist at the same time as passive investing has risen to dominance seems paradoxical. One would think that passive investing is not at all short-term oriented (although investors can and do actively trade passive indices). We believe that the remaining active managers, as well as other types of traders (like hedge funds), are turning over holdings as fast as ever, and the costs associated with frenetic trading represent an additional hurdle for outperformance relative to passively active strategies.[8] Put another way, has the market become short-term efficient, but long-term inefficient?

7. Note we are specifically talking about market capitalisation weighted indices. Equal-weighted indices may have low fees, but also have higher turnover and transactions costs, as well as continually selling winners and buying losers. **8.** Of course, all managers will try to optimise trading behavior around their prospective alpha opportunities.

Conclusion

As an active manager, we have to believe in the value of active management (or else why bother?). Active management is an important force for price discovery and a more efficient allocation of capital. There are many positives to passive investing, and in the US, it has undeniably produced better outcomes than active management in aggregate. But we must also acknowledge the potential free rider problem, and that the survival of active management helps mitigate that risk for passive investors. Ultimately, active managers are competing against passive strategies, and we are optimistic that strategies that mimic some of the traits of passive can compete on both performance and non-performance-oriented considerations.

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