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The dangers of passive investing in choppier waters

Over the past decade, there has been a pronounced shift away from actively managed funds to passive strategies. While we do believe that both types of strategy have a role to play in portfolios, these roles must be continuously re-evaluated, especially today, as we undergo a sea change in the investment landscape.

As of late, heightened inflation has compelled major central banks to embark on some of the most aggressive rate hiking cycles on record, credit standards have tightened quite dramatically, and the cost of credit has shot up. All this puts economic growth in jeopardy and marks quite a change from the days of easy monetary policy and abundant central bank liquidity that some say led to an “everything bubble” and allowed even zombie firms to refinance themselves without a lot of difficulty.

In such a context, we believe that focusing too much on passive and not enough on active could be risky.

Here's why:

1. **Passive investors buy the whole haystack**

In essence, passive investing involves buying the whole haystack instead of spending time and resources searching for the needle. Normally, when an index fund or ETF receives inflows, it will invest in assets based on their index allocation at that moment in time, without other considerations beyond their index construction rules.

Having a mixed bag of companies can be ok when times are good. But today, tighter financial conditions and slowing growth in the world's major economies are starting to expose vulnerabilities, calling for greater discernment in separating the wheat from the chaff.

2. **Passive strategies are relatively rigid**

Passive vehicles do not adjust exposure if they perceive certain sectors or companies look poised to underperform, they earn whatever the market earns based on the benchmark. This can lead to governance issues and brewing storms might go under the radar until it is too late.

By going through a company's financial statements with a fine toothcomb, active managers can construct a more nuanced allocation aimed at maximising upside potential while minimising downside risk. Currently, that might mean screening for companies with enough financial firepower to weather any incoming storm or for companies that managed to lock in low rates before the spike in credit costs… Active managers are also better placed to sidestep "problem segments" of the market which today might mean trimming holdings of firms exposed to commercial real estate. Index funds do not have the same agility to avoid proverbial wasp nests.

In a sign of the times, this year, iShares converted its $707mn MSCI Frontier and Select EM ETF to active management to "allow greater flexibility and liquidity in various market conditions".

3. **Risks can be overlooked or underestimated**

Linked to the above, is the fact that investors might not always understand the intricacies within the passive funds they are holding. Amid heightened demand in the last decade, passive strategies now also track murkier areas of the market that are more vulnerable to dislocations or default risk, and which were traditionally considered an experts' domain.

Before the banking crisis, CoCos had become a popular asset class, offering relatively high yields and many investors chose to play this trade via passive index funds. Prior to the Credit Suisse default, an index fund tracking iBoxx Contingent Convertible Liquid Developed Europe AT1 Index, would have had around 5.4% of its assets invested in Credit Suisse CoCos, a position that was all but wiped out after the rescue, much to the surprise of some investors.

An active fund would have had more flexibility to hold a lower (or no) position in Credit Suisse and thus, avoid this loss of capital. A passive debt fund will, by default, have the biggest positions in the company which issues the most debt.

4. Passive investment strategies are not immune to market risk

Passive investing means being exposed to a broad index and as such, performance will largely be dictated by market fluctuations. In a context where markets face more snakes than ladders, for example, during a recession, investments will most likely be negatively impacted. Note that the probability of a recession in the next 12 months is 65% in the US, and 50% in the Eurozone, according to Bloomberg consensus estimates.

5. What happens during a selloff?

Because passive investing can encourage crowding into specific corners of the market, a large risk factor is what happens if an unforeseen shock made investors want to jump ship all at once. It would be very difficult for the market to take the weight of all that selling, and liquidity could dry up for the product itself and for the underlying holdings. In such a scenario, bid-ask spreads could spike, meaning that investors might have to incur huge losses to exit their passive positions.

CONCLUSION

Over the past decade, positive correlations within and across asset classes rose to unusually high levels. Achieving good returns did not seem to require a lot of effort, and passive approached flourished, especially given ultra-low fees. However, given that the tide of liquidity that lifted all boats is now subsiding, investors need to confirm whether the passive vehicles they are invested in are still seaworthy.

In favour of active management, choppy waters could bring back a dispersion of returns – something that professional managers need to demonstrate their skill. In volatile and uncertain times, the name of the game is not just alpha generation, but also risk management. For this, accurate fundamental analysis is crucial.

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