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Passive Investing: Another Financial Bubble?

By Charles Brandes, CFA, Founder and Chairman, Brandes Investment Partners

Familiar patterns are emerging that should get us thinking about a possible financial bubble in passive investing.

Executive Summary

It is clear to me after almost a half-century as a professional investor, we can't escape financial bubbles. They form when security prices are pushed up without regard for the intrinsic value of the underlying asset. Typically, they are not recognized as *they happen* but only *afterwards*. Today, familiar patterns are emerging that should get us thinking about a possible financial bubble in passive investing, largely because money is being *directed* to passive investment vehicles rather than thoughtfully *invested*. If this is true, I do *not* advocate exiting the market. Instead, I encourage investors to seek value and stick with a good plan for the long term. In making my case, I also cite research done since 2008–09 on the value of active share which argues that generating alpha requires deviating from a benchmark to pursue better-than-index returns.

Bubbles Recur and Passive Investing Is Not Immune

It is clear to me after almost a half-century as a professional investor that despite growing economic sophistication, financial bubbles continue to cause financial and psychological harm.[1] We can't escape them.

All financial bubbles share certain characteristics but a driving force behind each is that it *appears* "to be different this time."[2] Typically, it is only when a bubble bursts that purported "experts" can make a diagnosis. Hindsight is always 20/20.

While bubbles can't be consistently predicted, looking at past examples uncovers remarkable similarities. No matter what the asset is, bubbles tend to form when prices are pushed up *without* regard for the intrinsic value of the underlying asset.

Bubbles are typically not conclusively recognized *as they happen* but only *afterwards*.

This disconnect between price and value is seen in the growth of passive investing in capitalization-weighted indexes. Investment dollars are flowing to companies *not* because of sound fundamental analysis, but because these organizations are in the benchmark. And because of the cap-weighting methodology (employed by many passive strategies), larger entities proportionately receive larger allocations simply because of their size.[3]

I'm concerned by these trends and what they mean for investors. This paper presents my analysis and suggestions about how to respond intelligently.

Is a Passive Investment Bubble Forming?

As I have noted, bubbles are typically not conclusively recognized *as they happen* but only *afterwards*. However, familiar patterns are emerging with passive investing that should get us thinking: what we know about past bubbles should raise questions today.

It's worth mentioning that Ned Davis didn't hesitate to label these patterns in his March 2017 research newsletter: "In conclusion, I feel we are in the late phases of a passive index bubble. I think over the next five years, there will be great opportunity for active managers to outperform passive managers."[4]

Whether you accept this verdict or not, it's clear that investors used to choose businesses to invest in and then measure results against a meaningful benchmark. Since a benchmark is an average, many investors found they were underperforming at times. In addition, over the past decade or two, investors have become:

1. Increasingly sensitive to fees and
2. More focused on short-term results.

Passive, or index, investing capitalizes on this reality.

Passive investing seeks to replicate an index, providing returns very close to the index returns—not significantly better or worse—but at a much lower fee than actively managed funds. I understand that lower fees contribute to passive investing's appeal. And I agree that the price you pay for something is very important—but make no mistake, it's only half the equation. The other, more important half, is the value you receive. A thoughtful comparison of price and value has been the heart of every decision we have made on our clients' behalf over the last 40+ years. And it's precisely this thoughtful comparison that's missing from passive management.

However, I recognize that passive investing provides investors with results that closely mirror benchmark returns, alleviating the angst caused by any period of significant, but short-term, underperformance an actively managed portfolio might encounter. The manager who produces market-like returns likely won't get fired or feel foolish about them. Many investors seem more ready to accept a portfolio almost certain to consistently underperform index returns a little rather than tolerate occasional periods of significant short-term underperformance from a portfolio with the potential to significantly outperform index returns over a long period.

The allure of passive investing has driven its extraordinary growth in recent years, with more forecast:

- In 2016, passive funds in the United States attracted $506 billion, and actively managed funds posted $341 billion in *withdrawals*, according to Morningstar Inc.[5]
- Index funds' share of total assets under management has grown steadily to nearly 30% (up from about 15% in 2006). Passive funds are forecast to grab more than half the assets in the investment-management business by 2024 at the latest, states Moody's Investors Service, Inc.[6]

As I reflect on the passive investment trends this paper describes, some more recent developments should be acknowledged. Companies offering passive funds have responded to the errors of standard cap-weighted offerings and are shifting to smart beta or factor-based investing. While this is better, the vast majority of flows are going to standard offerings and I think distorting prices. But even if trends that counter the rise of passive investing surface, the massive surge in index funds and ETFs won't likely stop cold.[7] This implies a passive investment bubble is a real possibility. Why?

Past Bubbles and What They Teach Us

How true it is: "The more things change, the more they stay the same." When bubbles recur, they tend to share common features: They are typically *not conclusively recognized* when they actually happen; they detach or *decouple price from intrinsic value*, and this usually causes prices to plunge. How true it is (part two): "Those who cannot remember the past are condemned to repeat it." Because bubbles have reappeared in different guises, two recent examples make me wonder if another is looming.

The Technology or Dot-Com Bubble

In the mid-1990s, the potential of the Internet for changing commerce became obvious.

The first Internet (or dot-com) companies were thought to be the "future" and their share prices rose on speculation. "Eyeballs on screens," (a quantification of dot-com users) displaced fundamental metrics (earnings, book value, etc.) as measures of investment merit.

Once the euphoria of skyrocketing growth wore off, financial gravity took effect: high-flyers without earnings or a sustainable business proposition plunged. Many dot-com companies disappeared; losses were staggering. To me, it is obvious that businesses must produce real goods and/or services customers will pay for. Otherwise, they may grow rapidly briefly but then crash spectacularly. When the bubble burst—as all have—many investors, including those who departed for supposedly higher returns, were hurt.

The U.S. Housing/Real Estate Bubble

As was true of other bubbles, a combination of financial, political and social factors created conditions that fueled the U.S. housing/real estate bubble. A truly *nationwide* real estate decline was to anyone's recollection unprecedented, so securitized subprime pools were thought to be insulated because they held loans from different locations. And continuously rising prices across the United States encouraged many to believe that they could only go in one direction: *Up*.

A false sense of security and ever-rising prices meant that prudent lending and common sense disappeared, resulting in, for example, *NINJA mortgages*: "No income, no job, no assets." Looking back, it's astonishing that any financial institution would lend to a borrower lacking employment and income, but it happened.

Some bubbles are geographically contained, but the real estate bubble was of another order of magnitude: it created an earthquake that violently shook the entire global financial system and impaired or destroyed well-established financial institutions.[1]

With passive investment vehicles, money is *directed* to companies indiscriminately.

Directed Money vs. Invested Money

A stock bubble forms when share prices inflate (and continue to do so) despite fundamental business economics. With passive investment vehicles, money is *directed* to companies indiscriminately. With almost 50 years of investing experience, I say "directed" because "invested" means a *rational* case for investing has been made, including an assessment of expected earnings, profits, etc. Inflows based on size and liquidity—*decoupled* from fundamentals—lack the purposeful intent and informed choice necessary for "investing."

Passively directing money simply causes stock prices for select businesses to inflate—regardless of other measurable factors. This reinforces the continual growth that grew other bubbles.

Now we should ask two questions:

1. What would cause a bubble to burst?
2. What could happen if it did?

On number one, *all* bubbles pop when the market realizes the price and the actual asset value have decoupled; the price is then recalibrated by *financial gravity*.

A Mass Selloff Scenario

How it might unfold:

1. In a cap-weighted index, assets are indiscriminately directed to all stocks: large caps get more
2. Investors pursuing short-term gains chase the trend, ratcheting up portfolio risk levels
3. Markets recognize share prices and values have decoupled: bubble cannot hold; share prices are re-based—potentially *below* underlying business value
4. Investors may seek en masse to exit, increasing redemption pressure and further exacerbating price declines for some passive funds
5. Markets respond to negative signals and passive selloff "contagion" spreads: financial crisis ensues domestically/globally depending on extent of impact
6. Active value managers, partially insulated from downturn, identify new investment opportunities

On number two, *nobody* can predict exactly what might happen or when. However, vast sums of passive money would likely leave the market, pushing share prices sharply lower. If so, it could also put severe pressure on liquidity of some of the big passive investment holdings, with share prices bid *below* their true underlying values—an overreaction typical of financial markets.

As the dominoes topple, passive investment providers would face mounting redemptions and if liquidity was inadequate, it could have serious knock-on effects. Since passive investing is not just an American phenomenon, the impact could be global as with the U.S. real estate bubble. While these potential effects cause concern, volatility is of benefit to long-term, value-focused managers.

A Prudent Approach to a Passive Investment Bubble

The benefits of capable active managers who adhere to pure-style investing over the long term are confirmed by data and analysis, not just deep conviction.

Given the possibility that a passive investment bubble is brewing and might not hold, what should prudent investors do?

Benjamin Graham earned an enviable investing track record, helped create the CFA designation and wrote enduring books on professional investing (e.g., *Security Analysis* and *The Intelligent Investor*). The underlying truths he identified are as valid today as they were when published.

Since then, investing has become more technologically advanced and reliant on complex financial models. Have we surpassed Graham's insights on investing? My view is that modern, sophisticated systems of investing—that drive passive investing—do *not* replace investing fundamentals. "Investing" decoupled from fundamental analysis is speculation.

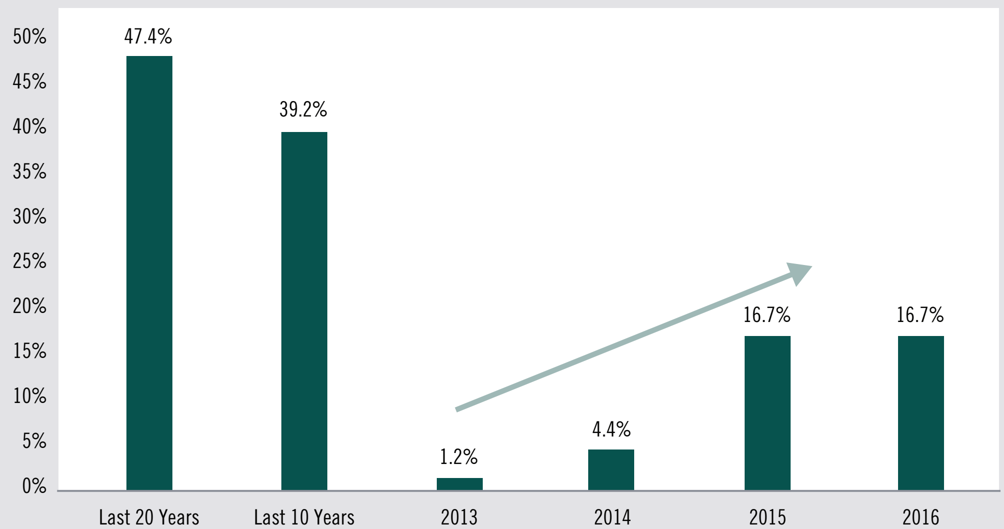
Speculation is *not* investing and is as flawed today as it was in the 1930s. Investing is purposeful, selective and long term—*not* passively directive. The benefits of capable active managers who adhere to pure-style investing over the long term are confirmed by data and analysis, not just deep conviction.

BRANDES INVESTMENT PARTNERS

In early 2017, Morgan Stanley's Global Investment Committee acknowledged the success of passive investing and the benchmark-lagging performance of many active managers. However, it also identified economic and policy factors creating momentum for active management, notably, a tendency towards volatility that prompts mispricing, as shown in Exhibit 1.

Exhibit 1: Volatility May Continue Rising Toward Historical Levels, Creating More Opportunities for Managers to Benefit from Potential Mispricings

Percentage of Days CBOE Volatility Index (VIX) Was Above 20



AS OF 12/31/16 | Sources: Morgan Stanley Wealth Management GIC, Bloomberg.

During my decades in this industry, I have often seen managers following a proven philosophy that have delivered benchmark-beating returns over the long term.

Morgan Stanley concluded capable active managers can make a difference:

> "…we still believe that 35 to 40% of the top managers add idiosyncratic alpha over long periods of time and thus their investment selections can be additive to diversified portfolios."[8]

Of course, I agree. Active managers may face skepticism of their value, but a study published in February that examined more than 20 years of U.S. pension data has found overall active managers have outperformed indexes. However, manager selection is still crucial for asset owners looking to beat the market.[9]

I believe the wide return dispersion among active managers reflects the possible rewards for sound manager selection. And during my decades in this industry, I have often seen managers following a proven philosophy that have delivered benchmark-beating returns over the long term and, I'm adamant, that such managers merit consideration.

How to find a good active manager:

- **Take a *long-term* perspective**
- ***Research* managers thoroughly**
- **Assess performance properly and on the *right schedule***

Do Some Active Managers Add Real Value?

This question is much debated but I think the evidence weighs heavily in favor of "yes." A simple review of active managers who have been around for decades (and here I suggest you look at track records that are over 20, 30 or 40 years) will show that many of those managers add value over their respective index.

Nevertheless, I also agree with John Bogle, the founder of one of the world's largest passive investment firms and considered the father of passive investing, when he famously made a comparison between effective stock-picking and looking for a needle in a haystack. Bogle has argued: "As it turns out, we are looking for a very small needle in a very large haystack."[10] In making this comparison, Mr. Bogle conceded there are active managers who outperform and add alpha. However, he concluded that since finding those managers is akin to finding the elusive needles in a haystack, investors should capitulate and buy the index (haystack) instead. I disagree.

Proponents of passive investing often claim that active management fees are too high and calculate how much these fees can erode the savings of investors. Of course, this is a mathematical fact. But of course, the opposite is also a fact.

Mr. Bogle and I agree that there are managers (those elusive "human needles") who deliver returns greater than the market. In theory, a 100-basis point performance advantage (annualized, after fees) over the benchmark would deliver an extra $1 million over 20 years for a $1.5 million initial investment.[11] Having worked in this business for almost five decades advising both individual and institutional investors, it causes me personal distress when I see investors capitulating and avoiding the opportunity for outperformance. Just because something is difficult doesn't mean we shouldn't do it. Rather, we should be careful, deliberate and take actions that put the odds of being successful in our favor.

So, how should one go about finding those elusive needles?

Take a Long-Term Perspective

- Be realistic about your investment time horizon. I think long term *starts* at 20 years and the longer the better. Results for shorter investment horizons will be more random.

Research Managers Thoroughly

- Research active managers and try to discern skill from luck.
  - I recommend looking at truly long-term track records: 20, 30 or more years
  - Look for style consistency: are they sticking to their knitting?
  - Seek out indicators that measure skill over good fortune or randomness. Consider measures such as active share (see the discussion on active share).
  - Is there evidence they take capacity seriously and don't favor growth in assets under management over investment performance?
  - Are they personally invested in their strategy: do they eat their own cooking?

Assess Performance Properly and on the Right Schedule

- Monitor the right things with the right frequency.
  - I believe that monthly, quarterly and annual returns are nothing more than noise and often distract the long-term investor. I know it's really hard to ignore performance but evaluating performance every five years would, in my opinion, serve investors well.
  - Review your manager annually and look for evidence that there is no major change in how they operate, i.e., no style drift, no significant personnel changes, no major corporate event, etc.
  - If your manager continues to manage your money as they historically managed your money (which caused them to be one of the elusive needles), then stick with them. If they have changed, then find another needle—*regardless* of recent performance.

Control Behaviors That Undermine Sound Investing

- Be deliberate in dealing with your own human behavior and investor psychology.
  - Benjamin Graham stated in *The Intelligent Investor*: "The investor's chief problem—and even his worst enemy—is likely to be himself."[12] Long before a Nobel Prize was awarded for behavioral economics, Graham understood that human behavior can derail an otherwise logical and sensible investment strategy.
  - Investors today have a big advantage over investors in Graham's day. The science of human behavior has evolved significantly; while that behavior will never change, we now understand it much better than before. There are countless books on the subject and firms like mine have developed tools to help counteract behaviors that undermine sound investing. For more on what we offer, please visit The Brandes Institute: brandes.com/institute.
  - There is no excuse for allowing human behavior/emotion to derail a good investment strategy. Finding and holding on to an elusive needle is difficult, but we are fortunate to be alive at a time when investor psychology is better understood and can be controlled.

Active Share

When looking for measures to discern skill from luck, I cite academic research on active share done by Martijn Cremers, now a professor of finance with the University of Notre Dame (formerly with the Yale School of Management) and Antti Petajisto, a portfolio manager at LMR Partners who has also taught at Yale and at New York University's Stern School of Business.

I will not replicate the detailed studies and analysis they have undertaken to assess the value of active management here. But I will quote the executive summary of a paper authored by Petajisto published by the CFA Institute in 2013:

> Using Active Share and tracking error, the author sorted all-equity mutual funds into various categories of active management. The most active stock pickers outperformed their benchmark indices even after fees, whereas closet indexers underperformed. These patterns held during the 2008–09 financial crisis and within market-cap styles. Closet indexing has increased in both volatile and bear markets since 2007. Cross-sectional dispersion in stock returns positively predicts performance by stock pickers.[13]

It seems to me that if a passive bubble burst and a steep share price decline followed, value-focused portfolios should be less adversely affected.

In a 2009 presentation based on research he undertook jointly with Petajisto, Cremers identified how and why active share can make a difference. He argued that high active share helped to identify better-performing funds because generating alpha required deviating from a benchmark, while a larger fund size made it harder to outperform.[14] However, in research published this year, Cremers emphasized that only active stock-pickers with *long-term conviction* (my emphasis) have been successful: short-term stock-pickers generally underperformed.[15]

What Does a Passive Investment Bubble Mean for Value-Focused Managers?

Long-term, actively managed funds applying a disciplined, value-focused process typically avoid more expensive markets. It therefore seems to me that if a passive bubble burst and a steep share price decline followed, these value-focused portfolios should be less adversely affected.

Value managers may also find unique buying opportunities in a post-passive-bubble environment, an environment ripe with the potential for an overreaction that could drive the prices of some or even many stocks *below* the underlying businesses' intrinsic values. Committed investors in these funds could therefore gain from a measure of downside protection and the potential for long-term upside gain. Manager quality would certainly matter, but I've seen this pattern happen before and firmly believe it could recur if a passive investment bubble gave out.

Modern technology may support efficient decision-making by capable managers, but it does *not* affect investing fundamentals.

Looking to the Future With Insights From the Past

Here is a summary of my argument.

Financial bubbles can only be declared after the fact. However, repeated patterns of behavior associated with bubbles can be observed.

Some may argue there really isn't a "passive" bubble now. Assets under passive management have increased significantly over the last 10 years. But they are still a smaller percentage of overall assets under management vs. active. Stock valuations (they say) are high, though not as extreme as we saw in the past. And no one sector, like technology or real estate, is leading a narrow advance. However, over my almost five decades in this business, I have repeatedly seen investors who failed to really consider price relative to value. Ultimately, that failure to consider value did not end well for those investors, and I see this quite a bit today. The global popularity of passive investing is decoupling price and value, which stokes conditions known to generate bubbles.

Modern technology may support efficient decision-making by capable managers, but it does *not* affect investing fundamentals. It does *not* displace prudent security selection as the foundation for sound investing. It does *not* shield investors from the growing risks of passive investing.

Seeking value with a long-term perspective is a time-tested method. This disciplined process offers potential protections if a passive investment bubble bursts, and it offers potential gains in a market of re-based prices.

Despite technological advances, new ways to invest and the relentless growth of passive investing, my message to investors is this: Do *not* exit the market. Pick good managers with demonstrated long-term results. Make a good plan. Stick with it over the long term. Use the advances in the science of human behavior and investor psychology to your long-term advantage. I am confident Ben Graham would agree.

[1]Elvis Picardo, CFA, *Five Of The Largest Asset Bubbles In History*. Investopedia, June 23, 2015. Retrieved June 7, 2017. investopedia.com/articles/personal-finance/062315/five-largest-asset-bubbles-history.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186

[2]Bruce Grantier, *This Time is Different: Behavioral Aspects of Financial Crises*. The Brandes Institute, May 30, 2010. Retrieved June 7, 2017. brandes.com/docs/default-source/brandes-institute/this-time-is-different-behavioural-aspects-of-financial-crises

[3]James Ledbetter, *Currency, Is Passive Investment Actively Hurting The Economy?*. The New Yorker, March 9, 2016. "Typically, stocks are indexed by market capitalization—the value of a firm's share price times the number of shares—from highest to lowest. A market with more passive investors than active ones will continue to push money into the largest firms, whether these companies are actually performing strongly or not." Retrieved June 7, 2017. newyorker.com/business/currency/is-passive-investment-actively-hurting-the-economy

[4]Ned Davis, Senior Investment Strategist, *The Passive Investing Bubble*, Ned's Insights, Ned Davis Research Group, March 22, 2017. Page 5.

[5]Trevor Hunnicutt, *Index funds to surpass active fund assets in U.S. by 2024: Moody's*. Reuters Money, Thu Feb 2, 2017 | 9:29am EST. reuters.com/article/us-funds-passive-idUSKBN15H1PN The report is available at: moodys.com/research/Moodys-Passive-investing-to-overtake-active-in-just-four-to--PR_361541 Retrieved June 7, 2017.

[6]Ibid.

[7]It is worth noting that "factor" and strategic beta models of investing are preferable to pure, index-based alternatives in the passive investment universe. These strategies do screen companies held in their portfolios and invest on the basis of factors and/or statistical models. However, selection by fundamental analysis might lead to other decisions.

[8]The Global Investment Committee, Morgan Stanley Lisa Shalett, Managing Director et al. *The Case for Active Management*. January 11, 2017. "Bottom Line: The Case for Active Management is Strengthening." Page 2, bullet 4.

[9]Tim Sturrock, *Active Management Pays Off, Study Says*, FundFire, a Financial Times Service, February 16, 2015. Cites a study by Alex Beath, PhD, of CEM Benchmarking, that assessed almost 200 plans. "On average, active management across a U.S. pension's asset allocation accounted for 58.6 basis points (bps) value added annually to pension returns, which, net of fees, still came to 11.8 bps of outperformance above a pension's overall benchmark…. However, each asset owner's experience may vary, depending on how talented or lucky their managers are. The study found the standard deviation of returns to be 270 bps, meaning that good managers can push returns nearly three percentage points over the benchmark and unsuccessful ones can do the exact opposite. Hypothetically, a pension that invested only in active strategies would have outperformed by 38.7% on average."

[10]John C. Bogle, Founder and Senior Chairman, The Vanguard Group, *Equity Fund Selection: The Needle or the Haystack?* Remarks to the Philadelphia Chapter of the American Association of Individual Investors Philadelphia, Pennsylvania, November 23, 1999. vanguard.com/bogle_site/bogle_speechesequity.html. Retrieved June 7, 2017.

[11]A $1.5 million initial investment would grow to $4.9 million over 20 years at 6.1% compounded annually; at 7.1%, the same initial investment would grow to $5.9 million. This hypothetical example is for illustrative purposes and does not represent any specific investment. Actual results will vary.

[12]Benjamin Graham, *The Intelligent Investor: A Book of Practical Counsel*, 4th rev. ed., New York: Harper & Row, 1973. P. XV.

[13]Antti Petajisto, *Active Share and Mutual Fund Performance*, Financial Analysts Journal Volume 69 · Number 4 2013 CFA Institute. Page 1. cfapubs.org/doi/pdf/10.2469/faj.v69.n4.7. Retrieved June 7, 2017.

[14]Martijn Cremers, Yale School of Management jointly with Antti Petajisto, *Active Share: A New Measure That Predicts Fund Performance*. PowerPoint Presentation on file, 2009. Slides 22–24.

[15]Martijn Cremers, *Active Share and the Three Pillars of Active Management: Skill, Conviction, and Opportunity*, Financial Analysts Journal, CFA Institute. Volume 73, Number 2, Second Quarter, 2017.

The CBOE Volatility Index (VIX) is designed to track market volatility, with high values implying pessimism and low values implying optimism.

Active share: The difference between a portfolio's holdings and those of its benchmark index.

Alpha: A measure of performance based on the excess return of an investment relative to a benchmark index.

Basis point: 1/100 of 1%.

Book value: Assets minus liabilities. Also known as shareholders' equity.

Smart beta investing: A passive strategy that tracks an index which is rules-based rather than market capitalization-weighted.

Past performance is not a guarantee of future results.

No investment strategy can assure a profit or protect against loss.

Mutual fund investing involves risk. Principal loss is possible. Investing in exchange-traded funds (ETFs) involves specific considerations for investors including, but not limited to, expenses, liquidity risks, and the possibility that ETF shares may trade at prices above or below their net asset value.

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