Brent Sheather's

# RESEARCH

Private Asset Management Ltd SEPTEMBER 2024

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.


## KARMA POLICE – PART 1

Remember when George W. Bush gave the "mission accomplished" speech on the deck of the aircraft carrier, the Abraham Lincoln? It was vintage G.W. – he declared, on May 1st 2003, that the war in Iraq had been won and combat operations were "done and dusted". We all know what happened next - six or so more years of bitter fighting and lots of death and misery. The Greek language has a word for this sort of embarrassing faux pas and it is "hubris". Wikipedia defines hubris as "extreme haughtiness, pride or arrogance. Hubris often indicates being out of touch with reality and overstating ones competence." Maybe it is karma but it seems that the finance gods tend to punish fund managers, intermediaries and investors that grandly declare "*mission accomplished*". A particularly glaring faux pas was the statement by Yale economist Irving Fisher a few weeks before the 1929 crash that "*stock prices have reached what looks like a permanently high plateau*". Other more recent examples include academic research which showed that small stocks outperformed and the resultant market enthusiasm for those companies, ahead of more than thirty years of underperformance. ESG investing, and its cheerleaders claim that "*you can outperform by doing good*", naturally gets a mention here – notably the zealous advocacy of ESG investing strategies, including the exclusion of defence stocks, just in time for the biggest war in Europe since 1945 and the largest increase in spending on defence in dollar terms, by Europe, ever. Inevitably, at the point of maximum optimism, the Karma Police decide that the cheerleaders need to be taught a lesson so the strategy either blows up completely and/or underperforms for a long period of time.

It seems to me that fund management groups and financial advisers, who advocate the exclusive use of passive funds are today supremely confident that their strategy is bullet-proof, that passive will take over the world and the death of active management is just a matter of time. Long story short, for passive investing proponents, today it is pretty much "*mission accomplished*". Maybe I am getting paranoid but I worry that some nasty surprise lurks in the future for passive investing given the hubris of its disciples, its popularity and its unethical foundations.

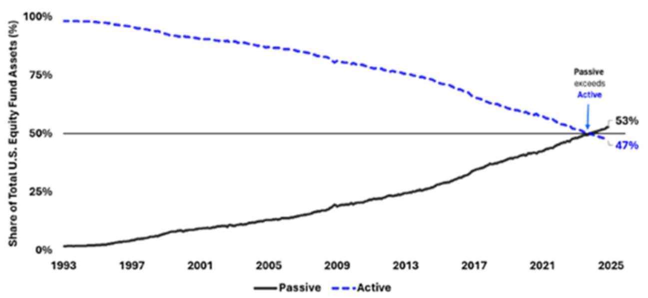
There are a number of reasons behind the big move to passive investing, some obvious, some less so. First the obvious reasons: due to low costs and the impact of the skewness of stock returns, passive funds outperform active. The work of S&P Indices Versus Active (SPIVA) is freely available and it updates the passive/active metrics regularly. Secondly, these days the media increasingly sings the praises of passive with groups like the Bogleheads regularly bashing active on YouTube and X (formerly Twitter). One of the most vociferous and vocal evangelists for passive investing is a former British journalist, now reinvented as an investment expert, by the name of Robin Powell. On X Mr Powell describes his role as "*working to change financial services for the better*". He recommends all retail investors investing in shares do so exclusively using passive funds and has described active funds management as "an unjustifiable tax on society". A less transparent reason for the adoption of passive is the fact that many advisors who charge a high annual fee to manage retail investor portfolios have determined that the best way to ensure that their own profitability is not impacted is to recommend a low cost, all-passive approach to their clients, thereby keeping client's overall fees less ridiculous. Passive is thus embraced by many financial advisors simply to enhance their own profitability, rather than any altruistic notions they might profess to hold.

How is passive investing unethical? It is not ethical for an investor who just owns index funds and benefits from efficient equity and bond markets not to contribute to the cost of the price discovery efforts which make markets efficient. The passive evangelists love to diss active management but the irony is that the concerted efforts of expert active participants is the reason index funds work. An obvious analogy of passive investing is an individual who doesn't own a car but relies on random strangers to take him/her to work, to the beach or down the road for a coffee. The degree of dependence is even more pervasive than that: not only do investors who 100 percent index not have a car, they also need the person who picks them up to tell them where they are going as well. All things considered individuals who index 100% are bludging off other market participants. Bottom line is that someone, somewhere has to pay for the vital function of price discovery. It is simply not equitable that these major beneficiaries of price discovery don't contribute their fair share. This bad contract has deteriorated in the last 10 years or so as costs have become an increasing factor in determining financial advisor competitiveness.

Before moving on I need to disclose that whilst I worry about the impact of the increasing dominance of passive funds my firm continues to use them extensively for clients, since about 1990 actually. We believe that they should comprise the core (about 50%) of most investor portfolios.

There have been lots of attempts by active managers to disrespect passive investing including one fellow who asserted that passive funds were worse than communism. The NZ financial planning sector has a long and embarrassing history of criticising passive funds with highlights including unit trust researcher, Financial Planning Group (FPG), then NZ's foremost promoter of high cost managed funds, describing NZ's first index fund, the TeNZ fund as being "unethical, flawed and potentially illegal". Back then commission based financial advisors regularly criticized passive funds with the recurrent theme being "owning passive funds guarantees underperformance of the market, after fees".

**Figure 1. Passive Strategies Surpass Active Management**




Source: Research Affiliates and Morningstar. Data as of December 31, 2024, and include U.S. open-ended funds and ETFs (with obsolete funds included). The lines represent the percentage of assets under management in actively and cap-weighted passively managed U.S. equity funds, 1993–2024. In February 2024, passive assets under management (black line) surpassed active (blue dashed line).

All of these efforts to call the top of the trend to passive were premature: the stampede has continued unabated and today cap-weighted index strategies apparently represent about 53% of total US equity fund assets versus 47% in actively managed funds as illustrated in the graph above. That is enough for this week. The next column will look at a recent paper which warns about the risks implicit in passive funds high weighting in developed equity markets.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.