Passive investing: If it's good enough for CalPERS ...

Giant pension plan's possible full-on switch to index funds speaks volumes

By **Jason Kephart**
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Chris McIsaac: No question, CalPERS move an 'exclamation point'

Passive investing has reached a watershed moment.

The second-largest pension fund in the United States is considering a move to an all-passive portfolio while at the same time, the largest brokerage firms are falling over themselves to push passively managed exchange-traded funds.

The California Public Employees' Retirement System's investment committee started a review of its investment beliefs last week, with the main focus on its active managers, according to sister publication Pensions and Investments.

CalPERS oversees about $255 billion in assets, more than half of which already is invested in passive strategies.

“It's sort of an exclamation mark on a trend that most are aware of,” said Chris McIsaac, managing director of the institutional investor group at The **Vanguard Group** Inc.

Fidelity Investments, meanwhile, has responded to the enthusiasm for passive strategies by doubling down on its agreement with **BlackRock Inc.**'s iShares unit. Fidelity increased the number of iShares ETFs that trade commission-free to its clients to 62, from 30, two weeks ago.

Fidelity's move came just a month after The Charles Schwab Corp. launched an ETF platform that offers investors more than 100 commission-free ETFs.

TD Ameritrade Inc., the third leg of the online brokerage world, has been offering more than 100 commission-free ETFs since 2010.

“We see don't see it as either passive or active, we see it as both. In a low-return environment, fees matter a lot,” said Scott Couto, president of Fidelity Financial Advisor Solutions.

“That's getting interest in passive investing over the short term. Over the long term, active management adds a lot of value,” Mr. Couto said.

“There will continue to be a growing interest in the passive side because cost matters to investors,” said Beth Flynn, vice president and head of third-party ETF platform management at Schwab.

“Virtually all our adviser clients use ETFs in some way, shape or form,” she said. “Usage is much lower on the individual-investor side, but growing at a pretty steady and rapid clip.”

More than 40% of individual investors plan to increase their use of ETFs over the next year, for example, according to a recent Schwab survey.

TD executives couldn't be reached for comment.

SHIFTING PREFERENCE

Passive investing is nothing new. Vanguard founder John Bogle launched the first index mutual fund in 1975. But the fund world has always been dominated by active management.

A decade ago, 86% of the $4.4 trillion in mutual funds and ETFs were in active strategies, according to Lipper Inc.

Investors' preference is clearly shifting, though. Active management's market share was down to 72% as of the end of last month, and passive funds clearly have all the momentum now.

As investors have gotten back into stocks this year, they have done so largely through passive funds. Passive funds took in $65 billion in the first two months of the year, while active funds took in $40 billion.

For anyone who has been watching fund flows over the past few years, the surge in passive strategies shouldn't come as a surprise.

Since 2003, investors have pulled $287 billion from actively managed equity funds, while investing just over $1 trillion in passive funds.

Even though the preference for passive strategies has been most dramatic in equity funds, passively managed bond strategies are gaining steam, as well.

Passive bond strategies have had $260 billion of inflows since the beginning of 2008. Between 2003 and 2007, they had $73 billion of inflows, according to Lipper.

“Indexing has proven to be a very compelling investment strategy, especially for investors with an extended investment horizon,” Mr. McIsaac said.

Costs have played a big part. They are, as Mr. Bogle likes to point out, the only thing that an investor really can control, and passive strategies are much cheaper than their active counterparts.

U.S. equity ETFs have an average expense ratio of 40 basis points, compared with an average expense ratio of 134 basis points for actively managed mutual funds, according to a recent Morgan Stanley Wealth Management research note.

What's more, a number of large-capitalization ETFs charge less than 10 basis points, while the cheapest actively managed large-cap fund charges 50 basis points.

Active managers haven't given investors much reason to stick around.

“Being active over the past 15 years has not been rewarding,” said industry consultant Geoff Bobroff.

The percentage of managers beating their benchmark has been shrinking.

Over the past 10 years, just 38% of large-cap-equity managers have beaten the S&P 500. Over five years, it shrinks to 31%, and over three years, it is just 18%, according to**Morningstar Inc.**

Making things even harder for those trying to pick active managers is that just 9% of large-cap managers outperformed the S&P 500 over all three time spans.

The inconsistency of actively managed returns is what prompted the review by CalPERS.

As P&I reported: “CalPERS investment consultant Allan Emkin told the investment committee that at any given time, around a quarter of external managers will be outperforming their benchmarks, but he said the question is whether those managers that are doing well are canceled out by other managers that are underperforming.”

'EVALUATING MANAGERS'

Rick Ferri, founder of Portfolio Solutions LLC, ran into the same problem while he was working at a brokerage firm early in his career.

“I spent a lot of time and money evaluating managers,” he said.

“It was a revolving door for most of them,” Mr. Ferri said. “You can't win unless you get very, very lucky.”

Mr. Ferri now runs an all-index portfolio for his clients' equity exposure. On the bond side, he still favors active management — when it is cheap.

“Sometimes that's the best way to get market representation,” Mr. Ferri said.

The $39.2 billion Vanguard Intermediate-Term Tax-Free Bond Fund (VWITX) owns 3,854 bonds and charges 20 basis points, for example. The $3.6 billion iShares S&P National AMT-Free Municipal Bond ETF (MUB), the largest municipal bond ETF, holds 2,196 bonds and charges 25 basis points.

CalPERS is expected to decide the fate of its active managers in about five months. At this point, it looks as though it could go either way.

Chief operating investment officer Janine Guilot told P&I that 27 preliminary interviews of CalPERS staff members, board members, money managers and external consultants showed a “wide disparity of views” on active management.

Mr. McIsaac isn't ready to write off active management altogether.

“There will come a period of time when active managers will do much better,” he said.

That is, if good active management can be found at a low cost.

“It's hard to find both,” Mr. McIsaac said.

The market ultimately will have the biggest say in the future of active management, Mr. Bobroff said.

“Is this the end of a trend?” he asked. “It depends where the market is going over the next five years. Your guess is as good as mine.”

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