Small investors' move to 'passive' stock funds becomes a stampede

Over the last few years investors have poured record sums into passive stock funds, including those that replicate the Standard & Poor's index of 500 big-name U.S. stocks. Above, the floor of the New York Stock Exchange last month. (Getty Images)

Tom Petruno

LOS ANGELES TIMES **4/13/17**

Whenever small investors have been pitched a financial product that promised to enrich them with little effort or expense, historically the smart response has been to turn and run.

There has been one shining exception over the last four decades: low-cost mutual funds that aim to do nothing more, or less, than generate the average return of the entire stock market, or a specific market sector.

These "passively managed" or "index" funds have delivered as they said they would — and have shamed many "actively managed" U.S. stock funds, the majority of which over the long run have failed to exceed or match the average market return after deducting their fees.

Passive funds were relatively slow to catch on with individual investors in the 1980s and '90s. But over the last few years, Americans have poured record sums into the funds, including those that replicate the Standard & Poor's index of 500 big-name U.S. stocks. In that same period, investors have yanked record amounts from actively managed funds.

The result: Conventional U.S. stock mutual funds that invest passively now hold $1.9 trillion in assets, triple what they had in 2007. Add in the $1.7 trillion in U.S. equity exchange-traded funds, another type of index portfolio, and the total in passive funds accounts for 42% of all U.S. stock fund assets — up dramatically from 24% in 2010 and just 12% in 2000.

The explosion in passive funds' growth has left some of its devotees almost giddy.

Mark Hebner, who founded Index Fund Advisors in 1999, has made it his life's work to persuade people "what a fool's errand it is to try and beat the market." His Irvine company devises portfolios of passive stock funds for investors.

"Imagine my joy after 18 years at this," Hebner said. "It's finally sinking in with investors." His firm directs $3 billion in client funds.

At index fund titan Vanguard Group, total investor assets topped $4 trillion this year. Investors sent Vanguard's stock and bond funds an astounding $277 billion in new money in 2016. Most of its major fund rivals, including Fidelity Investments, Franklin Templeton Investments and the American Funds, saw net cash outflows as more investors sold than bought.

"Passive investing has seized the high ground, and it ain't giving it back," said Russ Kinnel, director of fund manager research at Morningstar Inc. in Chicago.

But even as small investors reap the many benefits of indexing, the passive-fund juggernaut also is raising concerns. Some experts liken it to a new market bubble as investors pile on with U.S. stocks at record highs after an eight-year bull run.

Much of the migration to index funds has been led by fee-only investment advisors, such as Hebner, who have embraced the idea of using low-cost passive funds to build diversified portfolios for individual investors. The rise of automated "robo-advisors" also has boosted demand for passive funds.

The advisor's investing style then becomes the "active" portfolio component, said Brian Reid, chief economist at the Investment Company Institute, mutual funds' trade group. How advisors pick index funds, and how often they alter the lineup of funds, will determine the portfolio's performance — for better or worse.

"It's a shift from the mutual fund providing the active management to the advisor providing it," Reid said.

The passive fund industry is betting that many more individuals will be drawn to that simplicity in portfolio construction. That might include Jim Quinn, a 76-year-old Palos Verde Estates retiree who has long owned well-regarded actively managed funds including Oakmark Select and Dodge & Cox Stock.

Would he consider moving everything to passive funds? "I've definitely thought about it," Quinn said. His current stock strategy is "dabbling here and there," he said.

But as the passive fund business balloons, it raises risks for the stock market that many small investors may not understand:

• **Passive investing makes the market less efficient — meaning, less "honest."** This concern is rooted in the very nature of passive funds: They buy stocks without considering the fundamentals.

In classic financial theory the market sets the "correct" price for a stock at any given moment based on the buy and sell decisions of informed investors. But when money flows into conventional index funds, they must buy the stocks in their index regardless of the underlying companies' financial health or outlook.

"Of course it distorts things," said Rob Arnott, who has pioneered a fundamentals-based form of indexing at Research Affiliates in Newport Beach. "Price discovery," the term for research that gets to the heart of a stock's relative value, "is diminished as fewer and fewer investors care about the fundamentals," Arnott said.

Yet he and other experts doubt that the rise of passive investing has seriously undermined market efficiency. The U.S. stock market is worth $26 trillion, but only about 25% of that is owned by passive funds, Vanguard estimates. The rest is controlled by active managers at mutual funds, pension funds, banks and other institutions, or is in the hands of individuals.

Joseph Brennan, global head of equity indexing at Vanguard, said “there may be a theoretical limit” to how large passive investing can get before compromising the free-market pricing mechanism. “But it’s probably closer to 80%,” he said. “It’s certainly well north of 50%.”

• **Passive investing inflates already-hot market sectors**. Most major stock indexes, including the S&P 500, are “capitalization weighted.” So the greater a stock’s market value, the more influence it has over the index’s moves. It also means that, as cash pours into index funds, the funds must invest most heavily in the stocks that already are the market’s largest names.

Today that means shares of tech stars such as Amazon, Apple and Facebook.

Index giants such as Vanguard don’t dispute this. But they argue that the point of passive investing is to own the market as is — not to judge it.

Inigo Fraser-Jenkins, a market strategist at investment firm Sanford C. Bernstein, caused a stir on Wall Street last year after writing a report calling passive investing “worse than Marxism” because it can steer investment away from important new ideas.

Arnott in 2005 developed his own style of indexing to compete with capitalization-weighted indexing. Known as RAFI, for Research Affiliates Fundamental Index, the system weights stocks by certain standards, such as companies’ sales growth and net worth. The goal: Keep the index focused on stocks that are judged to be values.

“To succeed in investing you have to buy what others fear and loathe,” Arnott said. The idea behind RAFI “is to trade against the market's biggest bets” to focus on what’s unloved. About $130 billion in fund assets index using RAFI rules.

Hebner’s company invests via the mutual funds of Dimensional Fund Advisors, an index fund manager that also favors the idea of trying to tilt toward value. Dimensional oversees about $460 billion in assets.

But to index purists, any system that is biased against the market’s biggest companies is trying to beat the market — and therefore isn’t passive.

• **Passive investing could be a bubble that will eventually pop**. This is perhaps index investors’ worst fear, though not necessarily Wall Street’s fear: Could the recent torrent of cash into index funds suddenly reverse?

Index investing has been an increasingly easy choice since 2009, because most major stock gauges have been rising with few interruptions. If many investors who have poured into index funds have been chasing performance, what will they do if the big gains stop?

Passive investing is marketed as a long-term, buy-and-hold strategy. But Hebner acknowledges that “it's so hard to get people to let go of the gambling mentality.” If their investments turn cold, it’s human nature for people to want to shift money to what’s hot.

Because the S&P 500 has posted such strong returns since 2009, and because stock prices relative to earnings are historically very high, many Wall Street pros expect the index to struggle over the next five to 10 years.

That could give actively managed funds a chance to woo investors back, if the funds can show better stock-picking prowess. “There is a natural equilibrium,” said Salim Ramji, head of U.S. wealth advisory at fund titan BlackRock Inc. “As more money moves to indexing, there should be more ways for active managers to add value” and beat indexes.

Dan Wiener, head of Newton, Mass.-based Adviser Investments, which manages $4 billion in mutual fund accounts for clients, said that “any time you have losses or low returns in the indexes, people are going to start looking at active.”

The next severe bear market will test new index investors’ pain threshold, Wiener said. He notes that the S&P 500 lost nearly 57% in the 2007-09 bear market, and index fund managers didn’t intervene to lessen the decline — because that isn’t their job. They expected investors to ride it out.

It’s a reminder, Wiener said, that “if you think indexing is a panacea, you’ve got another thing coming.”

Outlook grows dimmer for stock-picking fund managers

The Wall Street sign near the New York Stock Exchange. (Bryan R. Smith / AFP/Getty Images)

Tom Petruno

Today’s infants may gasp in wonder 20 years from now at tales of how humans once were trusted to drive cars. They may also be shocked that humans once were trusted to pick stocks for investment portfolios.

The soaring popularity of “index” or “passive” mutual funds in the last few years has dealt another blow to the ranks of traditional “actively managed” funds — the ones with human portfolio managers who are supposed to ferret out the best stocks and beat the market average return.

ADVERTISING

Despite the roaring bull market since 2009, the number of actively managed U.S. stock funds has shrunk from 3,466 in 2006 to 2,957 now, according to the Investment Company Institute, mutual funds’ trade group.

Charles Ellis, one of the best-known chroniclers of the investment management business, believes that this is the beginning of the end for active management. His 2016 book, “The Index Revolution: Why Investors Should Join It Now,” pulled no punches.

The long-term performance numbers are sobering enough. In the 15 years through 2016, the vast majority of actively managed funds that own a diversified portfolio of U.S. big-company stocks trailed the indexes they were supposed to beat. Just 25.3% of those funds gained more than their index, according to Morningstar Inc.

The winning percentages were similarly low for funds that own shares of mid-size U.S. companies (20.5%) and for funds investing in emerging-markets stocks (36.4%), among others.

But Ellis says it's worse than it looks, in part because the data don't capture funds that performed so poorly they were liquidated before even 10 years had passed.

In an op-ed he wrote in the Financial Times in January, Ellis said the reality was stark: "Actively managed funds are not beating the market. The market is beating them." The industry's future, he said, "is grim."

Why, then, do investors still keep $4.8 trillion in actively managed U.S. stock mutual funds, and many trillions more in actively managed stock, bond and hedge funds worldwide?

Inertia clearly plays a large role: It's easier for investors to stay where they are than move their money. Also, selling an investment that isn't in a tax-sheltered account can create what Wall Street likes to call a "tax event" (i.e., a taxable capital gain).

But active management survives for other reasons. For one, performance data don't adjust for risk. If a fund manager earned slightly less than the fund's index over a given period, but took much less risk of loss with the portfolio, investors may judge that shortfall to be well worth it.

When you consider the risk factor, "the conventional wisdom that active always underperforms passive is not true," said Brian Reid, chief economist at the Investment Company Institute.

Marlene and Werner Roestel, retirees who live in Granada Hills, have built an investment nest egg made up of active and passive mutual funds, exchange-traded funds and individual stocks including Boeing Co. and healthcare firm Becton Dickinson & Co.

"We're not really trying to beat the market," Marlene Roestel said. Instead, she said, the couple wants to be very diversified, minimize their risk of loss and earn cash dividends. They also enjoy the challenge of investing.

"It's kind of a hobby for us," Roestel said. "When you're retired you have more time for this."

Basic human nature also keeps some investors actively engaged in the market rather than handing their money to passive funds.

"I like thinking I can beat them," said lifelong Los Angeles resident Jeff Bruce, 74, who owns stocks including Apple Inc., Home Depot Inc. and American Water Works Co.

"I try to be buy-and-hold," Bruce said. But his attitude is "they're not necessarily mistakes just because they lose."

Even Vanguard Group, the premier index mutual fund manager, contends that there's a place for active funds in investors' portfolios. In fact, of Vanguard's $4 trillion in fund assets, about one-third are in actively managed funds.

"We're strong believers in active," said Joseph Brennan, Vanguard's global head of equity indexing. "What we believe is you should be implementing them both, active and passive, with low-cost funds."

One of the active-management industry's most famed funds is the $52-billion-asset Vanguard Primecap fund, based in Pasadena. The portfolio, which primarily invests in well-known stocks including Microsoft Corp., Southwest Airlines Co. and Wells Fargo & Co., has trounced the Standard & Poor's 500 index over the last 15 years, gaining 9.7% a year to the S&P index's 7.2%.

Part of that success is owed to Primecap's low management fee. A fund's management fee is taken directly from the portfolio each year to pay the managers, thereby reducing investors' return. Primecap's fee is 0.39% of fund assets. By contrast, investors pay about twice that much at the average U.S. stock fund.

Matthew Raab, a 28-year-old accountant in Los Angeles, has accumulated some cash savings that he's hoping to invest in the next year. He is aware of the arguments for low-cost passive funds, but said he's open-minded to active funds despite their higher fees. "It's not a deterrent for me if they're earning their keep" with better performance, he said.

But Raab's generation lacks high-profile stock pickers such as Peter Lynch, who scored spectacular gains managing Fidelity's Magellan Fund in the 1980s. He achieved almost rock star status with baby boomers in that era, and persuaded many small investors that the market could be beaten.

Today, one easy way for actively managed funds to boost their investors' returns would be to slash management fees. Relentless competition drove down the average U.S. active-fund fee incurred by investors from 1.01% in 2000 to 0.78% by 2015, according to a Morningstar study. But the average passive fund fee also has fallen, from 0.26% to a mere 0.18%.

The result is a 0.60-percentage-point fee gap between the two. On every $1 trillion in active-fund assets, that amounts to $6 billion in income to fund managers.

The industry says it is working to cut fees faster, particularly on fund shares in retirement savings accounts.

But Russ Kinnel, director of fund manager research at Morningstar in Chicago, said fund companies overall "are wary of starting a price war. They don't want to call attention to themselves."

Particularly in the case of fund companies that are publicly traded, and have their own shareholders to serve, "they don't want to be cutting fees before they absolutely have to," Kinnel said.

But if cash continues to pour out of active funds, that tipping point may be fast approaching.