

Passive: Less aggressive?

– Alex Harvey, CFA

Warren Buffett described Jack Bogle, the founder of Vanguard who died last week, as the man who had the largest impact on investors' wealth yet charged nothing for it. Bogle's vision was simple: by definition, the average active manager must produce a lower return than whole of market net of fees. This principle, and the low fees that typically accompany index investing, spurred a trend that started in the mid 1970s and continues apace today. This law of average returns is crucial to the whole motivation behind passive investing, but there comes a tipping point when the active opportunity becomes compelling.

Over time, passive investing arguably rewards mediocre corporate performance as capital is allocated by market capitalisation, not by the return generated on the invested capital. The more this style dominates, the more inefficient the stock market becomes as an allocator of capital and the greater the opportunity becomes to generate above market returns by exploiting this inefficiency. While assets continue to accumulate into passive investment funds, the inefficiency will trump the opportunity.

The Financial Times estimates that in 2017 the share of passive equity assets had more than doubled over the prior decade to nearly 35%, with regional differences masking 40% penetration in the US and over 60% in Japan where the Bank of Japan is the largest exchange traded fund (ETF) buyer in the market.¹ For a long time the laggard, bond funds are now a rapidly growing part of the passive market as the higher costs associated with trading bonds favour ownership through passive vehicles like ETFs.

2018 was the year that saw the first headline zero cost tracker fund emerge, launched by Fidelity in the US,

achieved partly by using a proprietary index rather than licensing a 3rd party provider. This highlights an important consideration in all passive strategies; the index. Passive assets need indexes to track and the withdrawal of assets from active strategies has coincided with the proliferation of indexes. The Index Industry association estimates 70 times as many stock market indices as quotes stocks in the world¹. Ironically, we are moving towards the point where investors will need to make active index decisions, about their passive investments.

It is misleading to laud passive outperformance of active over the last 10 years as we have lived through one of the longest bull markets on record. Indeed, the rotation from active to passive is likely a contributory factor to strong index performance and underperformance of value stocks. Dispersion of returns (or lack of it) is symptomatic of this swelling part of the market as the tide of passive cash lifts all boats. BlackRock (owner of iShares) and Vanguard each took in over \$1bn a day in 2017. Over the last year however inflows slowed by 66% and 38% respectively². Could the tide now be turning?

Passive strategies play an increasingly important role in financial markets today and the trend towards more active corporate engagement (by passive industry participants) attests to this. They provide a means to access market exposure (beta) and bring down costs. But they are only part of the solution. At Momentum we carefully blend active, passive and smart beta solutions into our multi asset portfolio allocations to solve for a range of required outcomes. We are cognisant that investing styles evolve, but it is important to remember that in the same way cost does not equal value, passive does not solve for all.

¹ FT Trading Room "Number of stock indices at 3m dwarfs tally of quoted companies". 22nd January 2018

² FTfm: "BlackRock, Vanguard suffer asset declines". 21st January 2019

The Marketplace

- 2018 German growth at slowest pace in five years
- UK Parliament rejected PM May's EU divorce deal by 230 votes
- Brent Crude continued its strong run, rallying 3.7%, ending the week at \$62.7 per barrel
- Gold ended the week 0.6% lower at 1282.7 per ounce

Market Focus

US

- The federal government shutdown continued into its fourth week amid a stalemate over funding for President Trump's border wall
- US equities recorded their fourth consecutive week of positive returns, rising 2.9% on the week, and building on their strong start to 2019.

UK

- On Tuesday, Prime Minister May's Brexit deal was overwhelmingly rejected by 230 votes – the largest defeat for a sitting government in history. MPs voted by 432 votes to 202 to reject the deal. In response, the PM immediately agreed to cross-party talks to determine a way forward on Brexit, while UK opposition leader Jeremy Corbyn tabled a no-confidence vote against Theresa May's government. The PM won her confidence vote by 325 to 306 and has until Monday 21st January to present a new plan
- UK equities rose 0.8% on the week and Sterling rose 0.7% on a trade weighted basis .

Europe

- In Europe the main data focus was Germany's 2018 GDP reading which was in line with expectations at 1.5%, down from 2.2% in 2017. It was the weakest growth rate in five years
- Industrial production in the Euro Area fell 1.7% month-on-month in November of 2018 versus expectations of -1.5%. Year-on-year industrial production fell by 3.3% in November and is the biggest annual fall since November 2012
- Continental European equities advanced 2.2% in line with global markets this week.

Rest of The World

- Chinese exports fell 4.4% in December compared with the year before, while imports fell 7.6%. Car sales fell for the first time since 1990, down 4.1% from the previous year to 23.8 million in 2018
- On Wednesday, China's central bank injected a record \$83 billion into the country's financial system, the highest ever recorded for a single day, in an effort to boost liquidity
- Despite the weak trade data, Chinese equities advanced 1.4% on the week amid positive trade talks between the US and China
- Japan's consumer price inflation eased to 0.3% year-on-year in December 2018 from 0.8% in November and in line with market expectations. It was the lowest inflation rate since October 2017, mainly due to declines in the cost of food, housing and transport
- Japanese equities rose 1.8% on the week
- Turkish equities surged 7.4% - one of the market's strongest weeks in several years. The market benefited from an improved tone among world markets, as well as, the Central Bank of Turkey holding its key interest rate, the one-week repo auction rate, at 24%.

Asset Class/Region	Currency	Currency returns			
		Week ending 18 Jan. 2019	Month to date	YTD 2019	12 months
Developed Market Equities					
United States	USD	2.9%	6.6%	6.6%	-3.2%
United Kingdom	GBP	0.8%	3.7%	3.7%	-5.7%
Continental Europe	EUR	2.2%	5.6%	5.6%	-8.6%
Japan	JPY	1.8%	4.3%	4.3%	-15.2%
Asia Pacific (ex Japan)	USD	1.6%	4.6%	4.6%	-13.9%
Australia	AUD	1.8%	4.1%	4.1%	2.0%
Global	USD	2.2%	6.3%	6.3%	-7.1%
Emerging markets equities					
Emerging Europe	USD	2.7%	8.3%	8.3%	-12.2%
Emerging Asia	USD	1.7%	4.1%	4.1%	-16.7%
Emerging Latin America	USD	1.8%	11.9%	11.9%	-3.7%
BRICs	USD	2.0%	6.5%	6.5%	-14.6%
MENA countries	USD	1.7%	5.3%	5.3%	6.7%
South Africa	USD	0.6%	7.1%	7.1%	-22.4%
India	USD	-0.2%	-1.8%	-1.8%	-8.2%
Global emerging markets	USD	1.7%	5.4%	5.4%	-15.0%
Bonds					
US Treasuries	USD	-0.4%	-0.4%	-0.4%	1.3%
US Treasuries (inflation protected)	USD	-0.5%	0.2%	0.2%	-0.7%
US Corporate (investment grade)	USD	0.1%	0.6%	0.6%	-1.1%
US High Yield	USD	0.7%	3.8%	3.8%	1.0%
UK Gilts	GBP	-0.4%	-0.5%	-0.5%	1.1%
UK Corporate (investment grade)	GBP	0.2%	0.2%	0.2%	-1.8%
Euro Government Bonds	EUR	0.3%	0.3%	0.3%	1.3%
Euro Corporate (investment grade)	EUR	0.3%	0.2%	0.2%	-1.1%
Euro High Yield	EUR	0.7%	1.6%	1.6%	-2.8%
Japanese Government	JPY	0.0%	0.2%	0.2%	1.6%
Australian Government	AUD	-0.1%	0.0%	0.0%	6.0%
Global Government Bonds	USD	-0.6%	-0.1%	-0.1%	-1.3%
Global Bonds	USD	-0.4%	0.0%	0.0%	-1.7%
Global Convertible Bonds	USD	0.0%	2.4%	2.4%	-5.4%
Emerging Market Bonds	USD	0.9%	3.2%	3.2%	-2.1%

Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	2.1%	6.5%	6.5%	6.2%
Australian Property Securities	AUD	0.5%	4.3%	4.3%	5.2%
Asia Property Securities	USD	1.2%	5.7%	5.7%	-5.1%
Global Property Securities	USD	1.4%	5.8%	5.8%	-1.1%
Currencies					
Euro	USD	-1.1%	-0.8%	-0.8%	-7.1%
UK Pound Sterling	USD	0.2%	1.1%	1.1%	-7.1%
Japanese Yen	USD	-1.3%	-0.2%	-0.2%	1.0%
Australian Dollar	USD	-0.5%	1.8%	1.8%	-10.3%
South African Rand	USD	-0.1%	3.9%	3.9%	-12.3%
Swiss Franc	USD	-1.3%	-1.3%	-1.3%	-3.6%
Chinese Yuan	USD	-0.2%	1.5%	1.5%	-5.3%
Commodities & Alternatives					
Commodities	USD	2.1%	7.2%	7.2%	-4.4%
Agricultural Commodities	USD	0.6%	2.2%	2.2%	-4.6%
Oil	USD	3.7%	16.5%	16.5%	-9.5%
Gold	USD	-0.6%	0.1%	0.1%	-3.5%
Hedge funds	USD	0.2%	1.7%	1.7%	-6.9%

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