An index isn’t a fiduciary — and six other concerns about the push for passive

“IT IS DIFFICULT TO GET A MAN TO UNDERSTAND SOMETHING, WHEN HIS SALARY DEPENDS UPON HIS NOT UNDERSTANDING IT.” This quote from Upton Sinclair might resonate with proponents of passive investing who find themselves faced with another argument for active management, written by a commentator whose salary is indeed paid for by active management. But mindful of the immense challenges faced by institutional investors today and inspired by my firsthand observation of highly skilled asset managers over more than 20 years, I think it is worth sharing several reasons why I believe active management has a meaningful role to play in investors’ portfolios, even (and perhaps especially) in a world where passive investing may too. I frame this argument through seven concerns that I believe investors must address as they consider how passive and active strategies can help them achieve their investment objectives.

Seven concerns about the push for passive

1. An index isn’t a fiduciary
2. The “zero-sum” argument is overblown
3. Cap-weighted indices may not be aligned with investors’ most important goals
4. Passive performance has created a false sense of security
5. There is a reasonable case for market inefficiency
6. An above-average manager isn’t so hard to find
7. The backdrop for active managers and the investors they serve may be improving

Any views expressed here are those of the author as of the date of publication, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients.
1. An index isn’t a fiduciary

Passive investments based on market-cap-weighted indices have an undeniable appeal. Their costs are low and they are scalable, with the ability, in theory, to hold an infinite amount of capital while preserving the appropriate relative weights between stocks and with limited rebalancing or trading needed over time. (Note that I consider any portfolio that deviates from market-cap weighting to be “active” even if it is based on an “index.” For more on this point, see the sidebar at left.)

But an index is not a fiduciary. An index is defined by a set of rules (or, in some instances, by a committee) that has no specific reference to the interests or constraints of any investor. It defines an opportunity set without asking whether that opportunity set is aligned with the investor’s objective. To put it more bluntly, every investor has a reason for investing, but that reason is not the focus of those who create and manage cap-weighted indices.

A fiduciary, by contrast, is a person or organization that has two key responsibilities with respect to its clients: a duty of care, meaning the manager must know the client and offer the skill and care of a prudent adviser, and a duty of loyalty, meaning the manager must at all times put the client’s interests first. Historically, active management was primarily about meeting these fiduciary obligations. For decades before passive investment vehicles came into being, the role of an active manager (which is to say any manager) was to provide an investor with access to a particular market and, critically, to do so in a way that was aligned with the investor’s objectives. There was a clear focus on the interests of investors and on the suitability of the securities chosen, whether that meant seeking to protect the investor from market frenzies, overly speculative investments, or companies with poor management or corporate governance.

The now commonplace idea that active management is about beating a cap-weighted market index is a relatively new one that only came about once passive, cap-weighted strategies were broadly available and relatively mainstream. It is, in my view, an unfortunate idea for both investors and managers because it concentrates attention on a single quantitative measure that is apt to be misused. To understand whether a manager is acting as a good fiduciary requires judgment, nuance, and a keen understanding of portfolio holdings (as well as their rationale). It also requires recognition that the path to outperforming in the long run often entails some — and perhaps more than some — short-term disappointment (as we discuss on page 9). By contrast, to understand whether a manager is outperforming an index requires only simple math.

Investors contemplating passive strategies should therefore consider whether the index is sufficiently aligned with their objectives or whether a fiduciary can construct a portfolio that — after costs — will be better aligned. The notion of a “fiduciary” test for passive strategies may seem alien, but I think there is evidence that investors already recognize the importance of testing passive strategies against their objectives. We can see this in the way they apply the often-cited “zero-sum” argument for passive management.
2. The “zero-sum” argument is overblown

Proponents of passive make the case that investing is a zero-sum game, meaning that the cap-weighted index is the full investment set and for every investor who deviates from that set and outperforms it, someone else has to underperform it. Against this backdrop, attempting to outperform the index, after fees and costs, is viewed as futile — so passive is the logical approach.

In practice, however, investors are inconsistent in how they apply the belief in a zero-sum world. They tend to be comfortable applying it to a market such as large-cap US equities, but rarely to wider investment sets. For example, the current global market cap is roughly 40% equity and 60% fixed income (Figure 1). If the zero-sum argument holds true, then investors should accept that their portfolios will achieve the same return as that mix and not seek to do any better. But investors typically hold substantially more equity and less fixed income. Indeed, a 40% equity/60% fixed income mix would be the inverse of the 60% equity/40% fixed income paradigm that has guided investors for decades and, as indicated by surveys of institutional investors, continues to do so.

Why don’t investors use the 40%/60% mix that the zero-sum argument would suggest? It is simply not aligned with their objectives. Similarly, very few investors hold a global equity portfolio that is truly cap-weighted — there’s typically some home-country bias and perhaps some avoidance of certain countries (for example, some global portfolios have systematically underweighted Japan for long periods).

Figure 1
If it’s a zero-sum game, why don’t we all invest like this?

Global market capitalization

Equity
Fixed income


Faced with a passive approach that is not aligned with their goals, investors do not hesitate to deviate from market-cap weighting in the hope of achieving more favorable results, even if they know that for them to outperform this “benchmark,” someone else must underperform it. I believe investors should be equally open to deviating from other cap-weighted stock and bond indices, as these often may be poorly matched with their goals.
3. Cap-weighted indices may not be aligned with investors’ most important goals

Here are a few examples of what I consider to be “structural” misalignment, where the cap-weighted index holds meaningful exposures that may not be linked to an investor’s goals.

Emerging market indices may not deliver what investors are seeking. Ask investors why they allocate to emerging markets and they will often cite the growth opportunities expected to develop as these countries undergo a fundamental shift in the size and composition of their economies. But the composition of emerging market indices is often dominated by “first generation” companies that were able to grow and profit when these countries were in the early stages of development (e.g., natural resource companies and exporters). Companies with the potential to benefit from future domestic economic development (e.g., health care and consumer services) are often only a small minority of index holdings.

Investors have a shrinking tolerance for drawdowns. Many pension funds, endowments, and foundations — having lived through the global financial crisis (GFC) — have come to realize that they cannot withstand another downside event of similar magnitude, especially if the rebound from a future crisis is not as strong as the most recent experience. For these investors, the very structure of a cap-weighted index — which does not take into account diversification or risk — may be poorly aligned with their risk tolerance.

Fixed income indices serve no master. Fixed income indices — both single country and global — have the largest weightings in the most indebted issuers. No thought is given to the need to diversify across sectors or to assess an issuer’s credit risk. (For more on the limitations of passive fixed income strategies, see our paper, “Five reasons to be active in fixed income.”)

Moreover, the composition of these indices can change wildly. It seems reasonable that an investor might seek a US bond portfolio that is allocated in thirds to government loans, agencies, and corporates. But the ratio of these three sectors in the Bloomberg Barclays Aggregate Index is quite variable over time, and it is far from clear that the drivers of those variations are relevant to a typical investor.

This variability of passive indices extends beyond fixed income. Consider Figure 2, which shows some of the remarkable changes in the S&P 500 over the past quarter century. Would an investor who seeks diversified exposure to major sectors of the US economy really want to see some exposures in the portfolio double while others are halved?

Two notable periods of extreme change in index composition come from the TMT bubble of the late 1990s and the Japan bubble a decade earlier.
At the end of the day, I believe that most fixed income indices are not well aligned with investor objectives.

“I believe that passive investors, who simply go along for the ride as bubbles like these inflate and pop, are in a sense taking on riskier market bets than the “old-school” fiduciary active managers described earlier, who in their day likely created portfolios that were more stable and balanced than today’s passive strategies.

**Figure 2**

*Just along for the ride?*

Percentage change in S&P 500 weight since 1990

Source: FactSet. The sector weights are based on GICS Economic Sector groupings over the period 1 January 1990 – 31 December 2019. The sectors are reweighted to exclude the “unassigned” portion of the S&P 500 to maintain consistency over time with changing GICS sectors. The change in sector weights is calculated monthly and reflects the percentage change from the base date of 1 January 1990.

At the end of the day, I believe that most fixed income indices are not well aligned with investor objectives. Broad global indices of stocks and bonds may also be poorly aligned, especially when substantial shifts in country weights occur over time for reasons that may have little to do with investment fundamentals. Single-country indices can be poorly aligned if they offer insufficient diversification; for example, if they are dominated by one or two sectors — or worse, one or two companies (e.g., at its peak in 2000, the Canadian telecom company Nortel accounted for more than a third of the value of the TSE 300 Index). As a result, investors should consider whether active approaches may be better aligned over time with their fundamental investment objectives.

Cap-weighted indices may also be misaligned with investor objectives because of distortions between true market-cap weighting and the free float-weighted calculations used by major index providers. Float-weighted calculations will tend to underweight companies where the management, board, and employees have large ownership stakes, even though management of these companies may be better-aligned with investor objectives.
4. Passive performance has created a false sense of security

I have not yet addressed a very important source of potential misalignment, which may be paramount over the next decade. I believe investors often take it for granted that passive index-based equity strategies (as a “return-seeking” asset) will meet their return objectives over the medium to long term. But there is a very real chance that cap-weighted portfolios won’t deliver the low double-digit (or even high single-digit) returns that investors may need in the coming years. Historically, there have been numerous examples of equity markets — including Germany, Japan, France, and even the US — experiencing decade-long periods of flat returns (Figure 3). The pain those weak returns have inflicted on institutional portfolios has been substantial.

Figure 3
Countries that have experienced extended periods of low returns

<table>
<thead>
<tr>
<th>Country</th>
<th>Time period</th>
<th>% of times &lt; 0%</th>
<th>% of times &lt; 5%</th>
<th>Worst return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany (DAX)</td>
<td>1900 – 2019</td>
<td>17%</td>
<td>41%</td>
<td>-32%</td>
</tr>
<tr>
<td>Japan (TOPIX)</td>
<td>1920 – 2019</td>
<td>14%</td>
<td>29%</td>
<td>-7%</td>
</tr>
<tr>
<td>United States (S&amp;P 500)</td>
<td>1900 – 2019</td>
<td>5%</td>
<td>20%</td>
<td>-5%</td>
</tr>
<tr>
<td>France (CAC)</td>
<td>1900 – 2019</td>
<td>4%</td>
<td>21%</td>
<td>-5%</td>
</tr>
<tr>
<td>United Kingdom (FTSE)</td>
<td>1900 – 2019</td>
<td>1%</td>
<td>23%</td>
<td>-1%</td>
</tr>
</tbody>
</table>

Sources: Global Financial Data, Datastream, Wellington Management | Not representative of an actual account or investment. Index returns do not reflect the impact of fees or expenses. PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN loose VALUE.

Looking forward, a 2019 survey of investment consultants and asset managers found an average expected return of 6% – 7% over the next 10 years for US equities and non-US developed market equities.2 That would not be sufficient to allow many public pensions, endowments, and foundations to hit their return targets, given their diversified portfolios.

Of course, investors contemplating equity market performance in the dozen years since the GFC couldn’t be blamed for assuming that stocks will be an evergreen source of growth. During this time, passive strategies, particularly US equity strategies, did remarkably well across a range of objectives. Whether the objective was growth, income, growth and income, or low volatility, passive S&P 500 exposure delivered strong results, often both in absolute terms and relative to available alternatives.

But the post-GFC period has been very unusual. For the 10 years from March 2009 (the trough of the GFC) through February 2019, the 10-year Sharpe ratio for the S&P 500 was 1.25, extraordinarily high relative to the long-term average of 0.22 (1960 – 2019). It seems reasonable to conclude that this performance is not sustainable and the market is likely to deliver a lower risk-adjusted return over the long term, so investors should not be cavalier about assuming that passive investing in large-cap US stocks will let them achieve their goals.

2Source: Horizon Actuarial Services, Survey of Capital Market Expectations, August 2019
In itself, this caution doesn’t make a compelling argument for active management. Active managers won’t be any better aligned with investor objectives unless they can outperform passive indices. Fortunately, I think there is reason to believe they can.

5. There is a reasonable case for market inefficiency

Passive investing is premised on the belief that markets are reasonably efficient — that is, that prices are accurate reflections of all available information about a given security. But this assumes an inherent rationality in the behavior of market participants, and there are a number of compelling arguments, both intuitive and academic, about the forces of irrationality to which markets are subject.

One challenge is that “all available information” often means a flood of news, analysis, and commentary that can be overwhelming and perhaps misleading. Behavioral economics offers reasons why market participants may not only be distracted by this onslaught but also focus on the wrong information and extrapolate it beyond its useful time horizon (Figure 4). Multiply this irrationality by millions of market participants looking at thousands of securities and you get a recipe for noise, inefficiency, and opportunity.

![Figure 4](image.jpg)

**Behavioral explanations for irrational investment decisions**

- **Overconfidence** — People assume outcomes will fall in a range that is narrower than the true range of possibilities.
- **Optimism** — People have unrealistically optimistic views of their prospects.
- **Representativeness** — People draw conclusions based on skewed or insufficient evidence.
- **Belief perseverance** — People tend to stick to their initial conclusions for too long.
- **Anchoring** — People form estimates with too much weight on an initial, sometimes arbitrary, value.
- **Availability** — People give too much weight to recent or easily remembered events.
- **Loss aversion** — People display a strong preference for avoiding losses over experiencing gains, even in situations where they end up with the same net wealth either way.

Source: Barberis and Thaler, “A Survey of Behavioral Finance”

Benjamin Graham, pioneer of value investing, offered a compelling analogy: “In the short run, the market is a voting machine, but in the long run, it is a weighing machine.” Put another way, in the short run, the market focuses more on popularity and less on fundamentals. But in the long run, the market is more likely to weigh the substance of a company, and the results — the cash flows — ultimately win out. This suggests an ongoing opportunity for active managers who can tune out the noise, fight the crowd, resist the easy solution, and see through to the long-term drivers of a stock’s performance (particularly in a world where short-term investment horizons have reached new extremes, with high-frequency traders measuring holding periods in milliseconds).

In the end, my experience leads me to the strongly held belief that even in robust, transparent markets, such as large-cap US equities (see shaded box on next page), and with all available information in hand, the average or marginal investor may be making irrational decisions. And those decisions create opportunities that active managers can exploit.
6. An above-average manager isn’t so hard to find

As passive proponents often argue, just because markets are inefficient, it does not automatically follow that managers or their investors can profit from that inefficiency. To be successful in markets where passive indices are aligned with investor goals, active managers need to be able to add value with some consistency. In this case, relative to everyone who deviates from the cap-weighted index, managers must be “above average.”

From an investor’s point of view, the goal is to find an above-average active manager — and indeed one who is far enough above average to compensate for higher fees and transaction costs than passive investing. The good news is that if you accept the argument that there is some degree of market inefficiency, it becomes easier to see how a skilled manager can achieve above-average results.

Active management in US large cap: The ultimate contrarian call?

Investors interested in passive often start with their large-cap US equity exposure, with the view that it is likely to be one of the most efficient markets and therefore among the hardest to beat. There is some academic and intuitive evidence to support that view. The large-cap US equity market has better corporate disclosure standards, greater analyst coverage, and broader sector and company exposure than many markets. Low transaction costs arguably draw in investors, so there may be more competition for attractive opportunities than in thinner, less liquid markets. The historical evidence suggests that net alpha from active management has been lower in the US large-cap space than elsewhere.³

And yet, the large-cap US market has two characteristics that investors should consider before opting to go passive. First, it is noisy, with companies widely covered not just by analysts but also by the media. The noise-to-signal ratio — which I believe favors thoughtful active investors — may be higher than it is anywhere else. Second, and perhaps more important, the US market is large. It is still the largest market by dollar value in the world, and by a healthy margin. For US investors, who typically have some degree of home bias, going passive in large-cap US may mean going passive in more than half of their equity portfolio. Depending on return objectives, this may not be the optimal approach.

Investors may want to consider more global approaches if they aren’t comfortable with active portfolios focused on the US large-cap market but are reluctant to forgo active management of such a substantial component of their portfolios. The academic data on global equities has been more favorable, and some of the issues related to crowding and efficiency may be less prominent when portfolio decisions are made on a global scale. Even if US companies are well-covered, for example, there may be meaningfully less research (and capital) focused on how these companies stack up relative to their global peers. Although global investing has attracted substantial capital in recent years, I believe it remains underinvested as a category.

³See, for example, Joseph Gerakos, Juhani Linnainmaa, Adair Morse, “Asset managers: Institutional performance and smart betas,” Chicago Booth Research Paper, No. 16-02, November 2016
Ultimately, the value of any security is the discounted value of its future cash flows, and the price of any security is the market’s assessment of those future cash flows and of an appropriate discount rate. Managers must find securities about which the market’s assessment is wrong; but with the benefit of the behavioral economics lessons noted earlier, we can draw some reasonable conclusions about mistakes that market participants seem to make over and over again.

- Markets can become too pessimistic when companies and countries go through tough times and overconfident when times are good. (This creates opportunities for value managers.)
- Markets may have trouble pricing in the impact of companies and countries going through transformational change and growing at rates that are unprecedented or hard to fathom. (This creates opportunities for growth managers.)
- Markets have historically (although perhaps not recently) shied away from boring, more predictable companies whose results are likely to be more stable over time than those of their peers. (This creates opportunities for quality and low-volatility managers.)

Notably, these inefficiencies have been observed across asset classes, geographies, and various historical periods. Investors seeking “above-average” performance must find managers who can identify and take advantage of these and similar opportunities. Amid hundreds of managers competing for time, attention, and capital, investors should pursue managers with:

- A strong investment philosophy that explains why they expect to outperform over time and why the market gives them an opportunity to do so
- A clear investment process that maps the decisions they make as investors to this philosophy
- A mindset geared to the long term, since much of the inefficiency in markets likely comes from the average investor’s mindset and being too anchored to the short term
- A business model that is stable and resilient enough to weather periods of underperformance, since even top-performing managers will underperform at some point in the cycle (Figure 5)
- A fee structure that is aligned with expected returns from the strategy and the client’s interests

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Not every manager will be above average, but I am optimistic about institutional investors’ ability to “separate the wheat from the chaff.” I believe the tests discussed on page 9 — combined with some considerations in the next section — can help identify managers more likely to succeed in achieving investors’ objectives. As Figure 6 shows, even without distinguishing between the stronger and weaker institutional managers, the broad cross-section of active managers has historically outperformed benchmarks. The data in Figure 6 is gross of fees and the net-of-fee numbers would be less favorable. But, as we discuss in the next section, this 10-year period has been among the most challenging for active management. In the long run, I would expect active managers to enjoy a more favorable backdrop for generating returns.

In short, finding an above-average active manager isn’t easy, but given the inefficiencies described earlier, it may not be as hard as many believe. Moreover, the search may be getting easier as the environment for active management appears to be shifting.
7. The backdrop for active managers and the investors they serve may be improving

While the post-GFC conditions have been extremely challenging for active managers, there is reason to believe the tide is beginning to turn. Perhaps more important, I think institutional investors are better positioned today to benefit from active management than at any time in perhaps the last two decades.

Many commentators have linked the poor performance of active strategies in recent years to the fact that markets have often been dominated by macroeconomic developments rather than company-specific events. Most active equity managers are less well equipped for this type of environment, as their skill lies in conducting company-specific analysis and identifying individual stocks that are mispriced by the market.

We find evidence of the challenging macro-driven environment in market correlation and dispersion data. Historically, the “sweet spot” for active equity managers comes when correlation is low (stocks are not all moving in the same direction) and dispersion is high (the range of return outcomes is wide). We’ve seen just the opposite since the GFC. But there are initial signs that this is changing and further progress could come if volatility — which has been unusually low since the GFC and has likely suppressed equity dispersion — begins to normalize.

More broadly, it appears that there is a cyclical pattern of active and passive performance, with strong periods for passive strategies often followed by strong periods for active managers (Figure 7). The causes of this cyclicity may not be perfectly predictable, but the pattern suggests that the extreme environments for active and passive performance often prove short-lived. Indeed, potential passive investors should ask themselves whether we are witnessing an instance of performance chasing, where at this point in the cycle, passive is outperforming not because of a fundamental long-term advantage, but simply because that is what people are buying. As money shifts to passive, the flow of funds out of active strategies seeking to exploit the inefficiencies described earlier has likely been a headwind to recent active manager performance. But this outflow has potentially made inefficiencies more pervasive and the prospective future returns to active management more attractive. The idea of a “passive bubble” may seem far-fetched, but the cycles of passive and active management have historically been self-reinforcing until they are not — and often the fallout has not been pretty.

The declining investment in sell-side research, which may be a second-order effect of the flow of capital to passive, could add to market inefficiency — and many expect the EU’s Markets in Financial Instruments Directive II (MiFID II) to further reduce sell-side research in coming years.

In addition to changes that may make active management more likely to succeed in the years ahead, I see improvement and innovation in the way investors use active management. Investors are learning from past mistakes that they — and others — have made. For example, investors and investment consultants are increasingly aware of what I sometimes call the “hamster wheel” effect that comes from hiring managers in the wake of a period of very strong performance, and firing them when their subsequent performance fails to live up to what was often an unusually strong period. If the investor then replaces that manager with the current “hot” manager,
the cycle can repeat endlessly. To avoid the hamster wheel, investors could consider shying away from hiring managers with the strongest near-term track record or even taking a contrarian approach of adding exposure to struggling managers and reducing exposure to top performers. For many though, it may be more realistic to create a structured and deliberate process that will foster patience — with a formerly high-performing manager who might struggle out of the gate, for example.

Investors are also seeking to diversify more effectively across active managers and strategies. One tool that may help here is factor analysis. Most active strategies have some kind of factor “footprint” that can be understood and assessed through a combination of qualitative and quantitative analysis. Investors who understand the factor exposures of their managers — and of their portfolio in aggregate — can make better, more informed choices, both strategically and tactically.

**Active or passive: What now?**

For many, the idea of an “active versus passive” debate misses the mark, as both approaches may have a role to play. The question is how investors allocate between the two.

Where cap-weighted indices are, by their very structure, poorly aligned with investor goals, the decision to go active is a relatively easy one. Investors should follow the fiduciary model and seek a manager who can create a portfolio that is better aligned with their objectives, assuming this can be done at a reasonable cost.

Where cap-weighted indices are better-aligned with investor goals, the objective of active management is more about beating a benchmark, and investors must assess the inefficiency of the market and their own ability to identify an above-average manager. Going active undoubtedly means taking on an additional measure of risk and trading a known fee for an unknown outcome, but as noted, I am optimistic about the opportunities available to institutional investors today.

I would offer two final notes of caution, in both cases harking back to the perils of putting too much focus on recent events. First, investors should not assume the broad equity indices will be aligned with their goals — in particular, that they will deliver sufficient returns in the next 5 – 10 years. Second, investors should consider whether some of the recent outperformance of passive strategies is cyclical/self-reinforcing and will diminish over time.

In today’s world, I think there is a compelling case for more active management, not less. This is all the more true for contrarian investors, who will likely want to move in the opposite direction of the massive sums that have moved to passive. That said, there is no right or wrong answer here — and the author cannot claim to be an unbiased observer. But perhaps Figure 8 can offer investors some guidance as they work their way through these decisions.
In today’s world, I think there is a compelling case for more active management, not less.

As noted earlier, passive management has an undeniable appeal. But I believe that even the most ardent proponents of passive management should consider the concerns raised in this paper before embracing passive management. And I think most investors should grapple with these considerations as they determine the most prudent course for their portfolios. Passive investing may be the answer for some and an answer for many — but all investors will make more educated choices having thought through these issues.

**Getting the most from active management**

Given the seven concerns addressed in this paper, here are a few suggestions for investors pursuing active management:

- **Find managers whose investment objectives are better aligned with your goals** than an index. Today, that may mean strategies we call “cash-flow compounders,” which seek to invest in companies with strong free cash flows relative to their market price, or it may mean downside-oriented strategies whose managers can potentially outperform when markets are weak, including but not limited to low-volatility strategies.

- **Identify managers who may be more likely to succeed** because of their philosophy, process, and investment culture. Page 9 has more detail on key attributes to look for.

- **Incentivize managers appropriately** with a fair fee schedule (neither too high nor too low) and — just as important — the mutual expectation of a long-term relationship.

- **Take a contrarian approach to manager selection**, adding to managers when their performance has been weak and culling exposure after a long period of outperformance.