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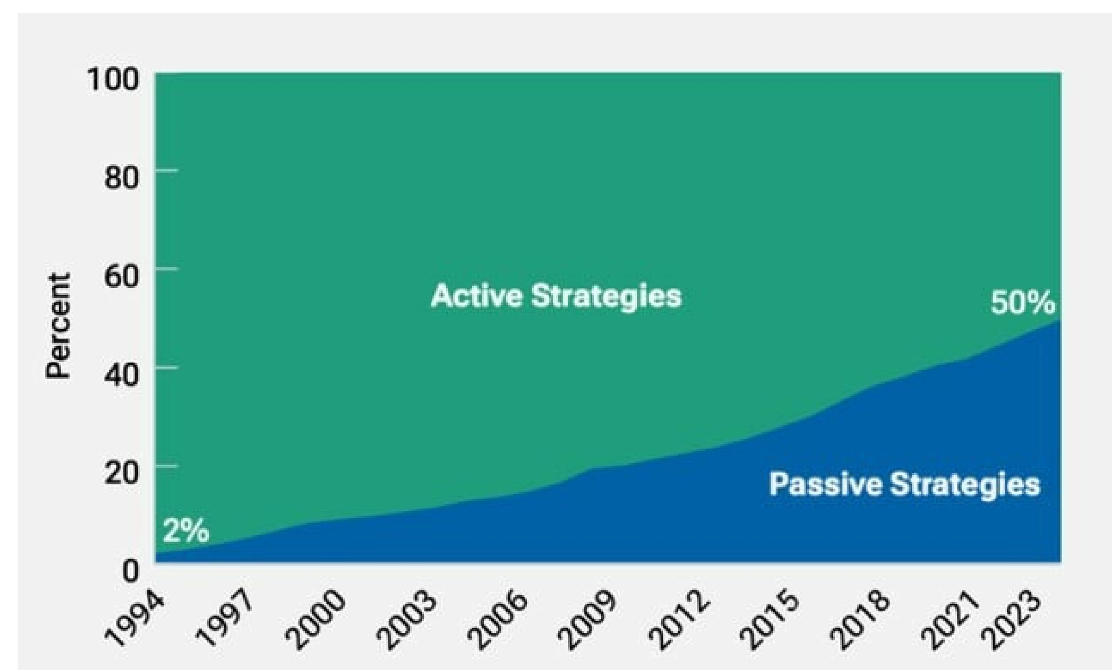
The Rise of Passive Investing

Passive investment funds are designed to replicate the performance of a specific index or benchmark, such as the S&P500. Unlike actively managed funds, where managers select specific investments, passive funds aim to mirror the index's performance by holding the same components in similar proportions.

Passive funds were pioneered by the late John Bogle, founder of the Vanguard Group, in the mid-1970s. Today, large firms such as Blackrock (iShares), Vanguard and State Street dominate the passive investment space. The accompanying chart illustrates their exponential growth. This vast scale and increasing dominance have raised concerns among many active fund managers.

Passive Market Share has Grown Rapidly

Chart 1: Half the U.S. Mutual Fund and ETF Market is Now in Passive Strategies



Source/s: Morningstar & T Rowe Price (31 December 2023)

Criticism and Concerns

1) Inefficient Capital Allocation

In 2016, fund manager Bernstein provocatively compared passive investing to Marxism in their report titled "*The Silent Road to Serfdom: Why Passive Investing is Worse Than Marxism*." They argued that passive investing leads to inefficient capital allocation because it does not discriminate based on individual stock valuations.

2) Market Bubbles

A 2017 report from US-based value manager, Brandes posed the question of whether a passive investment bubble is forming. The concern is that passive funds invest relative to index weights, pushing up the prices of the largest index constituents disproportionately.

3) Concentration and Volatility

Passive investing tends to concentrate investments in large-cap stocks, which can lead to greater market volatility. Michael Burry, the hedge fund manager, known for his successful bet against the 2008 housing bubble, warned in 2019 that the lack of price discovery in passive investing could lead to price bubbles.

4) Market Distortion

Early this year, hedge fund manager David Einhorn , stated in an interview with Bloomberg that passive investing has fundamentally broken markets. He argued that passive flows inflate the prices of certain stocks, while redemptions from active managers depress the prices of value stocks, exacerbating the valuation discrepancy.

Value Investing Perspective

A recent quarterly report from value manager GMO acknowledges the significant changes passive investing has brought to the investment landscape but argues that it **does not fundamentally change the long-term drivers of stock returns, namely future cash flows and prices paid for those cash flows**. They assert that active managers can capitalise on mispricing caused by passive flows. While the timing of these returns may be in question due to the scale of passive flows, ultimately, the math will play out.

Conclusion

The rise of passive strategies has undeniably altered market dynamics and the process of price discovery. Major firms like BlackRock and Vanguard have thrived in this environment, while consumer investors have benefited from lower costs and broader market access. The risks and possible market distortions will continue to be debated among financial experts. Our view is to embrace both passive and active investment solutions when constructing portfolios.

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