The Shift From Active to Passive Investing: Potential Risks to Financial Stability?

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Abstract

The past couple of decades have seen a significant shift from active to passive investment strategies. We examine how this shift affects financial stability through its impacts on: (i) funds' liquidity and redemption risks, (ii) asset-market volatility, (iii) asset-management industry concentration, and (iv) comovement of asset returns and liquidity. Overall, the shift appears to be increasing some risks and reducing others. Some passive strategies amplify market volatility, and the shift has increased industry concentration, but it has diminished some liquidity and redemption risks. Finally, evidence is mixed on the links between indexing and comovement of asset returns and liquidity.

Keywords: Asset Management, Passive Investing, Index Investing, Indexing, Mutual Fund, Exchange-Traded Fund, Leveraged and Inverse Exchange-Traded Products, Financial Stability, Systemic Risk, Market Volatility, Inclusion Effects

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