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Perspectives

The Shift from Active to Passive Investing: Risks to Financial Stability?

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Notes

[1] Moreover, the creation of some strategies, such as "factor" and "smart-beta" strategies, requires "active" choices about which factors to track and how to track them, bu ... ample, BlackRo ... ome indexing

[2] The en ... ve and passive

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[4] These ... mberg, Mornings ... SIFMA).

[5] On the underperformance of actively managed funds, see, for example, Johnson and Bryan (2017).

[6] Some of the commentary on the active-to-passive shift has been quite colorful. For example, a 2016 AllianceBernstein note was titled “The Silent Road to Serfdom: Why Passive Investing Is Worse than Marxism.”

[7] The Investment Company Act of 1940 requires that MFs and SEC-registered ETFs offer daily redemptions.

[8] As of March 2020, 97% of ETF assets were in passive funds (see Figure 1; source: Morningstar).

[9] Among the ETFs that do offer cash redemptions, only about one-third of AUM (2.6% of the aggregate ETF total) is in funds that offer only cash redemptions; the rest is in funds that also offer in-kind redemptions. (We are grateful to our colleague Tugkan Tuzun for providing these figures, which are based on data from IHS Markit and his analysis.) ETFs that allow both cash and in-kind redemptions may revert to using only in-kind redemptions when liquidity is scarce (see, for example, Dietrich 2013).

[10] Our discussion of ETF liquidity transformation focuses on primary-market activity, where financial institutions that serve as “authorized participants” (APs) interact with
the fund to create and redeem ETF shares. For other ETF investors, such as retail
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2,085 in November 2019 to 2,079 in March 2020 (source: Investment Company Institute; see www.ici.org/research/stats/etf).

[12] Amid the financial turmoil associated with the coronavirus outbreak, MFs experienced significant outflows in March 2020. At the time of this writing, it may be too early to assess coronavirus effects on active and passive fund flows, but the experience is mixed so far. In the domestic equity sector, active funds had larger outflows in March (0.7%) than passive funds (0.4% inflows), but in the corporate bond sector, outflows were larger for passive funds (6.9%) than for active ones (2.5%).

[13] The full set of explanatory variables for the regressions reported in columns 1, 2, 4, and 5 of Table 1 includes three lags of net flows, contemporaneous returns, and three lags of net returns. We winsorized net flows of the funds at the 1% level before aggregating. In our analysis, net flows are expressed as percentages of lagged aggregate assets.

[14] Table 1 reports a selection of the estimated coefficients. Not reported in the table are coefficients on lagged flow, which generally are statistically significant, and those for the second and third lags of returns, which are not.

[15] The interdependence between flows and returns complicates interpretation of the estimated coefficients on contemporaneous returns. Although endogeneity confounds
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possibility that aggregate flows respond differently to positive and negative performance but found little evidence of any difference.

[19] To be sure, these strategies are not typical passive strategies, because they require high-frequency rebalancing and often the use of derivatives—features that distinguish them from most plain-vanilla ETFs and index funds. Nonetheless, we characterize these strategies as “passive” because their daily rebalancing is rule based rather than based on an active decision.

[20] For example, when stock prices rise, a leveraged equity ETF’s net assets increase in even greater proportion, and the LETF must purchase stock or futures (or otherwise increase exposure) to keep its leverage on target. Meanwhile, an inverse ETF’s net assets fall, but its short position rises in value, so the fund must reduce the size of its short position (that is, increase net exposure) to stay on target.

[21] Some nonregistered vehicles, such as leveraged and inverse exchange-traded notes, mimic the investment objectives of LETFs and also trade in the same direction as recent market moves. However, unlike their investment fund counterparts, these notes are debt obligations of financial firms rather than passive investment vehicles.

[22] For an LETF with daily return r and leverage L, same-day rebalancing flows, as a fraction of assets, must be $(L^2 - L)r$. Hence, for an LETF that promises either double the
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[24] See www.sec.gov/news/press/2010/2010-45.htm.

[25] As we have noted, in September 2019, the SEC finalized a rule that streamlined the process of bringing ETFs to market. In November 2019, the SEC issued a proposed rule on the use of derivatives by mutual funds and ETFs (see www.sec.gov/rules/proposed/2019/34-87607.pdf). The proposal would lift the 2010 moratorium on the creation of new LETFs and allow sponsors of LETFs to use the new streamlined registration process set forth in the September 2019 ETF rule.

[26] The HHI is one of the most commonly used measures for market concentration. A rule of thumb is to regard HHI values of 2,500 or higher as indicating high concentration.

[27] The high concentration for passive funds is also reflected in the combined market share of the 10 largest passive-fund asset managers, which has averaged about 90% of total passive-fund industry AUM since 2004.

[28] Similarly, in 2014, outflows from PIMCO funds triggered by Bill Gross's departure appear to have benefited other asset managers.

[29] To be sure, index-inclusion effects may arise from activities other than passive (index) investing. For example, as we have noted, some nominally active investors engage ... ion effects. Further ... es to choose from; th ... ion stock indexes.

[30] Simila ... ce Shleifer (1986) a ... y (1996, 2002), L ... Petajisto (201 ... rchers have found ... ple, Madhava ... on effects for the R ... ion effects for the T ... nan, and Lee (2005) f ...

[31] Some ... ond mutual funds, which presumably would purchase the downgraded bonds. This offset could be

sizable, given that mutual funds own a larger share of high-yield corporate bonds outstanding than investment-grade corporate bonds (Barclays 2018). However, outflows from high-yield bond funds, which might accompany widespread bond downgrades, would reduce those funds' bond-purchasing capacity.

[32] In the section "Growth of Specialized Passive Investment Strategies That Amplify Volatility," we discussed specialized passive investing strategies that can amplify volatility by forcing portfolio managers to trade in the same direction as same-day market moves, even in the absence of investor flows. Here, we discuss the broader effects of ETF ownership on asset prices and liquidity, whether those effects are due to trading by portfolio managers or investors.

[33] See Sullivan and Xiong (2012) for detailed analysis of the vulnerabilities associated with excess comovement. Parsley and Popper (2020) focused on a related question: They studied how financial stability (among other factors) affects stock return comovement in a cross section of countries.

[34] See, for example, Vijh (1994); Barberis, Shleifer, and Wurgler (2005); and Sullivan and Xiong (2012).