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Perspectives

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







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Abstract

The past two decades have seen a significant shift from active to passive investment strategies. This shift has had significant impacts on (1) funds management and liquidity. Some pa... and others. Some pa... industry... ence on the... xed.

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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, but once rules are set, the strategy is executed passively (see, for example, BlackRock 2017). In addition, “active” decisions are needed to implement some indexing strategies, particularly for bonds.

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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 investors, sales and purchases of ETF shares are secondary-market transactions with similar investors (not with the ETF itself) executed on stock exchanges. A fund’s

liquidity transformation is less relevant for these transactions, which do not pressure the ETF about concerns about co-ordinated selling, which can allow wider price discounts. We discuss the implications of these concerns in [Comove](#).

¹¹ In [allowing](#) new ETFs by (see [www.sec.gov](#)) size regulation of ETFs (see [ETF growth](#), although the effect, from



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 inference about causality between contemporaneous flows and performance, the coefficient on contemporaneous returns is still quite relevant to financial stability. Fund flows might be destabilizing whether flows cause returns or vice versa, so the significance of the coefficient on contemporaneous returns is important for financial stability.

¹⁶ The significance of the coefficient on contemporaneous returns in [Table 2](#) shows that passive funds are more likely to experience outflows in the sample period.

¹⁷ More specifically, the coefficient on contemporaneous returns for the passive-fund sector is positive and significant.

¹⁸ The literature on the relationship between flows and returns is important. For example, Chen, Guo, and Wang (2019) find that the relationship between flows and returns is nonlinear and time-varying.



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 return of an index ($L = 2$) or the inverse of its return ($L = -1$), a 1% return on the underlying index would require same-day rebalancing flows equal to 2% of assets. In comparison, empirical analyses of the flow-performance relationship for mutual funds typically

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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 in closet indexing, and this activity likely contributes to index-inclusion effects. Further complicating matters is the fact that investors have so many indexes to choose from; the Index Industry Association reports that there are more than 3 million stock indexes.

³⁰ Similar to the findings of Shleifer (1986) and others (1996, 2002), L... Petajisto (2011) and others have found... Mad... on effects for the R... ion effects for the T... man, and Lee (2005) f...

³¹ Some... and 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).

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