

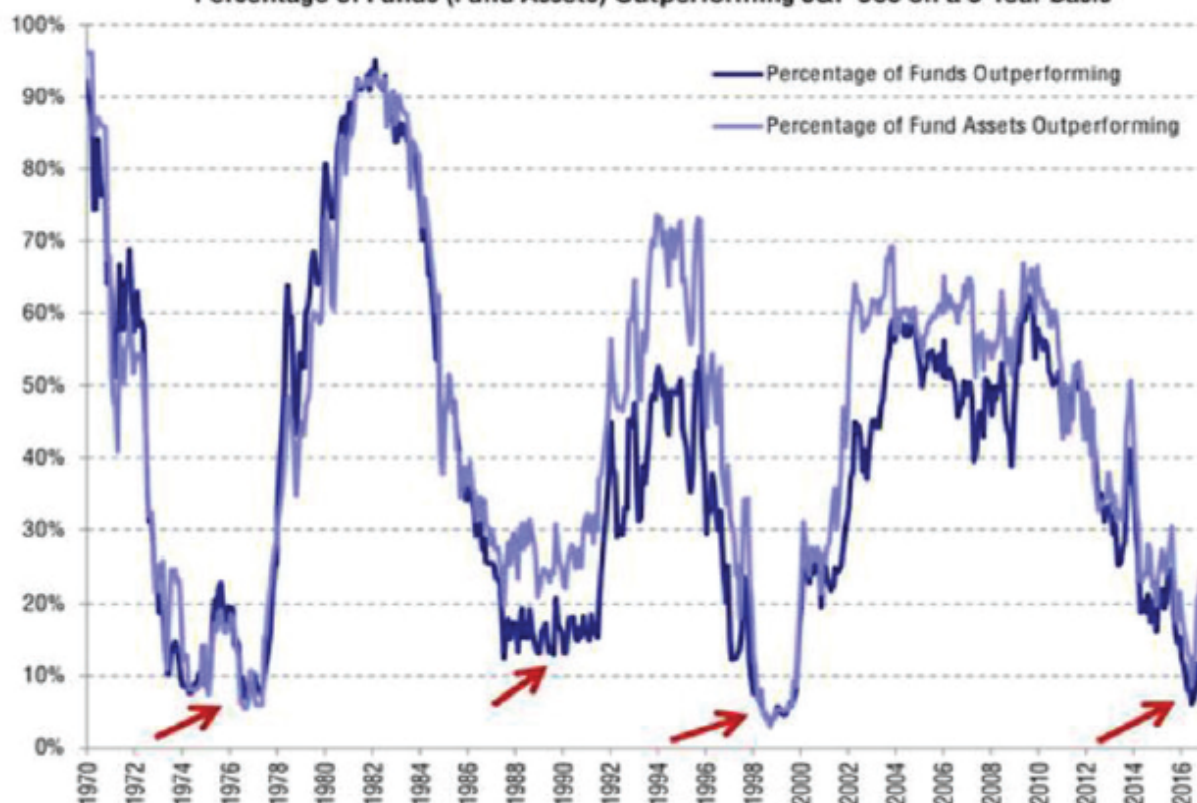


Investor preferences shift between active and passive investing in a cyclical manner. Periods where the market has a strong tailwind of momentum behind it tend to attract a greater demand for passive strategies especially when that momentum carries on for a prolonged period of time. Alternatively, periods of market turbulence tend to swing sentiment back to active investing as a means of avoiding the risk of large losses. In the most recent bullish cycle the combination of market direction and the availability of index-friendly instruments like exchange-traded funds (ETFs) have resulted in an unprecedented shift towards passive strategies and securities. To clarify the difference between the two investment approaches, active investing seeks to outperform the market by beating a benchmark such as the Dow Jones Industrial Average or the Barclays Aggregate bond index. Passive investing on the other hand pursues a strategy that mimics a benchmark index and attempts to replicate its performance. It is a contrast that has been effectively described by Ed Easterling of Crestmont Research as rowing (*active*) versus sailing (*passive*). Active investors are engaged in constant evaluation of companies and their fundamentals as means of finding value investment opportunities while passive investors are at the grace (or mercy) of the winds of the market wherever they may blow. The graph below highlights the underperformance of active strategies versus the S&P 500 index in past years which further

explains the growing popularity of passive investing.

## We Have Been Here Before – Each Trough Has Been Followed by Recovery

Percentage of Funds (Fund Assets) Outperforming S&P 500 on a 5-Year Basis



Note: For details, see Fig. 1 on page 2. Source: CRSP, Bloomberg, Robert Shiller data, Instinet research

This article is primarily focused on fixed-income passive investing, however, many of the issues brought up in this article can be applied to most asset class ETFs and securities that allow ease of passive investing.

## How Passive Investing Works

The mechanics of passive investing in the stock market are straight-forward. Select an equity index to which you would like to gain exposure, for example the S&P 500 or the MSCI China Index, and then buy the stocks in the proper amounts that are tracked in that index to replicate the performance. Done manually this can be a complex and cumbersome exercise especially when trying to replicate the index of a less-liquid market. As the market moves and the value of the securities underlying the index change, one must rebalance their holdings to remain aligned with the index. For a deeper understanding of the many factors that make replicating an index difficult please read our article [The Myths of Stocks for the Long Run Part V](#). The advent of index mutual funds and more recently exchange-traded funds handle the complexities of multiple holdings, weightings, and rebalancing allowing an investor to simply pay a small fee, buy a ticker and essentially own an index. An investor's ability to obtain general equity exposure or to build a portfolio with customized exposures has never been easier with the proliferation of ETFs. To offer some perspective about just how many ETFs are available, consider there are 38 ETFs available that are focused on U.S. energy stocks and over 132 ETFs hold Exxon Mobil (XOM) shares. Looking abroad to less liquid markets, one would find ten U.S. incorporated funds holding Indian stocks. The simplicity and customizability currently offered in the market is quite powerful.

## Bond Exposure

Traditionally, investors gained exposure to bonds through individual debt securities offered by brokers. Unlike stocks, the availability of most bonds, not including U.S. Treasuries, is dependent upon the inventory held by one's broker or their ability to source a bond from another broker. As such, finding a specific bond is more challenging and comes at a higher cost for an individual investor than buying an individual stock. A similar problem can emerge in the event an investor wants to sell a specific bond. This problem results in an indirect fee called the bid/offer spread and on occasion can cost the investor multiple percentage points. There are other considerations related to the dynamics of buying individual bonds versus acquiring bond exposure through a fund. These issues are well-articulated by Lance Roberts. The advent of index mutual funds and ETFs relieves much of the frustration and high costs of buying and selling specific bonds. The protocol described in selecting equity funds above is similar for bonds in that one can identify investment preferences in various major bond categories quite easily. The primary categories include:

- *Treasuries securities*
- *Mortgage-backed securities, asset-backed securities and collateralized debt obligations*
- *Agency bonds*
- *Municipal bonds*
- *Investment Grade corporate bonds*
- *High yield corporate bonds*
- *Emerging market bonds*
- *Developed nations sovereign bonds*

It is relatively easy, through these funds, to quickly gain exposure that tracks an index covering any variety of these options and specific sub-categories of these options.

## **Not As Advertised**

The flexibility and customizability offered through the world of index mutual funds and ETFs is remarkable. As such, there is a natural inclination by investors to assume that one will get precisely what has been advertised by these funds. However, confidence in that idea is easily challenged. Much of what has been developed over the past several years, especially with many ETFs, remains untested. The following are concerns investors should be aware of:

- *Tracking Error: ETF exposures to certain markets might not be precisely what the investor receives. For example, it has been documented that an investor who wishes to invest in an ETF for the equity market in Spain actually gets exposure to a variety of companies that although domiciled in Spain, produce most of their revenue outside that country. In that instance, and many others like it, an investor would not get the exposure to Spain he or she expects and may indeed be very disappointed in the ETFs tracking of the index for Spain.*
- *Optimization: The structure of index funds and ETFs are such that in many cases the fund managers are only able to establish positions in the underlying stocks or bonds of the indexes they track with some imprecision. This means they will use creative means of gaining desirable exposures and then gradually, if possible, reposition over time in order to more closely track the index. This tends to be a much bigger problem for bond funds. Since full replication of a bond index is generally not possible, bond funds rely on "optimizing" the portfolio in order to most effectively replicate the index.*

Bond offerings, like stocks, are finite so if the size of a fund grows as a percentage of the underlying index constituents, it will increasingly face the constraint of replicating the index and effectively mimicking index performance. •Optimization is imperfect so the ETF will suffer performance drift from the target index. Unfortunately, the flaws of replicating are often exaggerated during periods of market stress when investors' expectations are the highest.

- *Underlying Liquidity: Another related issue that arises with bond funds is that of establishing daily market value. The market price of some bonds held in a fund, especially those that are investing in less liquid markets, may not be readily available. If a bond fund holds securities that are illiquid, meaning they do not trade very often, then a realistic current price may be difficult to obtain. Many fixed income ETFs hold thousands of securities some of which do not trade daily or even weekly. This means that pricing is dependent upon estimates of the value on those bonds. These estimates of value may be derived from a third-party pricing service, surveys of bond market trading desks and internally generated models. Mis-pricing of securities is a known problem and one not typically considered until the fund is forced to sell. If the fund receives an inordinate number of redemption requests, what happens if they have bonds that do not trade very often but are nevertheless required to liquidate based upon investor requests? It is likely the sale price could vary, and sometimes significantly, from the last assumed price. Again this is most likely to occur at the wrong time for investors.*

These concerns have not yet emerged as a deterrent in the new age of passive investing popularity. We have only seen slight glimpses of what may be ahead in terms of challenges for the passive investor but it is fair to say this could be a major problem. Investors naturally assume they will be able to exit as easily as they entered these funds and at the stated value seen on their statements or trading screens. In a calm market the concerns are minor but there are serious questions about that reality should a wave of selling hit bond ETFs all at once. Although somewhat unique in its characteristics and certainly not a bond ETF, the recent debacle related to the inverse VIX ETF,



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Courtesy Bloomberg

## Risk Analysis ? The Benefit of Stress Testing

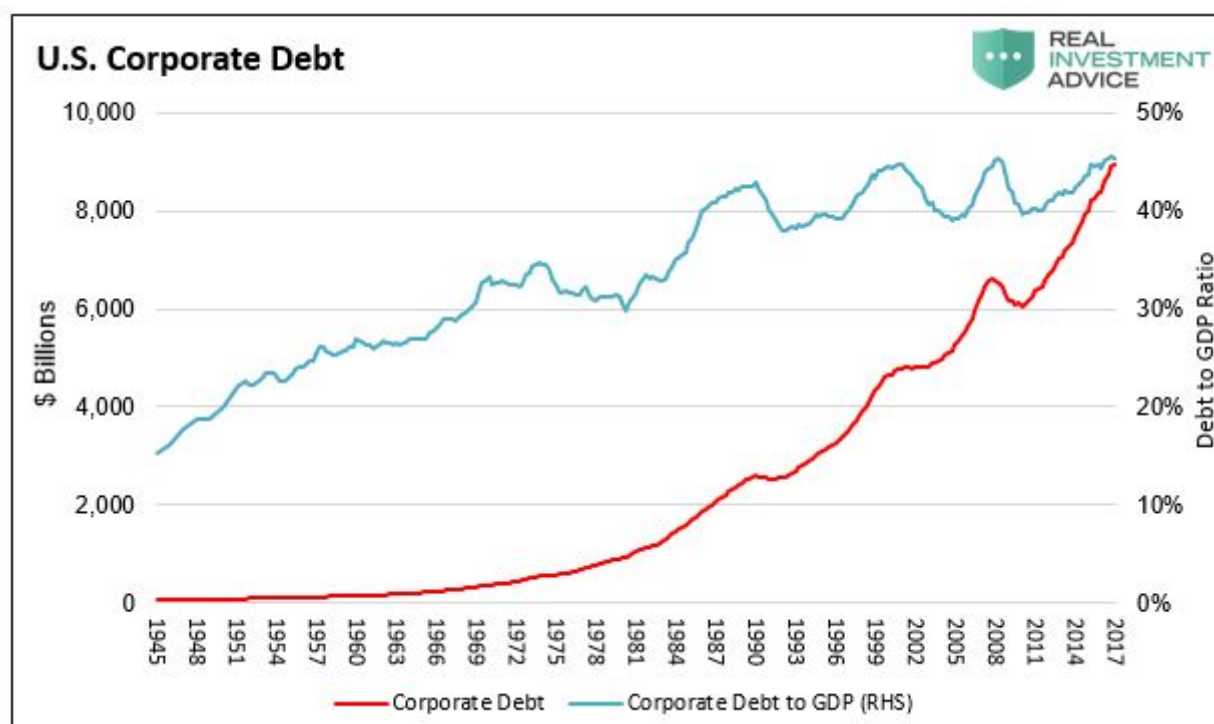
Given the importance of the issue of liquidity and what may transpire in an adverse scenario, we decided to look at the performance of a few ETFs and their related indices through the financial crisis as an indication of what a possible ?worst-case? scenario might hold. In doing so, we acknowledge no two historical events are the same but the analysis seems important to consider. From peak to trough, between April and November 2008, the Barclays Corporate Investment Grade index fell -10.8%. At the same time the LQD ETF which tracks that index fell -12.2%. The Barclays High Yield index fell -32.3%. In the same time frame the two high yield ETF alternatives,



HYG and JNK, fell -29.8% and -34.5% respectively. Today, these funds and others like them are much larger than they were in 2008. Furthermore, Bloomberg recently reported that many corporate debt funds are reaching further down the credit and liquidity spectrum in efforts to boost returns and some are even replacing high yield bond exposure with equities. As Lisa Abramowicz put it, *“While this is somewhat concerning, it’s also logical. Fund managers don’t see any imminent risks on the horizon that could shake markets, and clients will penalize lower returns.”* The remarkable thing about this observation is that paying too high a price for an asset is in itself an imminent risk. • One could convincingly argue that point as the most basic definition of risk. Nonetheless, it does indeed offer an accurate profile of the current character of the market. **Unlike actively managed funds where the manager evaluates individual securities, there is no price discovery mechanism for index funds and ETFs as their only consideration is whether or not they received a dollar to invest.**

## Summary

According to Benjamin Graham, this approach to putting money to work in the market defines the term speculation as it does not apply thorough analysis nor does it promise safety of principal and an adequate return. Although sympathetic to the idea that it is different this time as profit



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Courtesy St Louis Federal Reserve The cyclical nature of passive and active investing will continue to play out and that which is wildly popular today will eventually turn unpopular. **The hidden risks embedded in passive vehicles will emerge and those who so enjoyed the cheap grace of effortless and exceptional market gains will end up begging yet again for mercy amid the markets’ unforgiving justice.**