Hello passive, goodbye active: fund investors make the switch

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Investors in the US are increasingly dissatisfied with what they perceive as the poor value for money that active fund managers provide, and passive funds are the main beneficiaries of their switching.

In the past four years, assets held in passive investment funds have more than doubled, and the sector now accounts for $1.3tn of US investors' assets – just under one-tenth of the country's gross domestic product.

In fact, a recent poll carried out by Ignites of 1,001 fund management professionals – many of whom make their living promoting active products – showed that two-thirds have invested a sizeable amount of their personal savings in passive products. And 45 per cent said they have invested a "significant portion" in such funds. Only one in five claimed to avoid passive products altogether.

The findings highlight a trend that is not limited to employees of the financial services sector, but can be found across the US – from trust-fund fiduciaries to workers saving into their 401(k) retirement accounts.

The trend for savers to turn their backs on active funds and favour low-cost passive investment funds is mainly due to feelings of dissatisfaction with active fund managers.

Study after study has shown that only the very best active funds are capable of outperforming the market once fees are taken into account.

This is especially true in periods of weak or depressed markets, when the best active funds truly come into their own. They are able to limit investor losses, or even return a profit. But as the 2007-08 financial crisis showed, this is not the case for the majority of active managers.

A growing number of investors from across the wealth spectrum decided that they would rather put their chips in with funds that track the general direction of the market than take a bet that products they pay additional fees for will do any better.

As assets held within passive funds have swollen, the companies that manage the funds have been able to reduce the fees on them through economies of scale, thereby increasing the attraction for investors, and furthering their advantage on active funds.

Since 2004, assets held in passive funds – excluding exchange traded funds (ETFs) – as a proportion of all equity products increased from 12 per cent to 21 per cent, according to Lipper. Commentators have claimed that the chief reason for this increase is due to a feeling among investors that they no longer get value for money from active funds. Another reason for the success of passive products is the innovation that the sector has witnessed over the past two decades.

This year marks the 20th anniversary of the first ETF to launch in the US. The phenomenal success of these products continues to present a challenge to traditional mutual funds due to their low cost and their liquidity.

It has taken 20 years for ETFs to accumulate $1.5tn of assets, but iShares predict the products will reach $3.5tn by 2018.

The rise of ETFs has attracted interest, not least due to a fee war between the sector's main participants. This came to a head in September, when Charles Schwab cut expenses on its US Broad Market ETF from 6 basis points to 4bps. Investing $10,000 in the product will now cost each investor just $4 a year.

Critics claim that fee levels are reaching an unsustainable level, and that the asset managers who continuously slash their top-line charges are doing so only to attract headlines. The companies respond by saying they are able to reduce their costs because the assets they manage are rising.

In the 10 years leading up to 2012, the number of ETFs grew from 102 to 1,194, and new products were being brought to the market every week. In 2007 alone there were 270 products launched. Since then, growth has slowed slightly as a number of products that came to the market have closed. Last year, for example, 81 ETFs were liquidated. But since 2008, the Securities and Exchange Commission has allowed actively managed ETFs, which has led to a spate of launches.

There have also been significant developments in the technology and quantitative analysis that sit behind passive funds, leading to the growth of so-called "smart beta". Funds that use this style of investing are attempting to take a more analytical view of passive investing.

Typically, a passive fund will hold all stocks in a given index and invest more in certain companies according to their size. But critics claim it is flawed because the biggest companies do not necessarily grow the fastest.

Funds that promote themselves as smart beta therefore use other factors to determine how much they invest in different stocks. Some invest equally across all the companies, while others favour the least volatile stocks.

While these funds are generally more expensive than traditional passive funds, they typically carry much lower fees than active products. They are often marketed as funds that can outperform the market at much lower cost than active funds.

Another advantage that passive products have over their active counterparts is they do not attract the same feelings of blame from unfortunate investors.

In a recent study, Looking for Someone to Blame: Delegation, Cognitive Dissonance, and the Disposition Effect, academics at the University of Southern California found that investors are far more likely to blame and pull out of active funds following poor performance than with passive funds.

The research showed investors are more inclined to sell losing funds when they are actively managed than if they track an index. They are more accepting of upswings and downswings in the market when using passive funds than active.

The retirement sector is expected to be a growth area for passive funds, following the Department of Labor's rules that came into force last July, requiring more transparency in 401(k) plans over the investors' fees. Greater scrutiny of fund charges is likely to lead to cheaper passive funds.

As investors have increasingly rejected paying for indifferent service by active managers, passive funds have been the cheaper alternatives that have gleefully mopped up the assets.