MONEY
management executive

The Index Opportunity for Active Managers

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Low-cost, passive index funds continue to gain investor funds, challenging the industry's proponents of active management.

For the 33rd consecutive month through December, according to Bloomberg News and data from Morningstar, U.S. investors withdrew money from active managers. Last year, passively managed funds attracted almost $505 billion, compared with outflows of $340 billion from active funds.

That performance speaks to an opportunity for managers to embrace and tap into the transparency and cost benefits of rules-based investing, says Richard Redding, CEO of the Index Industry Association.

"What's happened is the power of indexing has forced any number of asset managers to either become or provide indexes so they can do ETF products," Redding says.

The association is still new, having been founded in 2012, but counts among its members all of the major indexes, including Nasdaq, MSCI, Barclays, FTSE Group and S& P Dow Jones.

Taking a historical approach, Redding spoke with Money Management Executive about how ETFs have impacted the fund industry and active managers.

Additionally, he discusses the competition index investing has fostered, and the role active managers still can play for investors.

An edited transcript of the conversation follows.

How does your organization view the growth of the index exchange industry in the U.S.?

One of the things that we found is product wrappers have helped increase people's awareness of indexes - so Bats, or New York Arca and Nadaq are all fighting for the listings of ETFs. What that's done is focus peoples' attention on how the underlying indexes are put together and compiled because, as you can see from the last couple of years, the vast amount of money flowing into index-based investments is outpacing the active funds for any number of reasons. If you look at some of the data, ETF assets globally have grown larger than hedge fund assets.

We actually don't take a position on individual products or where an individual product is listed, but we're actually happy to see competition for listings. We are happy to see the competition between all of the index providers and administrators at this point, because that's where a lot of the real innovations came from over the last few years.

The last thing European regulators wanted to do, which we warned them about, is to put forth regulation that would make it either too costly for people to do startups, or make it to the point where consolidation happens.

That's because there's been some really great ideas that have come out from even some of the smaller index providers in the last few years.

Competition between index exchanges has garnered attention even outside of the industry. Did you foresee the market becoming as competitive as it has?

Yes. But let's take a historical look at it. When the first kind of index funds came out there were all the stories written about how index funds were un-American, and who wants to be average? Even recently a big asset manager wrote about it akin to Marxism. So it's interesting to see that because indexes was a new and different way of looking at markets. The history was most indexes were created to be benchmarks, and it is still true that most indexes are benchmarks rather than investable products. What's happened is the power of indexing has forced any number of asset managers to either become or provide indexes so they can create ETF products.

You have had over time difficulties of managers in outperforming benchmarks. Some active managers have become very close to just being index funds in their composition. You've seen a dramatic change in the industry, whether it's just on the passive side of the business or now even on the active side, because of what indexes have done.

To me it's not a surprise because I've been around for so long, but I think a lot of people have awoken to it in the last few years. I think it's just testimony of a very long track record of performance and a lot of other benefits that people don't normally think about. A lot of investors just think about the fees, but a lot of it really has been the difficulty of active managers to outperform indexes over the long-term.

Will the negative industry connotations that currently come with index funds decrease over time with increased adoption of passive investing?

Think about the asset management in context to any other business. It got that press as un-American in the early days, and we don't think about it in these terms now, but it was probably pretty disruptive technology back then.

What has happened over time is some of the active managers wanting to use ETFs as a means for distribution, but what's required is they create an index. What's now probably a better term is rules-based investing. So they have to follow a set of rules-based criteria. That's one of the benefits of it that it has made the investments a lot more transparent.

The industry perspective is that while low cost passive is great for investors, these funds are hurting margins of many investment firms. What is your perspective on this?

What you see in the ETF field now is a lot of the active managers are getting into it, and I don't know if it's as much for issues related to fees as it has been about, "How do I get distribution?" I think one of the great things that happened out of the increase in use of ETFs and increase in the number of ETFs has been asset managers are looking at it to get into a distribution channel.

You have so many financial advisers now that have stopped individual stock picking and want to use indexes via ETFs. So how do you get into that chain?

Well that distribution chain probably does have lower fees than historical active funds that were out there, but the question is, do asset managers want to get into that distribution channel? For a lot of advisers it's not an and/or game anymore. It's, "How do I use the best of both worlds?"

Is there a case to be made that Vanguard is just getting too big?

I won't speak specifically to Vanguard, but I think the right way to look at this is, they may be very large in that space, but what's the total amount of assets that people invest in equities or fixed-income, or whatever asset classes belonging in a large mutual fund family like that?

Even though the numbers look very big, I mean what percentage of the assets do they really have in the United States that are put towards, say, equity and fixed income? It's actually a fairly low number.

The best thing that you see in that is there are multiple providers that look like that, that have tremendous amounts of money behind them.

So I find it difficult to go down that path and say that any one asset manager will ever be large enough to really be "too big" for the market.

Is there a challenge and concern, or worry, for the active manager if the passive trend continues?

I think, and as I said, I've been around long enough that I actually think there is a role for active management.

It's not an active/passive debate anymore about which is best. I think you need to start with the investor and what outcomes that he's looking for or she's looking for, and figure out what the best way to implement that strategy is. Because there are active managers that are truly talented and have over time outperformed the indexes consistently.

I don't think it's one or the other. I think the interesting thing is how people are talking about how a computer can select stocks better. I think this is where the whole idea of active and passive is getting blurred. I will say, for lack of a better term, that a lot of these ETFs out there that are very "active looking" their turnover and their methodology.

I think the right way to look at things is probably more rules-based versus something that's not. And what we all typically think of as kind of historically what active management is.

It's not just because you create something that's rules-based that it's going to do well or outperform.

I've been around long enough; I saw a lot of active managers in the '90s doing lots of work, gaining lots of money and their models were pretty interesting. The back tests worked very well. Then the unexpected happened.

[It's hard to prepare for such an event.] Do you give all your gains away in one event that should only happen once every hundred years?

A lot of that quantitative active management in the '90s went away because, you know, it wasn't rigorous enough to be able to handle shocks to the system.

No one knows if that's the future and if that works or, you know, because maybe someone does come up with a model that works through all markets, or adapts through all events. Who knows? I'm never one to say never. In a few years, maybe you can do all this with AI, who knows? It will be interesting to see what the test of time is.

It seems that the rise of robo advice has many drawing a line between an increase in popularity of index funds and an increased interest of digital advice. Do you have any thoughts on the twinning of those two trends?

[Our association] doesn't really have an opinion one way or another on what type of advice investors get.

The one thing that we care about is that however investors are getting their advice, the investors or the adviser actually understands what the risks are and the return outlooks look like.

Because things like smart beta have taken off, and one of the things we're going to be working on in the near future is doing some education around that, because we want people to understand in what markets smart beta will outperform or underperform in. And, are they using products like that to replace their core holdings or are they using it to complement their core holdings?

That's the kind of thing that I think makes it more difficult going forward; for advisers it's to really understand what the clients' needs are and figure out how to best implement it.

So, that could take a whole bunch of different forms, whether it's robo or still individuals.

But, that's not our issue. Our issue is that no matter how they do it, we have to understand what risks they're taking and the index methodology.