CITYWIRE

WM CEO warns that passives’ success carries risk

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We’ve been early adopters of passive instruments, going back to when we were first founded in Switzerland in 2009. At the time, only about 19% of the market share belonged to passive instruments – and that was in the US. Outside the US, the market share was in the lowsingle digits.

Since the beginning, we’ve applied a macro-top down approach to strategic asset allocation, focusing on the various risk factors and premia that are persistent, consistent, transparent and commercially available.

In 2009, this approach was a little more challenging, as there weren't many instruments to choose from – factors and premia were limited to value, size and profitability in various geographical markets.

Today, with a much larger range of factor ETFs available, there are many more to choose from, which we've incorporated into our portfolios.

However, not all passive instruments are built the same, nor are risk factors and premia always relatively attractive, so portfolio construction can quickly become a complex exercise.

Our process evaluates the long-term view of the factors and premia's position within the current macro cycle. It also considers their historical valuation, followed by an analysis of the valuation's strength relative to other risk premia.

Odd one out

We have always been a little more active on the fixed income allocation as passive instruments – historically at least – were market cap weighted to sovereign and large corporate securities dominated in USD, EUR, YEN and GBP securities. But that's not the whole debt market, and passives are supposed to capture the market, hence our active lean.

In 2011, I was invited to Scotland to meet some of the founding fathers of passive instruments and economic theory. I asked a simple question: passive works when you have active managers dominating market share – what happens when passive market share overtakes active?

Long story short, I was not invited to return the following year.

Yet here we are, and last month US passive equity instruments overtook active. I did not honestly think it would happen so soon despite passive

instruments' impressive growth in the past decade.

What does that mean for price discovery? Can mispriced securities now be more identifiable? Does it matter? Is the success of passive products in fact sowing the seeds of their own demise?

Nothing is free

There is a systemic concern that grows with the rise of passive products too. In general, passive instruments are believed to be low cost – and they are, from an expense-ratio perspective.

But there is no such thing as a free lunch, and passive fund managers are not relying on a single-digit basis point for their profits. In fact, they derive most of their profits from securities lending.

What this implies is that ETFs and passive instruments are not as cheap as you'd think – you pay for it by assuming counterparty risk.

This can lead to concerns of liquidity risk, as it is not unusual to see an ETF replicating an equity index experience 50% more volume than the underlying stocks themselves.

For this reason, despite being one of the very few, early adopters of passive instruments in Switzerland, we are now diversifying the manner in which we hold our securities.

We are diversifying investment structures, inherent imbedded leverage, counterparty risk and other architectural nuisances that get in the way of getting pure exposure to the markets.

We've been staunch and early investors in passive instruments, but we also know their weaknesses when the playing field has changed.

This article was written by Yann Rousset, CEO of Pilotage Private Wealth,

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