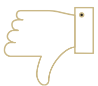
Top Risks to Monitor in Passive Investing

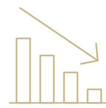
Passive strategies, that is buying just the index and never questioning the security's underlying value, have become increasingly dominant and are being regularly deployed in the portfolios of financial advisors today. The central motivation behind this strategy is the allure of low fees. However, passive investing is not without risks. In fact, many of these same risks are systematic to the passive strategy itself. By simply mimicking an index one is not making a call on the inherent value of a security in that index, the index itself, nor the macroeconomic underpinnings to the economy. Consider a few of the risks to monitor in passive investing:

Status Quo Bias: The passive investor can get a bit *too comfortable* with the current state of things. This tendency stems from the *false belief* that the good times, such as the current bull market, will last forever. Investing in passive equity strategies may have provided good returns in the past; however it would be a fallacy to assume the same will be true in the future.

Markets Becoming Too Expensive: In recent years, equity prices in the US have significantly expanded while corporate earnings have lagged behind. A savvy investor looks to *manage risk* and generate alpha by *evaluating* sectors in the market which are *overvalued*. Passive investors may fail take such evaluations into consideration.



Lack of Diversification: Many passive investment strategies will tend to mirror a broad market index. The risk here is that as the composition of that index changes over time, it may also become *less diversified*. This may result in exposure to *lower-quality* and *higher-risk* products.



Buying the Next Bubble: The reliance of passive investment strategies on broad market indices and ETFs effectively provides exposure to a range of securities. However, this strategy fails to take into consideration key factors such as *valuation* and the *quality* of a sector and/or company. Passive investors may be *overly invested* in expensive sectors.

Too Much Focus on Fees: A good *fiduciary* will look to protect the best interests of their clients. As such, advisors may choose to use passive funds since these carry the *lowest expenses*. This singular focus on fees inherently risks *missing out* on products with *greater added value* net-of-fees.

No ESG/SRI Integration: Socially responsible investment strategies are a vehicle for clients to *align their investments with their values*. Advisors often believe that ESG investing only serves the social good while ignoring the *financial benefits* of this strategy. Successful ESG integration could help mitigate risk in a portfolio and improve returns over time. Passive management is unlikely to incorporate ESG into their portfolio and, as such, forego the added benefits.

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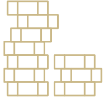
No Safety Net: The active investor will look for value by purchasing assets when they are *undervalued*. However, passive strategies fail to undertake such an assessment. The risk lies in failing to create a ***safety net*** in your portfolio for periods of *volatility*.



Passive Overcrowding: Passive strategies have grown hold an average of 17% of shares[1] in the S&P 500. The inherent nature of passive trading means this significant portion of the market is undergoing very *little turnover*. This may result in *artificial pricing* which hinges on the buying and selling of passive managers rather than the *fundamental characteristics* of the actual stocks. An active manager may be more readily equipped to identify said stocks.

ETF Liquidity: The intraday *liquidity* allowed by ETFs is one of the primary benefits of owning the product. However, this benefit can turn into a *liability* during volatile events such as "flash crashes" and technical glitches. Active managers are better equipped to *assess the risks* of liquidity as part of their overall investment strategy.

As financial stewards it is our duty to be aware of these risks and potential pitfalls. One should perhaps consider deploying a few active strategies such as tactical allocation, free cash flow, and thematic investing.

1. *Source: Goldman Sachs, September 2017 values reflect the percentage of shares owned by passive strategies in each index, as of June 30,2017.*

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