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Passive investing, active exposures

Transcript from April 6, 2022

Brian Bruce: One last thing that I wanted us all to talk about. I've read interesting papers that all of you have been involved in recently from a research standpoint. I'd like to give you the opportunity to talk a little bit about some of the things that you've been researching and thinking about in the last year.

Jim Rowley: I guess I'll start off. You know, I mentioned before we've an article coming out, published in the PMR Journal, how investors use passive for active. And it's, you know, tied together some of the trends I talked about before which is, you know, everybody seems to talk about the popularity of indexing and, again, the binary label. It's an index fund or it's not. But sort of the individual product level, and we thought, okay, but what if we built aggregated, asset-weighted portfolios and tested what are the actual portfolios performing like.

And we did so with just U.S. equity funds but traditional active, what we call total market index funds, meaning any index fund that has an actual legitimate objective of tracking a definition of the total U.S. equity market. And then another category of index funds that are not total market trackers, inclusive of style box, equal weighting, sector. It doesn't matter. As long as you're not a total market fund, but you still legally are an index fund. And we tracked the investment exposures of these products, and I think it's overlooked in the sort of popularity and trend toward passive is this suite of nontotal market index funds. When you look at the history over time, if I covered up the label, you'd think it was a portfolio of active because it does not track the total market.

And again, going back to this idea I talked about, well what's happening at the aggregated portfolio level as opposed to the product-by-product labels, and you find that they're tax-efficient vehicles, they're low-cost vehicles. But when you put them together in a portfolio, it seems like active, like Craig you pointed out, their investors are putting index funds together to recreate a portfolio of active exposures.

Craig Lazzara: I'm curious about this result, Jim. I mean, are there kind of consistent factor exposures that you see that are similar? I mean if you think of the non-TMI index world and the active world together, and you're saying they're more or less the same in terms of basic exposures?

Jim Rowley: Ironically, tying back to one of your papers, Craig, we did find that that portfolio of active funds consistently has a tilt towards smaller cap, which I know is a piece of your research. But we split our research into two periods, based upon the prominence of the S&P 500 index funds' market share if you will. I think it's upwards until July of 2009. I think S&P 500 funds were more than 50% of the market share of these nontotal market index funds and thereafter less than 50%.

So, we kind of looked at this, split them into two, and I'd say the nontotal market index fund portfolio, on either side of that timeline, has noticeable tracking error versus the broad market. So it does not track.

But then in the former period, we found out that that portfolio of index funds actually had higher than one market beta, a bit of a larger cap tilt and a little bit of a value tilt.

And then sort of moving to the second segment, if you will, actually, lower than one market beta and a little bit now of a smaller cap bias. And that smaller cap bias probably twofold, just less dominance of the S&P 500, but also the introduction of equal-weighted funds and the mid- and small-cap parts of the style box where large- and mega-cap were less prominent with investors and so they had more choices in the smaller cap arena.

Craig Lazzara: Who do you think, if the aggregate of non-TMI index funds plus the aggregate of active managers have a small cap tilt, who's got the big cap tilt to compensate?

Jim Rowley: Personal theory would tell me individual investors. I've always tried to read up a little bit on the concept of familiarity bias, which is to say that my mom and dad and my uncle, they know Amazon and they know Bank of America, and they know Microsoft because they're big, they're recognizable, it's probably really cheap to trade them, so I think we would find out individual stockholders hold the largest of the large; and then the professional managers sort of don't own that group.

Craig Lazzara: Yes, you alluded to something we've written about a lot, and I'll summarize part of it by saying if you, as an index provider or user of index funds, if you want to create an index, a U.S. index with a larger average capitalization than the S&P 500, I mean it's hard work. You can do it. I mean just own the top 50, for example, or the top 100. It's hard work though. I mean because the skewness of capitalization, particularly now. It's always been like this to some degree.

But, you know, there isn't an equality of size among those 500 issuers; and so the number of individual names in the S&P 500 that have a larger average capitalization than the average of the 500 is something. I'd have to look it up, but it's 30 to 50. It's not that many.

And so, and if you're building a factor index, thematic ESG, whatever it is, unless you're very attentive to the capitalization issue, you are going to end up with a smaller than average cap portfolio. Again, not necessarily a bad thing, but that's what's going to happen.

END OF RECORDING

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