Vanguard

The continuum from indexing to active investing

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Brian Bruce: So, you know, all of our panelists are involved in some form of the active/passive discussion, and that's our topic today thinking about that continuum between active and passive. And this isn't a new thing. I remember back in the day, I ran the International Indexing Group at State Street Global Advisors and people would ask me about, "Well what's active and what's passive?" then as we developed more funds that were twists off indexes. And I remember my answer was always, "Well if you've got one stock, I can tell you for sure it's active. And if you own everything in the benchmark at the same weight as the benchmark, I can guarantee that that's passive. And anywhere in between is up for discussion."

And so that's a pretty broad range that we have to start with, but I think it'd be really interesting to hear because all of you come from a little bit different perspective, to hear what you all view as the what is the continuum between active and passive and how you think about it.

Jim Rowley: I think one of the things we noticed from the continuum standpoint was maybe the past five, ten years a lot of the focus has been on, like, sort of this product-specific, almost binary measure of it's an index fund or it's not an index fund. And what we've been interested in is this idea of, hey, as investors, like, we have portfolios. We don't necessarily or we don't always just pay attention to the individual line of products, so to speak. At the end of the day, we own the portfolio in aggregate.

And I think for us this continuum idea is, well, what if we looked at this notion of indexing versus active at the effects of the portfolio? And we thought, look, we know that investors would recognize the portfolio of global securities would be inclusive of U.S. and non-U.S., but we know we have investors that engage in home bias. Even if they use two funds that are technically index funds, they might overweight U.S. securities. Well, that's technically an active bet against a global cap-weighted benchmark.

And, okay, what if we just looked at within the U.S.? We know we can chop everything up by style box and sector. We know investors don't necessarily always do market-cap proportional by the style box with which there's multiple definitions or by sectors, which there are multiple different providers' definitions, which means at what point do you get to say, "Well, but equal weighting is not really indexing." Well, but you own, like, a lot of the small-cap value index fund.

So at some point we go through this continuum, and you really look behind you and say, "Well, when did I make the transition for what was indexing and active?" But I think what's paramount to us is what are the effects of all these product choices when you aggregate it all back up at the portfolio level?

Craig Lazzara: In response to Jim's comment, I'm almost inclined to say if the only acceptable definition of a fully passive investor is one who owns the global market portfolio, or even in the U.S. the only acceptable definition of passive is one who owns the total U.S. market, then I'm inclined to say that there are no passive investors. And that can't quite be right either. I mean, certainly, when I bought my first S&P 500 mutual fund years ago, I thought I was doing passive stuff, but to a large degree, when investors make choices about asset classes, about subsets of asset classes, about countries, about credit risk and things, those are intrinsically active decisions.

So even if you say, "I'm going to be fully invested in the U.S. and I'm going to buy a total market index fund to do that," the decision to be fully invested in the U.S. and nowhere else is an active decision. There's nothing wrong with that, but from a nomenclature standpoint, I think that's correct.

Ben Johnson: Clearly so much nuance, right, like when we talk about the continuum. And I think continuum is the all-important word here because it's not binary, it's not either/or. Like, either/or is, like, by definition impossible for all of the reasons we've detailed and more, but it's just always a nice substitution effect from the point of view of the people asking the question is, "Well, can you set all of this nuance aside? You all seem like smart guys. Like, I need it to be much simpler than it is in reality."

So active/passive as a framing, I think, is going to be with us forever, but the nuance, I think, is only getting more nuanced as we've seen, especially within the realm of indexing this evolution of indexes from being targets or from first being sort of measures to targets, to now increasingly investment strategies. So, a list of stocks, right, make up your list; be that a list of metaverse stocks now. As we fast forward from railroads in the late 1800s to now 2022, is that an index in the traditional sense? Is that passive? Like, I would argue absolutely not.

And I think the other point that Jim rightly raises is we've seen a growing number of investors that are using index strategies and index funds in very active fashion, and in some cases almost hyperactive fashion. So it's really just gradients of activity that we're talking about at the level of even benchmarks, at the level where it matters most of investors' portfolios.

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