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The Friday Filter

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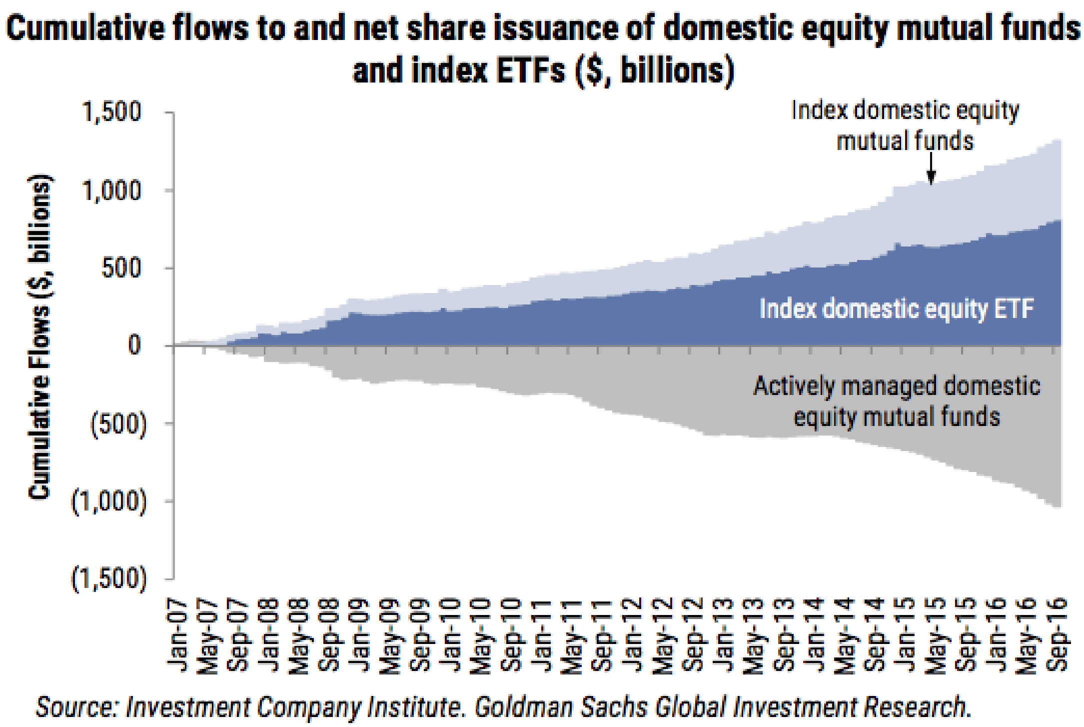
Passive investment – opportunity or threat?

Flows into passive or index-tracking investments have really gathered pace in recent years, particularly in global markets. Vanguard is probably the largest recipient of these flows, with assets under management increasing from $1 trillion seven years ago, to over $4 trillion today, the bulk of which is invested in passive, index-based strategies. Using the first quarter of this year as an example, Vanguard traders are investing as much as $2 billion a day into stocks such as Apple, Microsoft, Google, Facebook and Amazon, irrespective of price or fundamentals. The chart below highlights how dramatic the switch from active to passive managers has been in the USA in recent years.



South African flows are not as dramatic with the industry dominated by a few large institutions, but a key feature of our market has been the move towards a semi-passive approach by most domestic equity managers. This has been exacerbated by the very large index weighting of Naspers, to the extent that it has become a share that is very difficult not to own, and a 10%-15% position is fairly standard across domestic equity portfolios.

Recent flows into emerging markets have also been very strong. The top 10 holdings of the Vanguard Emerging Market ETF below shows that both Tencent and Naspers are key beneficiaries of these flows.

Vanguard FTSE Emerging Markets ETF

As of March 31, 2017

Ten largest holdings and % of total net assets[2]

Tencent Holdings Ltd.	3.5%
Taiwan Semiconductor Manufacturing Co. Ltd.	3.5
Naspers Ltd.	1.7
China Construction Bank Corp.	1.7
China Mobile Ltd.	1.3
Industrial & Commercial Bank of China Ltd.	1.1
Hon Hai Precision Industry Co. Ltd.	1.0
Itau Unibanco Holding SA	0.9
Bank of China Ltd.	0.9
Petroleo Brasileiro SA	0.9
Top ten as % of total net assets	16.5%

Given these industry shifts, many are questioning the rationale of an active management approach. Because active managers with a value bias usually add most value in a bear market, the continuation of this bull market has not helped the active managers' cause either. While we think there is room for both active and passive strategies, we do think that this massive shift will create opportunity for patient managers that adopt a sensible, value focused approach. The facts are that greater asset flows into index (and closet-index) funds and ETF's have coincided with continued shortening of investor time horizons. The logical consequence of this is that there is less competition for anyone who is prepared to invest differently to the growing herd, or have an investment time horizon that is longer. Not only is there less competition, but it is also less risky as you are not a forced buyer of expensive and popular assets held by short-term focused investors who are likely to get spooked when things get tough. While the risk of missing out on frothy gains is too much for many to bear, it is a natural consequence of a value driven approach, and one that we are very comfortable with. Whatever approach you choose, sticking to it is what is important. Howard Marks summarized this very well when he said,

"**To be a successful investor, you have to have a philosophy and process you believe in and can stick to, even under pressure**. Since no approach will allow you to profit from all types of opportunities or in all environments, you have to be willing to not participate in everything that goes up, only the things that fit your approach. To be a disciplined investor, you have to be able to stand by and watch as other people make money in things you passed on."

Our client portfolios have done relatively well, despite not owning many widely held companies that do not fit our approach at current prices. Should the stampede into passive strategies continue unabated we are very likely to underperform, albeit at significantly lower levels of risk than market averages. We believe in our philosophy and process and will continue to apply it with patience and discipline.

Thus, despite the industry move towards more passive approaches, I remain confident that the opportunity for a long-term, value-conscious approach remains very sound.