HOW PASSIVE WORKS

Alpha in a Passive World

There is a tide in the affairs of capital markets, which, taken at the flood, leads on to fortune. On such a full sea are we now afloat, and we must take the current when it serves, or lose our carefully constructed investment portfolios.

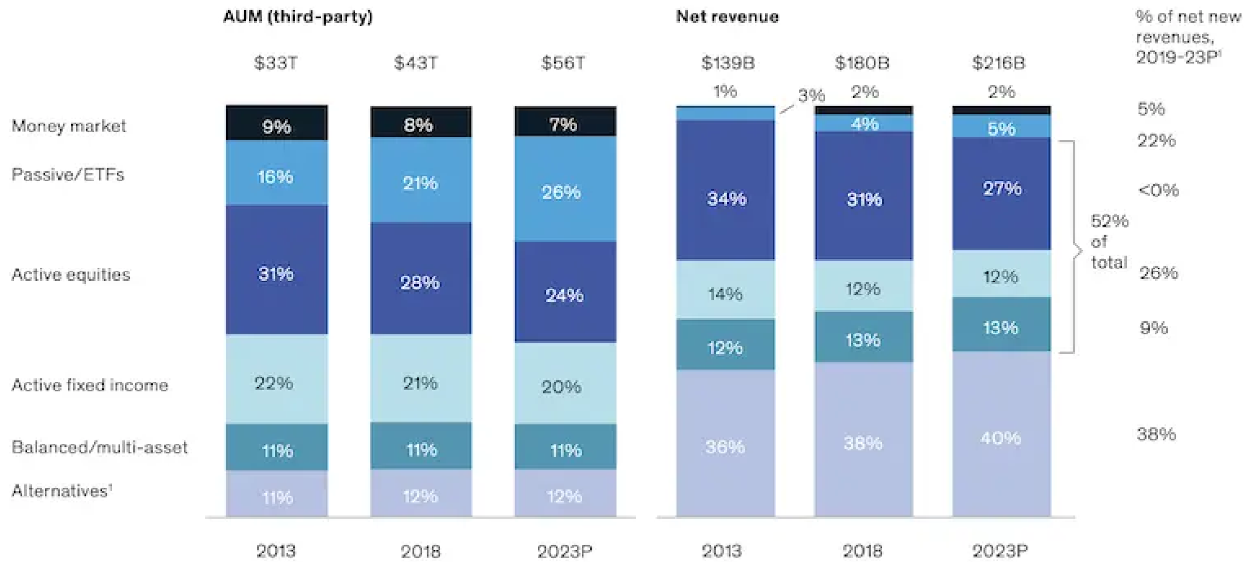
I would love to read Shakespeare's take on the present situation (especially on Twitter). Behind the seemingly mundane facade of the retirement industry, there lies a great potential for drama.

Let's start with the macro.

Is There a Big Short Opportunity Against Passive Today?

This is the question I've been asked most frequently by allocators and fellow GPs over the course of this research. Consensus models project that passive funds and ETFs will continue to take share over the next five years. You might ask: where could these models go wrong?

Fig 1. McKinsey projects that passive will continue to take share from active



Source: **McKinsey Global Growth Cube**

These are uncharted waters, but I see two potential areas of concern.

First: will Boomers sell retirement assets en masse, triggering forced passive selling and a market meltdown?

The industry-standard McKinsey and Cerulli models are proprietary, but their keystone assumption is straightforward: small net outflows from Boomers over the 2020s will be offset by mid-single-digit returns in the public markets. **NBER president Jim Poterba suggests** that withdrawal effects will likely be modest because demographic changes are slow and predictable. The **GAO adds** that most financial assets are concentrated in the hands of wealthy households, who will feel little pressure to sell assets to meet living expenses. The IRS forces retirees to sell retirement assets to make **required minimum distributions (RMDs)**; however, the **SECURE Act of 2019** deferred the RMD age from 70.5 to 72 years old, keeping more of these assets in the markets.

So far, it appears that the market can continue along its present path – Millennials should continue to accumulate as Gen Xers receive wealth transfers from Boomers. These generational shifts are not necessarily cataclysmic.

A more plausible selloff scenario is a vanilla market crisis amplified by our newly passive environment. I'll let you pick your poison here: credit concerns, falling corporate share buybacks, valuations, vanishing liquidity, fewer active managers to react to low prices, etc.

Scared Boomers might sell into a falling market as the working population faces layoffs and stops contributing to their retirement accounts. That scenario, however, is separate from an analysis of retirement capital flows.

Second: will private equity funds steal allocation from passive public equity funds and crash the public markets?

Target-Date Fund private equity allocations have not been announced yet, but we can speculate as to what will change. As a reminder, TDFs invest defined contribution plan assets, and TDFs currently rebalance between publicly-traded stocks and bonds, shunning private equity. In comparison, **defined benefit plans already allocate >10% to private equity** for the largest 200 US retirement pools. **Australia's A$2.7 trillion superannuation retirement scheme allocates >15% to private equity**. It seems unlikely that TDFs would reallocate from bonds to illiquid equity. So shifting, say, 10% of TDF assets to private equity likely means selling or contributing less to passive public equity.

Incentives may be the saving grace here for the public markets. Vanguard et al. want both to solve the US retirement problem and to profit from the system as it operates today. A market meltdown and a breakdown of the current retirement model represent a failed mission and a failed business. You should expect them to use all of the tools at their disposal, such as changing distribution policies and allocating international retirement assets into US public equities, to avoid disturbing today's fragile equilibrium.

In short, there are potential icebergs on the horizon, but they aren't definitively on today's path. To maintain a clear line of sight, I recommend monitoring Boomer retirement withdrawals, white collar unemployment, and Target-Date Fund allocation plans.

Finding Alpha in a Passive World

Aside from Big Short scenarios, fundamental investors should focus on strategies that benefit from an increasingly passive environment.

The good news is that there is less fundamental competition than ever, as passive and model-driven trading have pushed out discretionary active approaches. **JPMorgan**

Research estimates that only 10% of trading volume originates from fundamental discretionary traders.

One approach is to look at index options and volatility. Steady passive inflows and falling interest rates have led to a demand for short volatility strategies to generate income. Selling volatility has its merits, though its risks should be fully appreciated. This is the strategy that, done incorrectly, gave rise to the saying "picking up nickels in front of a steamroller." If the market is overwhelmingly short OTM calls and puts, index straddles may be underpriced. I would direct you to **Mike Green of Logica** as well as **Marko Kolanovic of JPMorgan** for research on this market structure theory and related strategies.

A second approach is for private equity firms and activists to take advantage of lax governance by passive funds. Blackrock, Vanguard, and State Street vote yes to virtually every proposed merger. ISS and Glass Lewis, their voting advisors, are much the same.

Fig 2. Percentage of mergers approved by Blackrock, Vanguard, and State Street

		BlackRock				Vanguard				State Street			
Country	Year	# of meetings	For (%)	ISS Match (%)	GL Match (%)	# of meetings	For (%)	ISS Match (%)	GL Match (%)	# of meetings	For (%)	ISS Match (%)	GL Match (%)
US	2012	96	100	100	96	66	100	100	100	67	100	100	100
	2013	141	99	98	96	149	99	97	94	118	98	97	93
	2014	101	99	100	99	119	99	100	98	91	97	98	98
	2015	131	99	97	97	142	99	99	97	106	96	96	97
	2016	186	100	99	97	184	100	100	98	150	97	99	98
	2017	156	99	99	98	81	99	99	98	145	99	99	98
UK	2012	9	89	100	100	8	100	100	100	7	86	100	100
	2013	4	75	100	100	5	80	100	100	2	100	100	100
	2014	5	80	100	75	6	83	100	100	12	83	100	67
	2015	10	100	100	89	13	92	100	100	13	92	100	100
	2016	12	100	100	92	13	100	100	100	11	91	100	100
	2017	6	100	100	100	3	100	100	100	9	78	100	83
France	2012	3	100	N/A	17	2	71	100	0	1	100	N/A	0
	2013	4	100	100	100	4	100	100	100	4	100	100	100
	2014	3	100	100	100	4	100	100	100	5	100	100	100
	2015	6	100	100	100	6	100	100	100	6	63	100	67
	2016	3	100	67	100	3	100	67	100	3	67	100	100
	2017	2	33	100	0	2	100	33	33	3	50	100	25
Germany	2012	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
	2013	2	100	100	100	2	100	100	100	1	100	N/A	100
	2014	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
	2015	1	100	N/A	100	1	100	N/A	100	N/A	N/A	N/A	N/A
	2016	1	100	0	N/A	1	100	0	N/A	1	0	100	N/A
	2017	1	100	100	100	1	100	100	100	2	100	100	100
Japan	2012	7	86	100	100	1	100	100	N/A	4	75	100	50
	2013	10	100	20	83	11	46	100	50	11	46	100	50
	2014	3	50	100	0	3	67	100	0	3	67	100	0
	2015	5	80	100	80	6	83	100	83	6	83	100	83
	2016	6	100	100	100	6	100	100	100	8	88	100	100
	2017	6	100	100	83	6	83	100	100	13	69	100	85

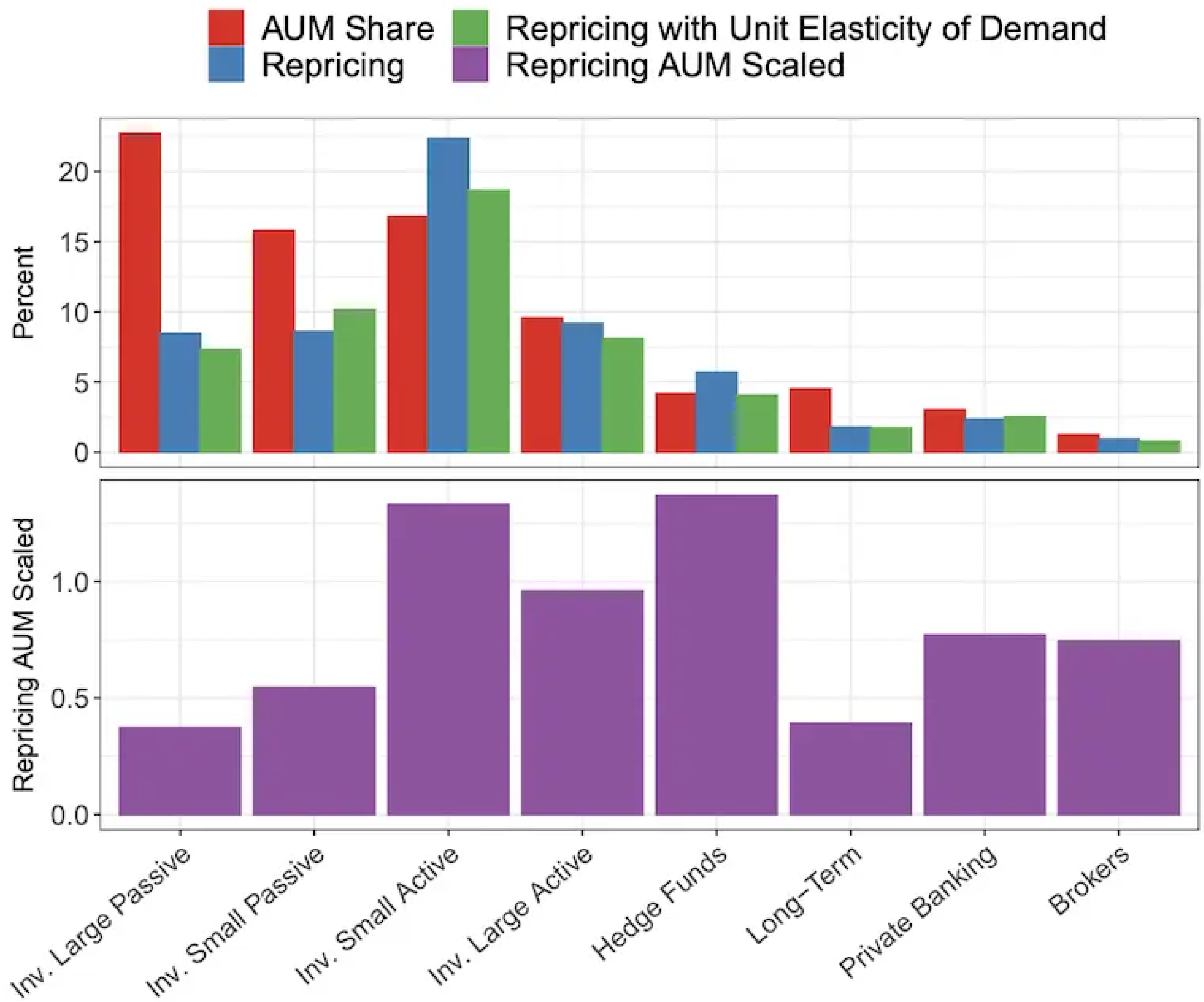
Source: Fichtner and Heemskerk (2019), ProxyInsight (2018)

We may be entering an age of "take-unders" instead of "take-overs." In this new environment, private equity funds and company management can collude to take a listed business private at far less than its fair value. **The voting advisor ISS provides some companies the right to review voting guidelines** before ISS sends its recommendations to investors. ISS also sells consulting services to the management of the same companies. So much for not letting the fox guard the henhouse.

A whole host of new governance issues and parasitic investment strategies may pop up with fewer fundamental analysts around to catch them. **Blackrock publishes their voting record** each year, confirming the intuition that passive funds may have difficulty scaling governance judgments by outsourcing them. These incentive problems are potentially solvable, but that potential seems a long way from being realized. I think, unfortunately, that corporate governance abuse may generate significant alpha going forward.

A third approach is to study which investors drive the majority of share repricing and how those investors interact with passive indexes. Some investors are much more important to driving stock prices up and down.

Fig 3. Impact on US equity prices by type of owner



Source: Koijen, Richmond, and Yogo (2019)

Index inclusion and exclusion are almost mechanical processes, published for all to see by providers like **S&P** and **Russell**. Combined with an understanding of how the major institutions operate, you can find that some firms are especially important to rerating an equity upward. No two ownership paths of successful stocks are exactly alike, but the similarities can be striking. Koijen and Yogo (Fig 3) have told me that they have an important update coming this summer. I won't steal their thunder, but I do recommend following their research. At the time of this writing, the SEC has just proposed new disclosure standards, so you should watch these shifts closely over the next few years. I'm a fundamental investor at heart, and I believe this to be an excellent framework for finding buying windows for companies that you want to own for the long run.

I hope you enjoyed this series on how the US retirement system drives capital flows and how that creates a new set of alpha-generating opportunities. Our markets are in the midst of a fascinating transition. I'd be delighted to speak with you in more depth about which fundamental strategies will work best going forward and how investors might consider these changing capital flows in their allocations.

Special thanks to the research staff at the NBER, McKinsey, Cerulli, and Vanguard for their help with this piece and to Mike Green of Logica for his work on target-date funds and retirement flows.

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The QDIA Aircraft Carrier & How Target-Date Funds Sustain It

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