Why is passive winning?

Tom Rampulla: The '80s were an active time. Active management was what it was about back then. There were more than 2,000 actively managed funds by the end of the decade—not a mention of indexing. Fast forward to today—passive interest is through the roof. The bars represent flows into active and passive funds. Look what happens in the early 2000s. Passive really starts to pick up and active starts to decline. If you add those bars up, you've got about a trillion dollars in flows into passive funds at the expense of active funds—it's about a trillion the other way. Why is passive winning at the expense of active?

Well, there are a couple of main reasons, and the first one is cost. And you're gonna hear me say this a few times—and not just because I'm from Vanguard—but costs really do matter. But many will say, "Hey in active management you get what you pay for. You pay an active manager a lot of money and they'll give you great returns. They're smart folks." But the problem is for active managers, they've got to overcome all those expenses, those investment management expenses, those distribution expenses, and the higher turnover and trading expenses just to break even with the market.

We took a look at what investors paid active managers over the last decade at the end of 2015—$437 billion. That's a pretty high handicap to overcome. What did they get? Those active managers underperformed the indexes by $545 billion.

Investors are noticing. They're voting with their feet. Over the last 15 years, $611 billion went into the cheapest funds. That's the lowest quartile of funds in the industry. A lot of that is indexing, but it's not all indexed. $549 billion came out of the highest-cost funds. And that's broad based cash flow. That's investors of all types.

We think that this trend will continue for quite some time. First of all, passive is an effective investment management strategy. It's easy to understand, it's transparent, it's cheap, and it gives you great results. Regulation certainly has been a tailwind for passive investing as well. And finally, despite this massive growth, passive investing is only about a fifth of global assets under management. There's a long way for it to run.

Second reason—and there's really no way to sugarcoat this—is poor performance. Poor and unpredictable performance in the aggregate. Why is that? Well, it's related to cost. But if you think about it, investment management is a zero-sum game. Somebody outperforms the average. For that to happen somebody's got to underperform. You've got the distribution with the bell curve. You've got the average in the middle. Half the managers outperform; half the managers underperform. That's just plain math. That's the way it has to work statistically speaking. But when you introduce those high costs of active management, that shifts the outperformers firmly in the low-preforming camp. It's tough to overcome those expense barriers as an active manager. How tough?

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Meet the speaker

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So here we have the percentage of active managers outperforming in the U.S. large cap equity space; 16%. Emerging market equity. If there's ever an asset class where on-the-ground research and knowledge of local companies has an advantage, it's got to be emerging markets; 32%. Global high yield. Again, 14% of managers outperform the index. We'll end up with U.S. small cap equity—you know where I'm going with this—36% of managers. For active management—someone you're paying a lot of fees to—your odds aren't very good. You're better off with a coin flip.

The famous Charlie Ellis wrote an article in the Financial Times about this very subject. If you look back many years ago—we used 1963 here—17% of assets were professionally managed. The rest of the participants in the market were individual investors. And no offense to any folks back then, but more relatively-unsophisticated investors. So it was easier for managers to outperform.

Look at today, as of 2015, almost 70% of the market is professionally managed. Instead of professionals trying to outsmart regular individuals, it's a bunch of professionals trying to outsmart each other. Look at the number of CFA candidates absolutely explode. As a corollary to this, Charlie also says that in addition to the professionalization of the investment management industry making it more difficult to outperform, technology and the availability of information makes it more difficult as well.

So active management's dead, right? No, not so fast. We don't think it's necessarily dying. But we do think it's evolving. And, in fact, it absolutely must evolve in order to survive.

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