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The Active versus Passive Debate Evolves

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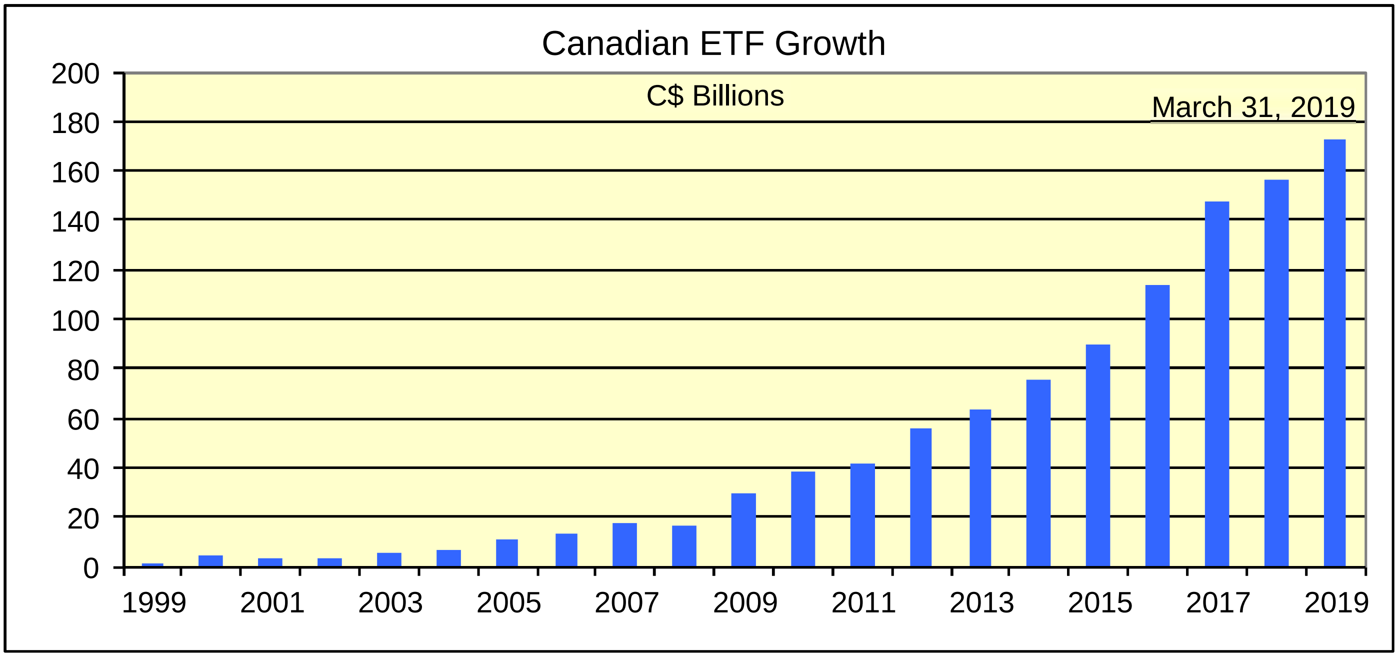
Historically, Canada has been slower to adopt new investing vehicles than either the U.S. or Europe. However, once Canadians buy in, they are every bit as interested in these new tools as their international compatriots. Recent statistics have underscored the growing interest in Canada of investing in exchange-traded funds (ETFs). The Canadian ETF Association reported there were 701 ETFs available in Canada, and in March, assets had broken above $172 billion for the first time.[1] As can be seen in the graph below, growth in ETF assets in Canada has been nearly exponential. Recent forecasts suggest a further doubling of these assets in the next five years.[2]



Sources: Bloomberg L.P. and Canadian ETF Association.

Passive investing

Accompanying this rising tide of ETF use is the dramatic increase in passive investing. Passive ETFs may appear very attractive as they are promoted as being easy to understand and having low costs. It is

[1] Canadian ETF Association, Monthly Industry Statistics, March 2019.
[2] Bank of Montreal, *ETF Outlook Report*, January 2019.

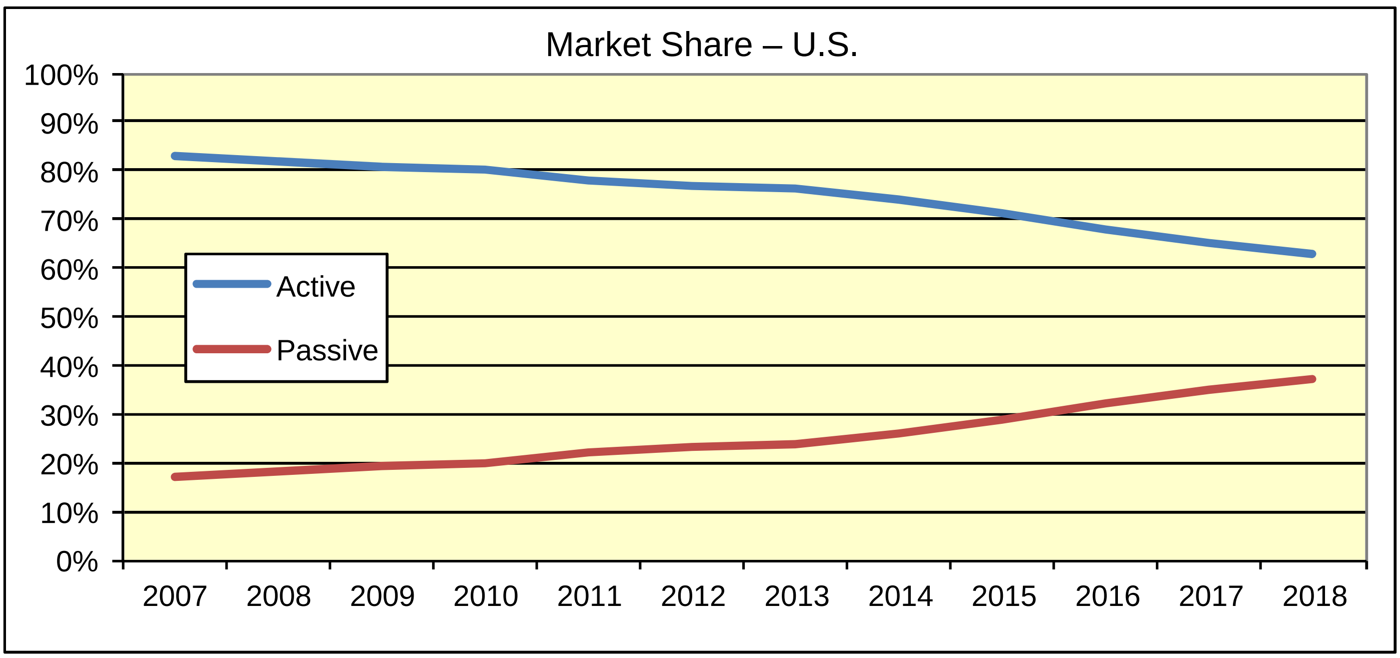
important, however, to discuss their use with a professional advisor so that a clearer picture of the benefits and potential pitfalls are understood.

Of course, certain definitions of the key terms in passive investing are necessary. First, a market must be selected – the stocks in the S&P 500 Index, for example.

Then, each investor who holds securities from the market must be classified as either active or passive.

A passive investor always holds every security from the market, with each represented in the same manner as in the market. Thus, if security X represents 3% of the value of the securities in the market, a passive investor's portfolio will have 3% of its value invested in X. Equivalently, a passive manager will hold the same percentage of the total outstanding amount of each security in the market.

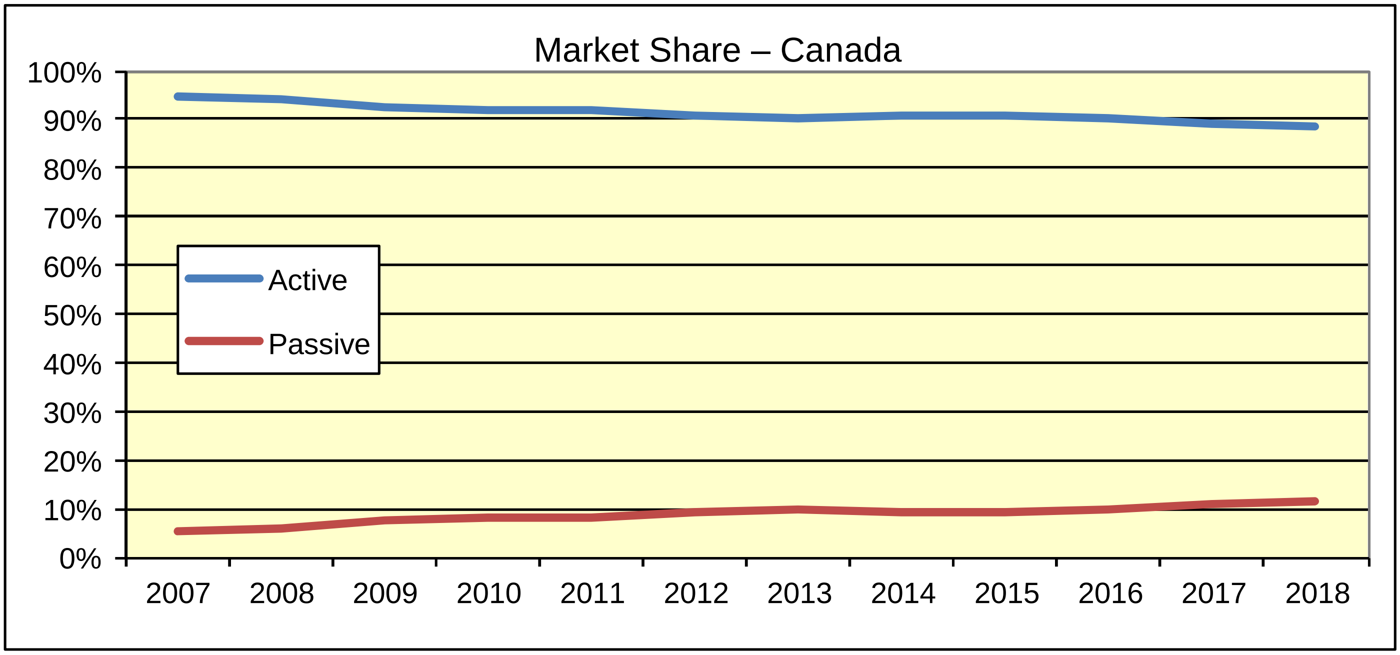
In short, an active investor is one who is not passive.[3]



Sources: Morningstar Inc.; and PWL Capital Inc., The Passive vs. Active Fund Monitor (2018).

[3] *Financial Analysts Journal*, Vol. 47, No. 1, January/February 1991.

As a by-product of their earlier adoption in the U.S. market, the ETF holdings of American investors have helped raise the market share of passive investments relative to active investments. As can be seen in the previous graph, this growth has recently accelerated and it is reasonable to believe that a 50/50 passive/active split will be reached within the next few years. It is important to keep in mind that not all ETFs aim to provide low-cost exposure to market indexes. However, each of the top 10 (by market capitalization) U.S. ETFs is a passive, index-tracking investment. There are some 1,750 U.S. ETFs, but these 10 alone accounted for US$924 billion in market capitalization, approximately one-third of the total U.S. ETF market capitalization of US$3 trillion at the end of 2018.[4]



Sources: Morningstar, Inc.; and PWL Capital Inc., The Passive vs. Active Fund Monitor (2018).

Similarly, in the Canadian market, each of the 10 largest ETFs (in terms of market capitalization) are passive, index-tracking products. In fact, of the top 25, 19 are passive, index-based products. Together, these passive products make up 33% of all Canadian ETF assets.[5] So, given the number of ETFs now available in Canada, Canadians have more than three and a half times as many choices as their U.S. counterparts on a per capita basis. However, as can be seen in the above graph, the penetration of passive assets has been far slower in Canada than in the U.S.

While it may seem counterintuitive, passive investing actually relies on the existence of active investors. As passive investors are "price takers," it is necessary for at least two active investors to set that price by agreeing where the security should trade hands. This continuous process of price discovery sets the prices for all the securities in a benchmark index. Based on this daily pricing action, passive investors will be forced to either buy or sell individual securities so that their holdings continue to mirror the benchmark index. For instance, in March 2019, Morgan Stanley Capital International (MSCI), the world's leading equity index provider, announced plans to sharply raise China's weighting within its flagship MSCI

[4] Investment Company Institute, 2018 Investment Company Fact Book.
[5] Canadian ETF Association.

Emerging Markets Index, to 3.3% in November from the prevailing 0.7%. On the surface, this may not appear to be a significant development. However, the MSCI Emerging Markets Index is tracked by mutual funds and ETFs with a total of US$1.9 trillion assets. As a result of the proposed change, each of these investment products will eventually be forced to purchase the underlying stocks. Naturally, the news prompted buying from active investors who looked to get in early and thus capitalize on the forced buying that was to follow. This pre-emptive buying allowed active investors to be the ones who may have "bought low." They may then have the opportunity to "sell high" in the future as the passive investors are forced to pay whatever the market price is in order to accurately reflect the revised benchmark index.

Algorithmic trading

Not surprisingly, as the above example illustrates, active market participants will look for anything that might give them an investing edge. Any scrap of information may be useful, and the historic behaviour of the markets is often used as a guide to what may happen in the future. A pattern that is often repeated may turn into a rule of thumb or even an axiom. "Sell in May and go away" is frequently held out as one of these rules/axioms. However, things may change over time as market fundamentals shift. This can be illustrated by an appropriate hockey analogy. When do you pull the goalie? Looking back to the early 1980s, when a game could actually end in a tie, the risk/reward of pulling your goalie to add a sixth attacker tended to favour delaying this tactic to very near the end of the game. Since then, the risk/reward profile has changed and coaches who have studied the statistics may be pulling the goalie with as much as 10 minutes left in the game. In financial markets, there may be any number of these kinds of tactics. Algorithmic trading uses automated, pre-programmed computer trading instructions so that a buyer (seller) can react immediately to a certain opportunity.

Growth of inefficiency

One of the chief problems with the discovery of these trading tactics is their widespread use often creates self-fulfilling outcomes. The more one of these rules of thumb is believed to be "true," the more likely it will be that a large number of traders will have their computers set to autopilot and ready to act at the same time and in the same way. As passive investors are forced to jump on the bandwagon, the markets can move very rapidly and in a more sustained manner. This becomes problematic if there are not enough active investors with an opposing view to take the opposite side of the trades when the algorithmic trading kicks in. This combination may serve to make the markets more volatile and less efficient. During the market weakness seen in December 2018, the financial press highlighted this as an issue.[6] Nevertheless, when the algorithmic trading and "passive" piling on has actually run its course, active investors may re-enter the market and selectively scoop up the bargains. The U.S. financial markets are generally viewed as being the most efficient. Still, it may be the case that this efficiency is being countered by the latest developments in active algorithmic trading and the forced actions of the large passive ETFs.

[6] "This sell-off was caused by a computer-driven 'footrace'". Jim Cramer. CNBC, December 4, 2018.

ETFs are becoming increasingly popular, but that does not mean that ETFs are suitable for every investor. Taking advantage of professional advice can help provide a better understanding and proper framework for investing in ETFs.

Conclusions

- ETF use in the Canadian market, while still lagging the U.S., has expanded dramatically, both in the assets held and the number of choices available. However, increased popularity does not mean ETFs are the right fit for every investor.
- While the active/passive debate continues, increased use of passive investing tools appears to be raising the potential for both market volatility and inefficiency.