Markets

End of Era: Passive Equity Funds Surpass Active in Epic Shift

By John Gittelsohn

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- Stock pickers overtaken as investors run toward index funds
- The balance of power has changed in the stock-fund industry

It's official: inexpensive index funds and ETFs have finally eclipsed old-fashioned stock pickers.

Passive investing styles have been gaining ground on actively managed funds for decades. But in August the investment industry reached one of the biggest milestones in its modern history, as assets in U.S. index-based equity mutual funds and ETFs topped those in active stock funds for the first time.

Stock picking isn't dead. But the development marks the official end of money managers' position as the guiding force in the American stock market -- and the seemingly inexorable rise of low-cost index-driven investing. If, as expected, the shift keeps gathering momentum, the implications will be enormous for the industry pros, financial markets and ordinary investors everywhere.

into a giant through his stock-picking prowess, concedes there's no turning back.

No Second-Guessing

"We have so many funds beat the market 10 years, 20 years, but we're not going to second-guess the customer," Lynch, Fidelity's vice chairman, said in an interview. "We're not going to say, 'You fool! You idiot!' If you want to buy an index fund, here it is."

And buy they have. August fund flows helped lift assets in index-tracking U.S. equity funds to $4.271 trillion, compared with $4.246 trillion run by stock-pickers, according to estimates from Morningstar Inc. Investors added $88.9 billion to passive U.S. stock funds while pulling $124.1 billion from active this year through August, the firm estimated.

The unraveling for stock pickers accelerated after the financial crisis, when investors burned by the markets flocked to low-cost passive funds.

Passive Edge

More money is now managed in passive than active US equity funds

Source: Morningstar Direct
Preliminary estimates through August

Passive funds came onto the scene in the 1970s and took hold with the advent of ETFs in the '90s. Their popularity soared with the bull market that began in 2009, as cost-conscious investors rode benchmark indexes and most managers lagged.

Driving the migration is cheaper fees. Passive U.S. equity funds cost an average of about 10 cents a year per $100 of assets, compared with 70 cents for active funds.

"That represents investors keeping more of their own money," said Eric Balchunas, a Bloomberg Intelligence analyst. "If there's a loser in this, it's probably the asset-management industry. The rise of passive represents the rise of very low fee products and ultimately that's going to mean some pain for them."

Race for Revenue

As fees compress, firms are casting wider nets for revenue. Vanguard Group, the $5.6 trillion giant that started the revolution with its S&P 500 Index mutual fund, is pushing harder into the personal

Flows at Boston-based Fidelity, which lost its position to Vanguard as the largest U.S. mutual fund manager in 2010, show how strongly tastes have changed.

While many of its biggest active products, such as the $118 billion Contrafund, racked up better returns, customers pulled $20 billion from its traditional equity fund lineup in the first half of 2019 and poured $52 billion into its passive offerings, Morningstar estimates.

"They're far more tolerant of passive products, partly because of how they're investing," Kevin McDevitt, the Morningstar senior analyst who assembles the fund flows report, said in an interview. "It's kind of a set it and forget it kind of thing."

Financial advisers are helping to fuel the move. They can build client portfolios from an array of index offerings. That approach caps potential gains, as index funds won't top any year's performance charts. It also limits manager risk -- the chance that a star will suddenly stumble.

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The passive wave is forcing firms to cut the fees they charge in order to stay competitive. Meanwhile, their expenses for technology, talent and regulatory compliance are rising, further squeezing profit margins.

Some active managers have suffered relentless outflows as higher operating costs hurt relative performance, and their own stocks have suffered. Bloomberg's index of large asset managers fell 34% in the five years through Aug. 30, even as the S&P 500 rose 46%.

More Deals?

Pressure on the industry is spurring speculation of more consolidation. PwC forecasts a 14% decline in the number of funds and a 22% drop in expense ratios by 2025.

indexes exceeds amounts traded in individual stocks.

"The theater keeps getting more crowded, but the exit door is the same as it always was," Burry wrote in an email exchange with Bloomberg. "All this gets worse as you get into even less liquid equity and bond markets globally."

To be sure, U.S. stocks held in passive and active funds combined represent less than one-third of the total market, with the balance owned by individuals, pensions, insurers and other investors, according to the Investment Company Institute.

And active managers remain confident.

Capital Group, founded in 1931, has resisted indexing. The closely held, Los Angeles-based firm says its long-term returns mostly beat passive products, whose lack of agility would be exposed in a bear market. The firm's $190 billion Growth Fund of America, managed by a 13-person team, returned an annualized 8.1% in the 20 years through August, versus 6.3% for the Vanguard 500 Index Fund.

"Many investors believe they are making the 'safe' choice in picking an index fund," said Steve Deschenes, Capital Group research and development director. "The most popular index funds expose customers to the full brunt of downturns. Strong active managers can provide less volatility and a smoother ride."

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