The Role of Exchange Traded Funds in the Active vs. Passive Debate

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1. Introduction

The first steps in passive investing go back more than 30 years. In the year 1971, the first pioneers at Wells Fargo Bank launched their first passive product. The investment process of the product looks very simple, almost trivial at first glance: the portfolio was invested using an equal weighting approach. The management of the portfolio, however, proofed to be very cumbersome. This is hardly surprising: equally weighted portfolios have to be rebalanced frequently. And remember: neither PCs nor Microsoft did exist at the time and the only computers available were – compared with today's technology – slow and expensive. It took more than five years until this complicated investment process was replaced by the first cap-weighted index mutual fund (launched by Vanguard). This portfolio was fully replicated and owning all the stocks in the index with the same weight as the index. The relatively slow product development did go hand in hand with the development of the assets under management. The IPO of the mutual fund launched by Vanguard was able to attract a mere US$ 11 Mio. The reason for this limited success was most probably the reaction of the investment "experts" to this kind of product. According to John C. Bogle, Founder and Former Chairman of The Vanguard Group, "the fund was greeted by the investment community with derision, dubbed 'Bogle's folly', and described as un-American, inspiring a widely-circulated poster showing Uncle Sam calling on the world to 'Help Stamp Out Index Funds'". As of the end of 1976 less than US$ 100 Mio. were invested in index funds.

Now, how is it possible that such a simple and at first glance uninspiring concept is able to provoke such emotions?

To be able to answer this question, a thorough analysis of the structure of today's fund industry has to be made first. Active fund managers are highly professional and typically have an academic background. Together with their colleagues from research, they try to evaluate companies which are either undervalued or do have an expected earnings growth, which should result in a price performance better than the average company in the market place. On the other hand, index funds do have a completely different approach. They use no company research, buy simply all the securities in the index and don't do any active trading at all! This means that managers of an index fund are only executing transactions when the index changes or the mutual fund does have in- our outflows. This investment strategy is so simple that many investment professionals have problems accepting indexing as an investment strategy at all. While managers of active mutual funds spend a lot of time evaluating companies and investment decisions, passive funds completely ignore any company news at all. Index funds may even have stock holdings in companies, which are reporting a loss or will be reporting a loss, do have financial or other difficulties or – even worse – are about to announce bankruptcy.

One might question – with good reason – whether an index portfolio managed in such a way, is managed diligently. Is it not the responsibility of a fund manager to make sure the customer's portfolio does avoid such securities? This issue becomes even more relevant in the light of the corporate scandals which took place in the last 2 to 3 years in the US. In my view, exactly these arguments were the reason for the heated debate which took place 30 years ago and continues to be controversial today. Even nowadays, index funds are very often not taken seriously and questioned by the community. Managers of index funds are often called "monkey" managers.

However, what is very often forgotten in this controversial debate is the following question: What are the most relevant aspects for a fund manager if awarded with a mandate? In my view, maximising the return for the client is the job of the fund manager. Obviously, there are a number of aspects, which have to be taken into consideration. Some of the aspects have to do with risk awareness, personal financial situation, forecasted expenses and current liabilities of the client etc. Knowing all these aspects, a strategic position has to be defined. This strategic positioning has to be managed in such a way, that the return on behalf of the client is maximised. And even such a simple expression like return can lead to endless discussions. In my view, return should be defined as the return after all fees and taxes.