Trillions: The Rise of Passive

How The Asset Management Industry Got Disrupted

Marc Rubinstein Oct 15

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I don't know if you remember what you were doing in the summer of 2019? I do. I was hiking the Via Spluga, an ancient Alpine trading route that runs from Switzerland into Italy. Occasionally, I'd pull out my phone to check directions, taking a sneaky look at how markets were doing at the same time. Talk was of a trade war between the US and China, but the impact on stocks was muted. In the time I walked 40 miles, the market barely moved. Over the whole month of August, the S&P 500 was down 1.8%, slightly worse than an average August, but nothing to write home about.

Yet under the surface, one of the most profound shifts in market structure was taking place.

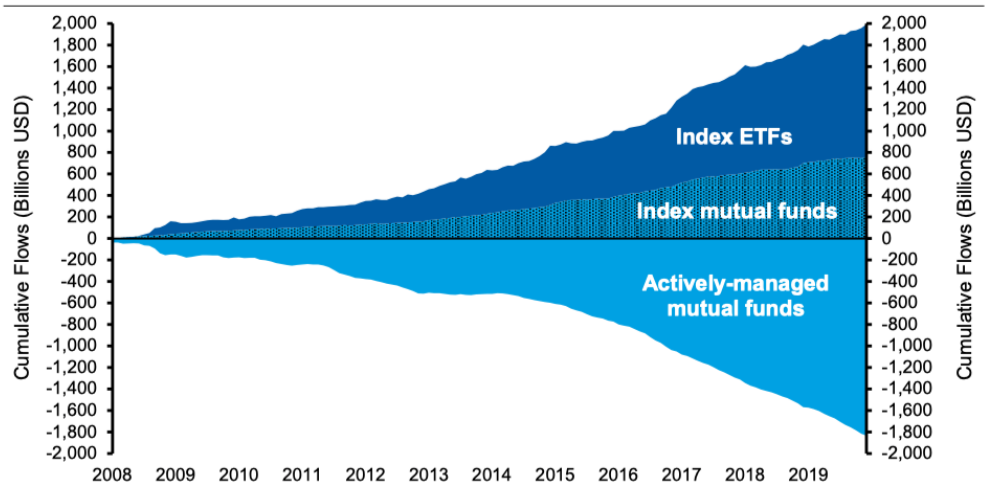
Sometime in August 2019, the amount of money invested in passive investment vehicles – funds that simply track indices like the S&P 500 – eclipsed the amount of money in actively managed funds for the very first time.

The moment was years in the making. Money had been pouring out of active US funds and into passive funds for a long time. Just ten years earlier, active funds made up 75% of US fund assets. In August 2019, the balance tipped.

To be clear, I'm not talking about the entirety of stock ownership here. A lot of stock ownership sits outside open-ended fund structures – in hedge funds, for example, or in retail brokerage accounts. In addition, my focus is on the US; fund markets elsewhere in the world are not yet at 50% passive (except Japan, which is at 73%).

But the shift is still significant. In the early days of passive, colleagues in the world of active portfolio management would debate the theoretical limit of passively managed assets. Historically, stock prices were set by the actions of active investors, who pored over financial statements and analysed company prospects in an effort to determine value; the passive sector was an overlay, designed to mirror their work in the collective. Now, the roles have flipped. As active investor David Einhorn wrote in a letter earlier this year, *“Passive investing has become so prevalent that passive index investors are no longer price-takers...but rather price-makers. Their demand sets the price. From our perspective, price-making rather than price-taking calls into question the entire premise of passive investing.”*

The story of how we got to this point is fascinating and in a new book, *Trillions*, Robin Wigglesworth tells it brilliantly. Robin estimates that there are now $26 trillion of assets tied up in passive investment strategies. He casts the story as one of technological disruption. Active fund managers were doing well, until a bunch of outsiders came along with different ideas.



Source: Investment Company Institute.
Note: U.S. domestic equity funds; Mutual fund data is net new cash flow plus reinvested dividends; ETF data is net share issuance and includes reinvested dividends.

Source: Michael Mauboussin, Morgan Stanley

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The First Index Fund

The first index fund opened for business in July 1971. The principles underpinning index funds had been discussed in the halls of academia for some time but hadn’t yet been put into practice. Some bankers were familiar with these principles, including John McQuown, who ran an internal think tank at Wells Fargo. McQuown was intrigued by the idea and assembled a group of academics to help further research it.

After an earlier false start, McQuown and his team launched a fund that would invest an equal amount of money in each of the 1,500 or so stocks listed on the New York Stock Exchange. Initially the fund had one client: the pension fund of luggage maker Samsonite. However, it proved very difficult to manage. To maintain equal weightings, stocks had to be bought and sold all the time, boosting trading costs in the fund. So in November 1973, Wells Fargo launched a simpler fund open to all the bank's institutional clients that would seek to mimic the performance of the S&P 500.

For a while, the new index fund was tricky to manage too because it didn't have sufficient assets to splash around all the constituents of the index. It was seeded with $10 million from Wells Fargo's own pension fund and Illinois Bell's retirement system; it wasn't until it grew to $25 million that it was able to buy shares in every one of the index members.

Like many other innovations, index funds didn't catch on immediately. By the end of 1975, the Wells Fargo fund had $150 million of assets. Another early pioneer, Batterymarch, launched an index product in 1972-73, but found no takers until the end of 1974, when the New York City Teachers' Retirement Scheme invested $10 million. By the end of 1975, Batterymarch was at $100 million of assets under management.

Fees were attractive – just 0.03% to 0.06% of assets under management – but these new index funds faced a lot of skepticism, especially from the traditional fund industry. Several investment firms including Mellon (now part of Bank of New York) and American Express looked at launching similar funds but didn't proceed.

> *"If people start believing this random-walk garbage and switch to index funds, a lot of $80,000-a-year portfolio managers and analysts will be replaced by $16,000-a-year computer clerks. It just can't happen,"* one mutual fund manager told the Wall Street Journal in 1973.

Nevertheless, funds like the Wells Fargo and Batterymarch ones continued to have a group of vocal cheerleaders within the academic establishment. Chief among them was Nobel prizewinner Paul Samuelson. In 1974, Samuelson wrote an article for the Journal of Portfolio Management titled *Challenge to Judgment*. He cited what Wells Fargo and Batterymarch had done and urged other institutions to set up passive funds, "if only for the purpose of setting up a naive model against which their in-house gunslingers can measure their prowess."

One man who read the article was John Bogle.

Strategy Follows Structure

John Bogle was previously CEO of Wellington Management, a large Philadelphia-based fund management company, but was ousted in 1974 after a failed merger and the loss of over a half the firm's peak assets under management. Not prepared to go quietly, Bogle realised that he still had some power via his position on the boards of the underlying funds that Wellington managed. By law, each fund had an independent board that represented the interests of fund investors. Normally, the relationship between a fund's board and its investment advisor is tight, but Bogle threatened to shake things up.

As he writes in his autobiography:

> *The situation was, as far as I know, unique in the annuals of the mutual fund industry: an extraordinary confrontation between a group of mutual funds with its own CEO (me) and its long-time investment adviser, Wellington Management Company, then holding virtually complete control over the funds' affairs.*

Lobbied by Bogle, the fund directors voted to carve up some responsibilities of the fund management process. While they left investment management and fund distribution with Wellington, they brought fund administration in-house. This meant setting up a new subsidiary company, which they called Vanguard, which would manage fund financial affairs, shareholder recordkeeping, legal and compliance, and handle share purchases and redemptions. The company would be truly 'mutual' – owned by investors in the underlying funds. Bogle would continue to serve as CEO of the funds and became CEO of the new venture.

It was in his first few months at the helm of his new company that Bogle became aware of Samuelson's article. He realised that Vanguard was uniquely positioned to operate low-cost index funds for retail investors. As a mutual organisation, his was devoid of typical conflicts that emerge between the profession of investing and the business of investing. Nor did he have any of the $80,000-a-year portfolio managers and analysts on his staff, eager to protect their position. Bogle would later argue that the structure of the firm was the foundation for the widespread launch of index funds; in his words, "strategy follows structure."

In 1976, Vanguard filed a prospectus for its "First Index Investment Trust". It projected that the cost of managing the fund would be 0.3% per year in operating expenses and 0.2% per year in transaction costs, compared with as much as 2% to 3% for an actively managed fund. Bogle had to convince his board that a fund offering was consistent with the company's mandate. He argued that since the fund was technically unmanaged, it wouldn't present a problem, and distribution could be outsourced. Vanguard signed a deal with Standard and Poor's to license their index for a sum much lower than the value that would ultimately accrue to this piece of intellectual property.

Samuelson was excited. In a piece for Newsweek in August 1976, he wrote, *"Sooner than I dared expect my implicit prayer has been answered. There is coming to market, I see from a crisp new prospectus, something called the First Index Investment Trust."*

Yet like Wells Fargo in the institutional market before it, the Vanguard fund was slow to take off. Bogle thought he could raise $150 million in the initial offering of the fund. After his roadshow visiting financial advisors and investors, his underwriters warned him that he may only raise $30 million. In the end, he raised $11 million.

Vanguard's First Index Investment Trust didn't cross the $100 million mark until the end of 1981, and that was only after merging it with another $58 million fund. But the slow start kept competitors away, and bank-owned money managers like Wells Fargo were prohibited from selling to retail investors, so for a long time Vanguard had the market to itself. By 1988, it had grown its assets to $1 billion, putting it in the top 5% of US mutual funds by size.

It was at this time that Bogle "realized he had something. And then set himself up to build it up," according to a colleague Robin quotes in his book. He launched new funds, tracking different pockets of the stock market. Curiously, it is at about this time that Batterymarch, one of the early pioneers of institutional index funds alongside Wells Fargo, decided to give up. "After reading that there were by then seventy-five index fund providers, LeBaron decided that it had become such a commoditized industry that it made no sense for Batterymarch to continue it."

Today, Vanguard manages over $7.2 trillion of assets. With scale, it has been able to push its expense ratio down to 0.09%, versus over 0.50% in the firm's early days. And it's not even the biggest player in the market. Remember Wells Fargo? Well, in 1995, Wells Fargo sold its investment advisory business to Barclays and in 2009, Barclays sold it to Blackrock. When Barclays bought the Wells Fargo business, the combined firm managed $256 billion of assets; by the time they sold it, it was managing $1.85 trillion. Along the way, Barclays cultivated a business in exchange-traded funds, which today is a cornerstone of Blackrock's business.

ETFs: The "Fabric of Capital Markets"

In early 1992, Jack Bogle hosted a meeting in his office in Valley Forge, Pennsylvania with the vice president of new product development at the American Stock Exchange, Nate Most. Most pitched him an idea for a new fund – one that could trade throughout the day on an exchange just like any stock. Bogle was dismissive. *"Why would anybody want to buy the market at 10:30 in the morning and then sell it at one o'clock in the afternoon?"*

Nate Most took the idea instead to Standard and Poor's and, in January 1993, the exchange-traded fund (ETF) was born. Most great financial innovations are really legal and operational innovations, and the ETF is no exception (another good example is the Eurobond). It required exemption from some securities rules and creation of others. The first ETF tracked the S&P 500 index; it charged 0.2%, the same as the equivalent Vanguard fund, and on its first day of trading it traded over a million shares.

But just like its predecessors in the index world, growth was then slow. Financial advisors were not paid to distribute the ETF and so had no incentive to do so; nor were banks paid underwriting fees. At one point the American Stock Exchange considered scrapping it. It took until the summer of 1993 for that first ETF to hit $300 million of assets – enough for it to be profitable – and by year end its assets were $461 million.

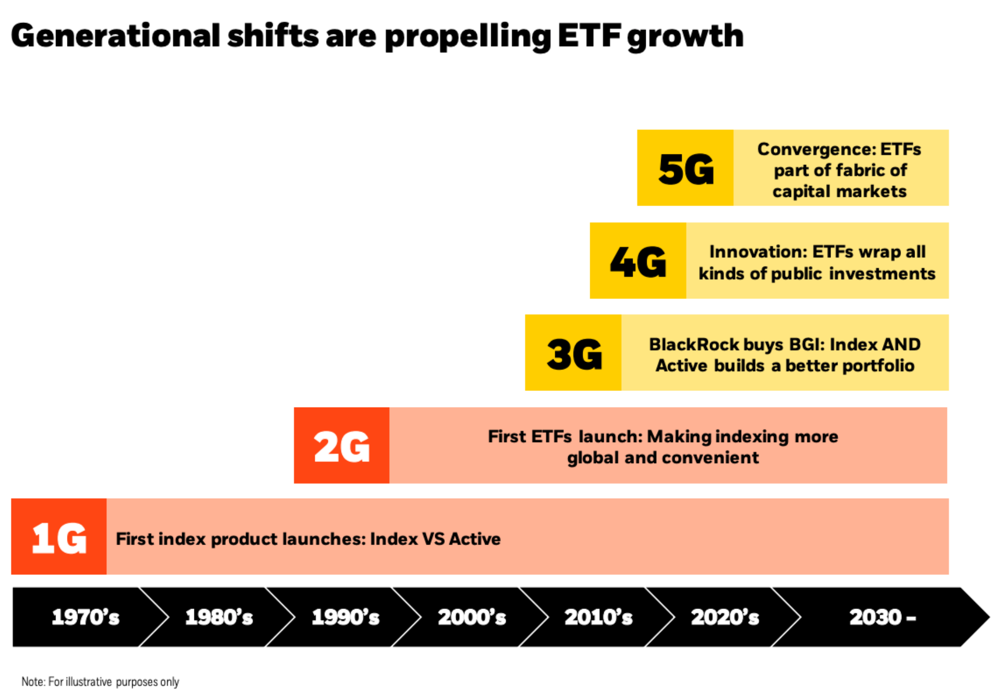
ETFs were soon copied by other providers, including Wells Fargo/Barclays, where a team worked together with Morgan Stanley on a suite of ETFs to track MSCI indices (Morgan Stanley was part owner of MSCI). They called the product World Equity Benchmark Shares – later renamed iShares – and went live in 1996. Unsurprisingly, given the experience at Standard and Poor's, growth was slow. Morgan Stanley later sold its interest in the venture to Barclays for $1. But Barclays invested heavily in iShares, launching lots of new ETFs and marketed them heavily. It recognised the brand value of using well-known market indices and negotiated fixed-term exclusivity agreements with index providers to solidify its position.

Almost ten years after Jack Bogle met Nate Most, Vanguard finally launched its first ETF. But by then, it was too late; Barclays was the market leader. iShares became the jewel in the crown within Barclays' investment management business, overseeing $408 billion of assets on the eve of the financial crisis. It was the forced sale of this business – as a way to raise capital to shore up its balance sheet – that brought it into the purview of Blackrock.

This week, Blackrock reported earnings for the quarter ending September 2021. ETFs are a cornerstone of its business. The firm now manages $9.5 trillion of assets, of which a third are ETFs and a third are index funds. Yet ETFs are a lot more profitable than traditional index funds as they have come to encompass ever more esoteric portfolios of assets. Blackrock's average fee on an equity index fund is only 0.04% but the average fee over its equity ETFs is 0.22% – that's roughly halfway to the 0.53% it secures on active equity funds.

At an investor day earlier this year, Blackrock argued that ETFs make up only 5% of the global equity market, leaving plenty of room for growth. They identified five iterations of ETF innovation. V1.0 was the index product, launched in 1971; V2.0 was the ETF itself in 1993; V3.0 was when investors started using ETFs within an actively managed portfolio; V4.0 is the creation of new portfolios to track; V5.0 is "where ETFs are becoming a more central part of the capital markets themselves."

Against the backdrop of these trends, Blackrock estimates global ETF assets will double from $8 trillion currently to $15 trillion by 2025.



Source: Blackrock Investor Day, 2021

The New Captains of Capital

Blackrock's size is a concern Robin lays out in his book. As a low cost business model, the passive asset management industry tends towards scale. Three firms dominate. Over the past decade, around 80 cents of every dollar that has gone into the US investment industry has ended up at one of those three firms: Vanguard, State Street, and Blackrock. As a result, the combined stake in S&P 500 companies held by the three has increased from about 5% in 1998 to over 20% today. Because not all investors vote at annual meetings, these three firms account for about a quarter of all shareholder votes, according to a study cited by Robin. The study projects that, if left unchecked, the three firms will amass over 40% of votes within 20 years. Fortunately, the situation is being checked. Blackrock announced last week that it would devolve voting rights to its clients – pension funds and the like – on 40% of the equity index assets it manages.

But there's another concentration of power that sits behind the passive asset managers, and that's the concentration of power in the hands of index providers – firms like S&P and MSCI – who license their indices to the passive management firms. We talked about it last year in *The Business of Benchmarking*. In June, the European Fund and Asset Management Association called on regulators to intervene:

> *"These companies have significant market power and can unilaterally set virtually all contractual conditions since the customers on the asset management or banking side cannot undertake the activities that are essential to their business without the data provided by these firms."*

In addition to these points about concentration, Robin's book highlights two other criticisms commonly levelled at the passive management industry. One is the proliferation of products. There are now around 8,000 ETFs in existence and three million indices, compared with 41,000 public companies. Choosing the right ETF or the right index is little different to choosing the right stock. In its usual fashion, the financial industry has complicated a simple design.

Second is that the industry is distorting markets – the criticism David Einhorn makes at the top of this piece. Robin's view is that passive strategies contribute to a diverse market ecosystem, no different from other investing innovations before them such as hedge funds or mutual funds.

Underlying all of this, like most things, is technology. Technology has reduced the cost of replicating parts of the market passively but it has also increased the rate at which information – the raw material of active managers – gets disseminated. It is the interaction of both these trends that my active colleagues, talking about the threat from passive, may have underestimated all those years ago. With neither of these trends in an end state, the share of passive, as Blackrock projects, will likely keep on going up.[1] That makes Robin's book an important read.

Trillions: How a Band of Wall Street Renegades Invented the Index Fund and Changed Finance Forever by Robin Wigglesworth, Penguin Business £25/Portfolio $30, 352 pages

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1
Michael Mauboussin anchors this idea in the Grossman-Stiglitz model.

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