Lincoln Private
Investment Office

London

January 2018

The risks of passive investing

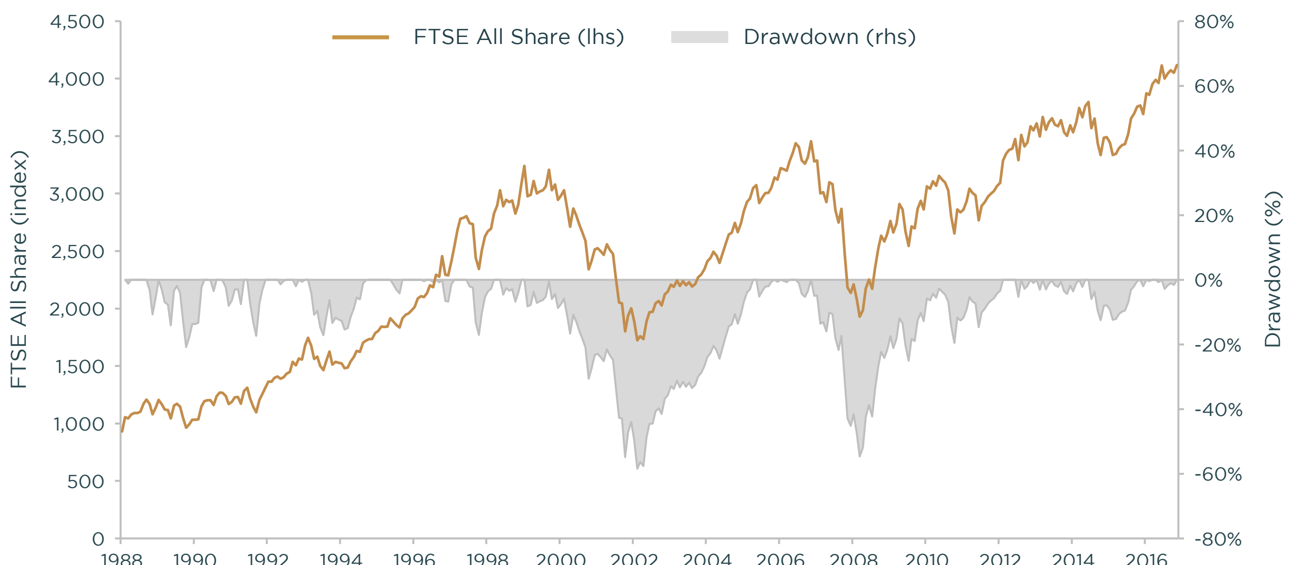
"Investors, on average and over time, will do better with a low-cost index fund than with a group of fund of funds". Warren Buffet, active investor

"If everybody indexed, the only word you could use is chaos, catastrophe". Jack Bogle, founder of Vanguard, one of the largest providers of passive investments

The past couple of decades have seen a dramatic increase in the value of assets being managed on a passive basis through investments such as ETFs (Exchange Traded Funds). The above quotes come from two of the world's most respected investors and are statements that appear, on the surface at least, to go against their own core investment philosophies and highlight the diverse views within the investment universe around passive and active investment techniques. Here, rather than focus on the active versus passive argument directly, we aim to provide our view on when we believe one approach is more appropriate than the other by looking at some of the risks of a passive approach and when we believe that it is most appropriate in a portfolio context.

There is a misconception that passive investing is low risk investing; this is simply not true. Passive investing takes away one risk – the risk that the active decisions a manager of a fund makes will damage performance. However, in making a decision to invest passively an investor still has to make a number of risk decisions: which index to invest in, which currency to invest into, and potentially when to buy and sell the passive fund.

When investment markets experience periods of positive returns it is easy to demonstrate how a passive approach would perform well. However, for many investors it is not only about the returns received over a period of time, but also about the volatility. A passive fund is fully invested at all times and cannot hold cash positions, in contrast to an active manager who is able to reduce portfolio risk by holding cash or employing hedging strategies when they believe that there is increased market risk. The graph below shows the FTSE All Share index and highlights the positive returns overall, but also the periods of losses, or drawdowns. We can see a number of periods where an investor, who was invested passively, would have experienced a drawdown of more than 15% of their capital and instances of falls in value of 50% to 60%.



This document has been prepared and distributed for information by Lincoln Private Investment Office LLP ("LPIO") and is a marketing communication. LPIO is authorised and regulated by the Financial Conduct Authority. The information in this document does not constitute an offer by LPIO to enter into a contract/agreement, nor is it a solicitation to buy or sell any investment. Nothing in this document should be deemed to constitute the provision of financial, investment or other professional advice in any way.

Lincoln Private
Investment Office

London

January 2018

The two tables below show the sector weightings of the FTSE All Share index and the weighting of the top ten holdings in it. Looking at the first table there is a huge bias towards financials, but very little exposure to the real estate sector. At different points in the business cycle, as global sentiment changes, there can be very good reasons for wanting to be exposed to individual sectors differently. During the global financial crisis for example, the finance industry was in meltdown, and prior to the collapse of the equity markets in 2000 technology stocks made up a larger part of the equity market than they had before. From a risk perspective there are times when specific sector allocation sees the investor exposed to unnecessary systemic risks that an active manager may seek to avoid or at least reduce.

The second table shows that indices can be biased towards holding the largest companies. Using the FTSE All Share again, HSBC makes up 6.2% of the index. The complete index includes 640 companies and yet we can see performance will be very influenced by HSBC. Passive investors are forced into buying these companies regardless of any assessment of value or price. Another way to consider the same point is that the largest 20 names make up a full 50% of the index, and that 607 names make up less than 0.5% each.

Sector	Weight
Financials	24.5%
Consumer Staples	14.4%
Energy	11.4%
Industrials	10.0%
Consumer Discretionary	9.9%
Health Care	9.3%
Materials	8.5%
Telecom. Services	3.7%
Utilities	3.3%
Information Technology	2.6%
Real Estate	2.4%
Grand Total	**100.0%**

Issuer	Weight	Sector
HSBC Holdings PLC	6.2%	Financials
BAT PLC	4.1%	Consumer Staples
Royal Dutch Shell PLC	3.9%	Energy
BP PLC	3.7%	Energy
GlaxoSmithKline PLC	3.3%	Health Care
Royal Dutch Shell PLC	3.3%	Energy
AstraZeneca PLC	2.8%	Health Care
Vodafone Group PLC	2.5%	Telecom. Services
Diageo PLC	2.4%	Consumer Staples
Unilever PLC	2.1%	Consumer Staples
	34.4%	

Over time, as a company or sector becomes more expensive, passive managers are forced to buy more of it, which results in pricing that can become further and further away from what would be considered a company's fair value. This concentration risk and herd mentality is inevitable in passive investing and can lead to exaggerated falls during a market correction.

On a more technical level, and referring back to the quote we opened with from Jack Bogle; the whole market could never be passive. A key element of having buyers and sellers in any market is that of price discovery which plays an important role in capital allocation.

One well known advantage of passive investing is that it is relatively low cost. We believe that in areas of the market where it is hard for an active manager to outperform, passive strategies are an ideal way to gain exposure. In addition, there are points in the cycle where we would hold a much higher proportion of the portfolio in passive investments. Passive strategies can be a highly effective tools in a portfolio to rapidly increase or decrease exposures to a particular market and allow us to implement a change of our views in a time efficient manner. However, as we approach the later stage of the investment cycle it is normal to see a much greater dispersion of returns, where instead of all stocks rising or falling together, there is a much greater focus on individual company specifics and significant outperformance of better companies. In this environment we would tend to favour an active manager who has the ability to research and identify those areas of the market and individual securities that offer value.

In conclusion, we believe that both active and passive investments have an important part to play in portfolios, but that in the current environment, the risks of an over-reliance on a passive approach are significant. It is also important to note that we also believe it is only worth paying the extra cost for active investment if you are accessing a genuinely skilled manager who is targeting real outperformance.

Lincoln Private Investment Office

This document has been prepared and distributed for information by Lincoln Private Investment Office LLP ("LPIO") and is a marketing communication. LPIO is authorised and regulated by the Financial Conduct Authority. The information in this document does not constitute an offer by LPIO to enter into a contract/agreement, nor is it a solicitation to buy or sell any investment. Nothing in this document should be deemed to constitute the provision of financial, investment or other professional advice in any way.