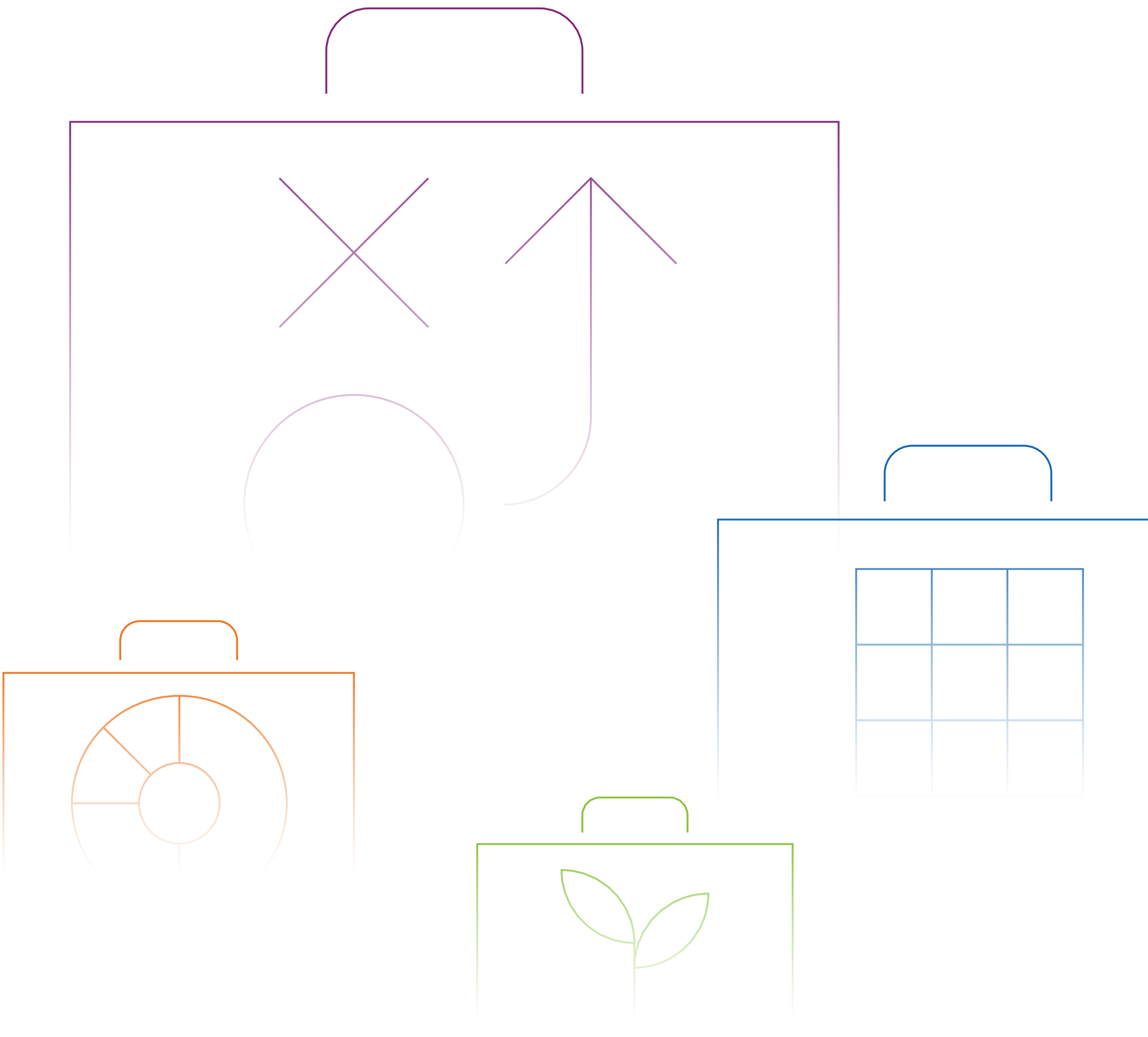
Guide to Passive Investing



The passive fund industry has seen an increase in popularity over the last few decades, as more investors move away from actively managed funds and opt for passively managed alternatives. At the end of last year, passive mutual funds and ETFs made up 20% of the assets in Europe's €9.4tn fund industry, with an impressive 9.5% growth over the previous 12 months compared to the 2.1% asset growth of actively managed funds. Europe also boasts the largest and most comprehensive market for passively managed sustainable funds, accounting for more than three fourths of global assets.[1]

[1] https://direct.morningstar.com/research/doc/999383/Passive-Sustaiable-Funds-The-Global-Landscape-2020

There are several factors that have driven flows into passive funds. Investors are increasingly aware of the importance of minimising investment costs, which has led them to favour lower-cost funds, in turn supporting the growth of the passive fund industry. In fact, European investors are paying lower expenses, on average, than ever before.

The average fee paid by investors, represented by the asset-weighted average ongoing charge across all funds for the categories that Morningstar recently analysed, was 0.69% in October 2020—a 31% decline from 2013. The passive fund industry has led the charge in slashing expenses, with a 30% cut in average fees since 2013 compared with a 17% reduction among active funds.[2]

[2] https://direct.morningstar.com/research/doc/1013646/European-Fee-Study-December-2020

With the rise in demand for passively managed strategies, this guide serves as an overview to the passive investing landscape and how Morningstar's independent research can help investors make more informed decisions in this space.

An Intro to Passive Investing

A passively managed fund is a fund whose investment securities are not chosen by a portfolio manager, but instead are automatically selected to match an index or part of the market. By contrast, active strategies do not track an index. Instead, active fund managers make security selection decisions based on their own ongoing research, analysis and expertise.

The two main investment vehicles used to invest passively are:

1. Index Mutual Funds

Index funds were introduced in the 1970s and made it easier to achieve returns in line with the market at a low cost. With these types of funds, the manager chooses investments to mimic the benchmark. Some index funds buy all the stocks in their benchmark index, while others use optimised sampling to closely match the index's return without owning every security.

Similar to traditional active mutual funds, these funds price once a day. One hallmark of passive investing is transparency—detailed index rules are usually published by third parties and fund holdings are available at least daily.

2. Exchange-Traded Funds

Exchange-traded funds (ETFs) were later introduced in the 1990s. ETF and index mutual funds share many common traits and are often managed by the same investment management teams. Seen by many as an upgrade to the mutual fund structure, ETFs are traded throughout the day on exchanges like stocks.

Passive investing is often synonymous with investing in broad markets like the S&P 500 or FTSE 100. While most passive assets still sit in market trackers of this sort, there is an expansive and ever-growing menu of funds – particularly ETFs – which offer more complex exposures. These include thematic ETFs which pick and weight stocks based on their exposure to a theme such as robotics. Others aim to outperform the market by tilting towards a factor, such as strategic beta funds, which will be covered later.

Approaches to tracking also vary between funds. In many cases a fund will buy and sell all securities in the index, but in others, particularly in less liquid markets like fixed income, this becomes impractical. In these cases, a fund may buy a representative sub-set of the investment universe selected to mimic the risk and return characteristics of the index.

In other cases, a fund will enter into a swap contract with a bank to receive the return of an index. While this approach can often bring benefits including tax advantages and tracking fidelity, this approach does add an extra layer of complexity and has become less popular in recent years.

What Are the Benefits and Limitations of Passive Investing?

Passive investing has several notable benefits for investors.

- Passive funds generally charge lower fees than actively managed alternatives. This is because the process of tracking an index can be highly automated and costs minimised through scale. This has been a major factor in the rise of passive investing in recent years as the higher fees of actively managed funds does not always equate to better returns.

- By harnessing the collective wisdom of the market at a low cost, broad passive funds in most markets have proved difficult to beat over longer time horizons.

- Passive investments promise greater transparency. In most cases, an investor can access detailed index methodologies which clearly describe the investment process and compare directly against fund holdings, which are published at least daily. The most passive funds employ easy to grasp strategies and therefore require less monitoring and a lower due diligence burden.

- Diversification has been described as the “the only free lunch in finance” by Nobel Prize winner Henry Markowitz. Passives and broad market trackers tend to be well diversified. For example, a fund tracking the MSCI World index can provide exposure to over 1500 separate stocks.

Of course, passive investing is not without its limitations. The following might be seen as potential downsides of investing this way.

- Vanilla market trackers promise the return of a market, even when the market becomes disrupted. Passive funds are compelled to keep buying as the market overheats, and conversely in market crashes, index funds are forced to sell in line with a panicked market.

- In some markets, active managers have proved their worth over long periods. (For a market-by-market success rate, see the latest iteration of our Active/Passive Barometer detailed below.)

- Not all passive funds track simple and transparent indices and some of the more complex funds can resemble black boxes. Most non-vanilla passive funds, a grouping which includes ESG, thematic and strategic beta funds, make systematic active bets against the market. Not all of these bets will come off and investors risk underperformance versus the broad market.

- Some passive funds employ swap-based exposure to their index or, if physically replicated, can engage in securities lending. Both of these practices add an element of counterparty risk and should be understood before investment.

Bridging the Gap Between Active and Passive: The Rise of Smart Beta

As passive investing continues to evolve, many funds are now offering a hybrid-type strategy known as smart, or strategic beta that marries the benefits of both passive and active investing strategies. These products are touted as sophisticated and smart approaches to achieving alpha that select and weight holdings based on factor specific metrics. (For example, a value ETF may select its holdings based on ratios such as price-to-book.) Strategic beta funds are designed to capture academically substantiated factors such as value, low-volatility, momentum and quality, which have been shown to provide returns above the market over long periods and have been understood and exploited by active managers for decades.

Strategic beta funds are also much more cost-effective than their active counterparts, but often pricier than purely passive plays, because of the smaller fund sizes and the product development costs associated with building a distinctive investment strategy.

Similar to a passive investing approach, a strategic beta still tracks an index. But it isn't a typical market cap weighted index—it's a factor-based index, such as a value index, created by an independent index provider. Over most of the past decade, the strategic-beta space grew more rapidly than the broader exchange-traded product (ETP) market. Strategic-beta ETPs' growth has been driven by new cash flows, new launches, and the entrance of new players. As of Dec. 31, 2020, there were 1,367 strategic-beta ETPs, with collective assets of over €1 trillion worldwide.[3]

[3] *Morningstar Global Guide to Strategic-Beta Exchange-Traded Products*

Morningstar's Passive Investing Research and Ratings

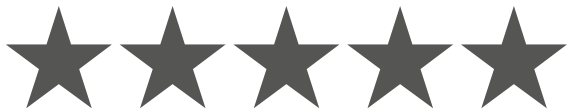
The days are long gone where investors weighing index-tracking strategies only had a relatively small number of simple, well-known indexes to choose from. Today investors are faced with a bewildering array of passive strategies.

Morningstar has been conducting independent investment research since 1984 to help investors sort through the myriad of options, scrutinising individual offerings and trends. Today, our coverage extends to over 3,700 funds thanks to the work of more than 120 analysts operating globally, making it one of the largest independent manager research teams in the world.

Our rigorous, trusted research process helps firms to deliver better outcomes, reduce costs, comply with regulatory and governance pressures, and ultimately to differentiate themselves from competitors. At the core of this is our proprietary ratings system which can be used to rate and analyse passive funds.

The Morningstar Star Rating

Morningstar Rating™



The Morningstar Rating is a purely quantitative, backward-looking measure of a fund's past performance that serves as a good starting point when it comes to narrowing down a sizable investment space. While this rating helps investors identify funds that performed well on a risk-adjusted (ex-post) basis, arguably what matters most for investors is the fund's forward-looking prospect to outperform (ex-ante).

Morningstar Analyst Rating for Exchange-Traded Funds and Index Mutual Funds

Morningstar Analyst Rating™

This is Morningstar's forward-looking, medallist ratings system that takes the form of Gold, Silver, Bronze, Neutral, and Negative. The Analyst Rating for exchange-traded funds and index mutual funds identifies those funds that we believe should be able to outperform a relevant peer group, within the context of the level of risk taken, over the longer term.

The pillars of our analysis are the same regardless of whether we are rating a passively managed index fund or ETF or an actively managed fund. However, their relative impact on our overall assessment of a fund differs somewhat when it comes to analysing and rating index funds and ETFs.

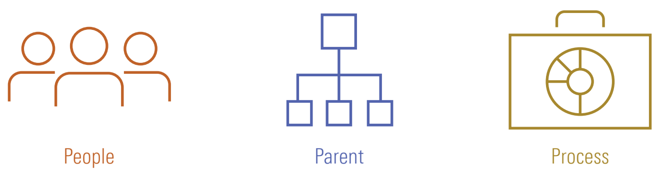
Keeping costs—both explicit ones, such as the expense ratio, as well as implicit ones, like the cost of portfolio turnover—at a minimum is paramount in the context of running an index tracking fund.

As such, it should come as no surprise that the top-rated funds that we analyse are among the lowest-cost options in their Morningstar Categories, not just versus their actively managed peers but also relative to competitive index fund and ETF options.

Rating Framework: The 3-Pillar Process

Morningstar's global analyst team has identified three key areas that we believe are crucial to predicting the future success of strategies and their vehicles: People, Parent, and Process. These pillars form the spine of our research approach and ratings, and we evaluate each of them when assessing a fund. In so doing, we not only evaluate each pillar but the interaction between them, which we believe is crucial to understanding a strategy's overall merit.

The Three Pillars of Morningstar Research and Analysis



People

Management matters when it comes to index funds and ETFs. Skillful managers and traders stand a better chance of tracking their benchmark over time, and they are better equipped to cope with challenging conditions. As is the case with active funds, we prefer teams with long track records. Teams that have run index funds and ETFs for several years—whether with their current firm or with a prior one —will generally be ranked higher than those who are relatively new to the job. Similarly, we prefer teams that focus solely on running index funds and ETFs as a core competency rather than a sideline.

Just as with active funds, we give teams that manage index funds and ETFs credit if they invest in their fund. It signals their commitment to the overall philosophy of indexing. That said, it is important to recognise that index fund and ETF managers are unique from their peers overseeing active funds. The fact that members of teams managing index funds and/or ETFs are not as highly compensated as managers of active funds are, and that they tend to manage a relatively larger number of funds, somewhat diminishes the importance of co-investment. As such, we tend to make a more holistic assessment of these managers' compensation and how it aligns their interests with those of fund shareholders.

Issues we consider:

- The structure of the portfolio management team.
- The amount of experience the team has in managing index funds and/or ETFs.
- The division of responsibilities among the various team members.

- Whether indexing is a core competency for the manager/team.
- The role that portfolio managers play in trading for the fund.
- Whether the manager invests in the fund.
- The historical level of personnel turnover and whether it has resulted from regular rotations of employees or stems from other issues.

Parent

Our Parent rating for index funds and ETFs is identical to those for actively managed funds from the same parent firm. This is because our parent-level assessment takes a holistic view of an asset manager's operations, culture, fees, etc.

Issues we consider:

- How the firm is organised, its ownership structure, and the makeup of its equity ownership.
- Whether the firm has adequate resources to support its offerings – trading, research, technology, etc.
- The quality of the fund offerings across the firm.
- The firm's ability to retain managers and analysts.
- The firm's record with respect to handling manager transitions.
- The firm's growth plans.
- The firm's product development philosophy and its track record in launching new funds and shuttering unsuccessful ones.
- Whether compensation policies align managers' interests with that of shareholders.
- Expense ratios.
- The firm's overall level of transparency, especially in its communications with shareholders.

Process

Portfolio Construction: Our analysis of index funds' and ETFs' process focuses on the construction of these funds' underlying benchmarks and the systems and portfolio management techniques that their sponsors have put in place to achieve high-fidelity tracking of those benchmarks. As such, our assessment of these funds' process spills over into understanding the capabilities of the index provider as well.

Issues we consider:

- Index concentration.
- The rules dictating the rebalancing and reconstitution of the fund's benchmark.
- Whether or not the index portfolio adequately reflects the opportunity set available to active managers in the fund's peer group.
- If the fund tracks a strategic-beta index, we try to understand whether it seeks to exploit well-known, time-tested risk premiums or is potentially a product of back-testing and/or overfitting of data.
- Any changes to the benchmark index's methodology over time and whether they have yielded positive, neutral, or negative results.

Portfolio Management: After examining process as defined by the makeup of an index fund's or ETF's underlying benchmark, we move on to understand how these funds' managers set about tracking their indexes. For these funds' managers, tight tracking is a never-ending task that involves numerous trade-offs and requires, among other things, robust systems and a capable team.

Issues we consider:

- Portfolio management approaches (for example, sampling, full replication, or synthetic replication).
- Use of derivatives in managing the funds and how any associated counterparty risk is being monitored and mitigated.
- Tracking issues that might arise during the construction of a fund's benchmark.
- How portfolio managers handle index reconstitutions or other changes to the benchmark.
- How portfolio managers attempt to minimise trading costs.
- Techniques, such as securities lending, aimed at improving tracking performance.
- The fund's distribution policy and how cash drag is minimsed.
- The creation and redemption process. In the case of ETFs, we want to understand the portfolio manager's approach to managing creations and redemptions of new fund shares.
- In the case of ETFs, we also examine portfolio managers' relationships with the funds' authorised participants and market makers.
- Pricing mechanisms employed by index funds' managers to mitigate the effects of dilution.

- The frequency and magnitude of capital gains distributions.
- The magnitude, volatility, and underlying drivers of ETFs' premiums and discounts to net asset value.

The latest European Active/Passive Barometer can be downloaded here.

Morningstar's Active/Passive Barometer

The Morningstar Active/Passive Barometer is also a feature of our passive investing research that helps investors to make more informed decisions when it comes to their strategies. The Barometer is a semi-annual report that measures the performance of Europe-domiciled active funds against passive peers in their respective Morningstar Categories.

The Active/Passive Barometer uses unique ways to measure active managers' success:

- It evaluates active funds against a composite of actual passive funds—not versus a costless index. In this way, the benchmark reflects the actual, net-of-fee performance of the passive funds available to investors.
- It assesses active funds based on their beginning-of-period category classification to better simulate the funds an investor would have chosen at the time.
- It considers how the average unit of currency invested in various types of active funds has fared versus the average unit of currency in passive funds.

The Active/Passive Barometer is comprehensive spanning nearly 21,000 unique active and passive Europe-domiciled funds that account for approximately EUR 4.4 trillion in assets, or about one third of the total European fund market. In short, it's a useful measuring stick that can help investors calibrate the odds of succeeding with active funds in different areas based on recent trends and longer-term history.

Find out more about Morningstar Indexes here.

Morningstar Indexes

Morningstar Indexes combines the science and art of indexing to give investors a clearer view into the world's financial markets and can be used in the construction of passive portfolios. Our indexes are based on transparent, rules-based methodologies that are thoroughly back-tested and supported by original research.

Covering all major asset classes, our indexes originate from the Morningstar Investment Research Ecosystem—our network of accomplished analysts and researchers working to interpret and improve the investment landscape. Clients such as exchange-traded fund providers and other asset management firms work with our team of experts to create distinct, investor-focused products based on our indexes. Morningstar Indexes also serve as a precise benchmarking resource.

Ready to Discover More?

Morningstar's passive investing research and ratings can all be accessed within our flagship investment and research platform, Morningstar Direct.

Register for a free trial of Morningstar Direct today.