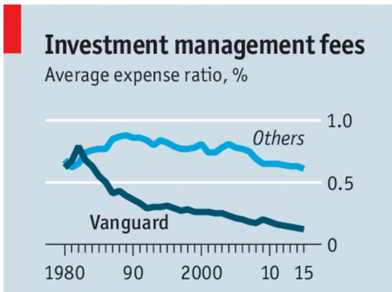
Fund management

Slow-motion revolution

The rise of low-cost managers like Vanguard should be celebrated

Jun 11th 2016



Economist.com

IN THE past few years, industries including retailing, music and taxis have been spectacularly blown apart by low-cost innovators. Less celebrated is Vanguard, a fund-management group that also fits the disruptive mould. It offers diversified portfolios for retail investors at a fraction of the cost of the industry average, thanks in part to a mutually owned structure that means it cuts fees rather than pays dividends. It now runs more than $3.5 trillion of assets, and takes in another $1 billion or so from investors every working day.

This is no overnight success: Vanguard was founded in the 1970s. That such a superior model has taken 40 years to reach today's position is testament to two failings of finance. One lies in incentives in the industry. Many products are sold by brokers or investment advisers and, for a long time, the salesforce was paid by commission. Vanguard does not pay commission, so the business went elsewhere.

The second failing is investors' fault. Most of Vanguard's funds are "passive". They do nothing more than try to match their benchmark (an index like the S&P 500, say). When this idea was first mooted, people scoffed. Who would settle for mediocrity? Better to pick one of the star "active" managers with a record of beating the market. The law of averages does indeed suggest that some managers outperform. But though you can spot such titans in retrospect, it is hard in advance. Otherwise, why would anyone give money to the also-rans?

Regulators have belatedly tackled the incentives problem by requiring advisers to be paid by fees, rather than commissions. And an era of low interest rates and low returns has made investors more aware of the damage from charges. Too many savers have suffered the drip-drip of fees on their long-term returns in the vain pursuit of outperformance—money for old hope. A 25-year-old saver who invests in a pension for 40 years on an annual charge of 1% will take a 25% hit on the average dollar deposited in their pot, irrespective of returns; for those who pay 1.5% a year, the loss is 38%. The total fees on the average Vanguard tracker are 0.08% a year.

Money is gushing into passive funds. In America they raked in $400 billion in 2015; actively managed funds endured outflows. Because of economies of scale, it costs little more to run a $10 billion index fund than to manage a pot of $1 billion.

Are there risks from the disruption of fund management? Critics of big tracker managers like Vanguard and BlackRock argue they make financial markets more volatile. In theory, tracker funds could lead to swings as investors pile in and out of all shares simultaneously. But the evidence that retail investors withdraw *en masse* from tracker funds when the market falls is thin—they did not during the financial crisis. And new types of tracker funds are emerging that invest in stocks based on different criteria such as dividend yield; that should reduce the tendency to herd.

Another worry is that tracker managers will be less vigilant in rooting out bad management practices at the firms they invest in, as they do not have the option of selling if they are unhappy. It is true that passive funds could do more to hold companies in their portfolios to account (even if more vigilant governance adds a small cost). But problems of inadequate governance afflict active managers as well as passive ones.

A third—somewhat contradictory—concern is that a stockmarket dominated by tracker managers would lead to collusion. As such funds grow, they take big ownership positions in firms that compete with each other. Vanguard owns 5% of American stocks, for example; it is among the top three shareholders in the four biggest banks in America. If firms share a large shareholder, they might feel less obliged to compete. But trackers do not seek to attract investment by boosting their returns, unlike actively managed funds. As a result, they have less reason to encourage collusion.

The trackers of my tears

If passive funds go from accounting for roughly 30% of global stockmarkets to, say, 70-80%, then some of these worries would have more bite. But that will take a long time; despite the surge of money into passive funds, the share of actively managed stocks has only fallen from 78% to 70% in the past six years. For the foreseeable future any risks from tracker funds are far outweighed by their ability to offer cheap, diversified funds to retail investors. The real problem is not the rise of Vanguard and the other tracker funds; it is the rotten deal that retail investors have received from the fund-management industry for far too long.