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**Justin Tay**  
Consultant

Justin is a Consultant and a member of the Global Equities Research Team (GERT). Before joining JANA in 2017, Justin worked

at Zenith Investment Partners as a Senior Investment Analyst. His responsibilities included fund manager research across multiple asset classes and contribution to the portfolio construction effort for the firm's consulting clients. Prior to Zenith, Justin worked for a leading private wealth advisory firm as a Research Analyst where he was responsible for conducting investment due diligence.

Justin is a Certified Investment Management Analyst® (CIMA®) and holds a Bachelor of Commerce (majoring in Finance and Economics) from the University of Melbourne. In 2014, Justin was awarded the BlackRock/Portfolio Construction Forum sponsored CIMA® scholarship.



**Matthew Gadsden**  
Senior Consultant

Matt consults to a range of super and non-super Implemented Consulting clients but also contributes to

servicing one of JANA's largest traditional clients. This involves providing considered advice across a broad range of investment issues, asset classes and client specific requirements. In his dual role, Matt is also Head of JANA's Global Equities Research team.

Prior to joining JANA in January 2012, Matt worked at Plum Financial Services as a Pricing and Strategy Analyst providing pricing analysis and strategic direction to the Plum Leadership Team. Matt has also gained industry experience through his tenure at two boutique financial planning practices as a para-planner/financial planner.

Matthew holds a Bachelor of Business (Economics & Finance) from RMIT and a Masters of Applied Finance from Macquarie University.

## CHANGING MARKET DYNAMICS: THE RISE OF PASSIVE INVESTING AND EXCHANGE TRADED FUNDS (ETFs)

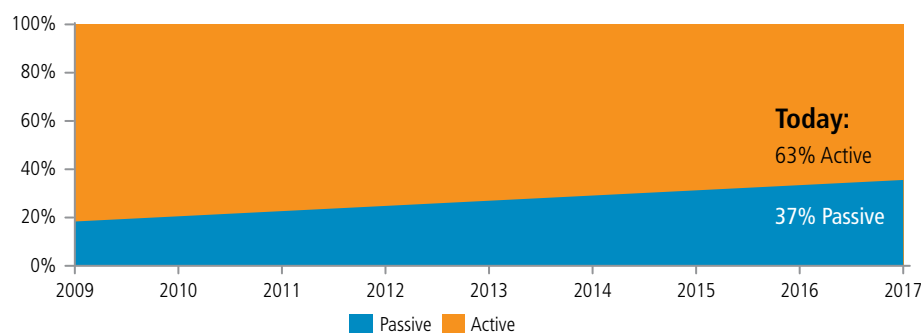
### Introduction

The acceleration in passive investing, and in particular the rise of Exchange Traded Funds (ETFs) as a popular approach for investing passively, is a phenomenon that is well documented. Without seeking to argue the merits or disadvantages of ETFs or other passive instruments, the growth of its market share and speed of uptake raises an obvious question as to what impact the rise of passive investing is having on markets, be it from an excess return or risk perspective. JANA reflects on this question in this month's issue of MyConsultant.

### Passive & ETF investment ownership and the reasons for its rapid growth

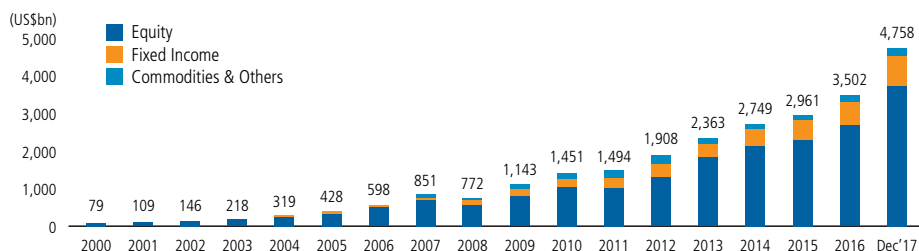
Chart 1 below highlights the significant growth in passive investments as a proportion of the US equity market from 2009 to 2017 and Chart 2 reflects the growth in Exchange Traded Product (ETP) or ETF assets between 2000 and 2017.

**Chart 1: Growth in passive investments**



Source: Strategic Insight SimFund, BofA Merrill Lynch

**Chart 2: Growth in Global ETF's**



Source: BlackRock Global ETP Landscape

BlackRock notes in its December 2017 ETP Landscape update that, "Global ETPs brought in US\$633bn in 2017, exceeding 2016 full year flow record of US\$378.4bn". The global ETP market has increased more than fivefold since the Global Financial Crisis (GFC) to stand at approximately US\$4.8tn.

Within the passive investment universe, the rise of ETF exposures has been significant. ETFs represented 4% of overall passive exposures at the start of 1998, but by December 2016, had grown to 46% according to a survey conducted by research house Morningstar. Accordingly, a large part of the recent growth in passive assets can be attributable to ETFs.

There are several reasons for this growth in ETFs and passive investing, with some of the most common ones being:

- > Disappointment in active manager performance;
- > Greater focus on fees and/or investors managing to a 'whole of portfolio' fee constraint;
- > The rise of sophisticated quantitative techniques and computing power which have given rise to more 'passive' or smart beta products, thereby providing the market with greater choice in the range of passive instruments available to gain more granular exposure to underlying market components (e.g. regional, sector, style (value, growth, low volatility), etc);
- > Large pension funds such as the European Pension Fund and Norges Bank are unable to invest via capacity-constrained active managers;
- > Changes to financial adviser regulation and remuneration structures in the US has seen a significant portion of the industry migrate from active trail-commission mutual fund products to lower cost passive products where advisers can charge a fee for asset allocation.

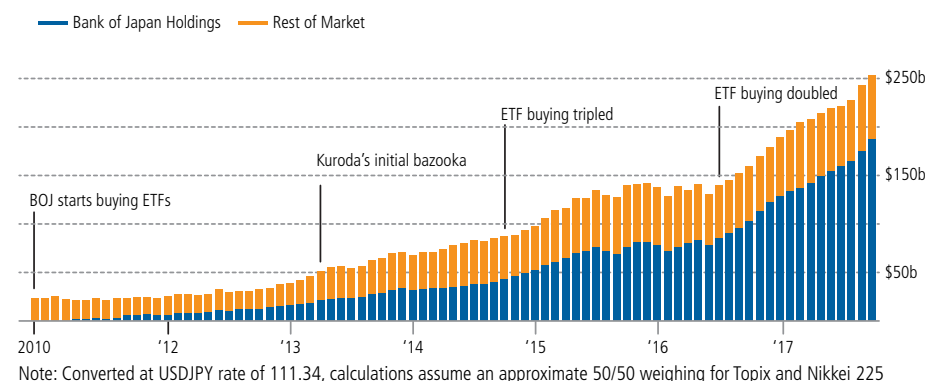
In summary, the adoption of passive investing and ETFs as a favoured instrument for implementing passive investments is largely an equity-based phenomenon and in particular in the US, where actively managed mutual funds appear to have been the funding source for new flows into passive products. However, we note that active management is still a very large part of the market, even after accounting for the significant growth in passive over the last decade.

## Have large passive ownership stakes in companies caused market distortions?

An area for investigation is whether large passive ownership stakes in individual companies has caused market distortions.

Japan is a good case study given the impact of the Bank of Japan's (BOJ) extraordinary quantitative easing measures that include the purchase of Japanese ETFs (along with government bonds and equities) in an attempt to stimulate the economy and increase inflation to its objective of 2% p.a. Initially implemented in 2010, these purchases have had a dramatic impact, with nearly 20 trillion Yen of capital in aggregate being deployed since the programme began. Chart 3 below outlines the extent of BOJs ETF purchases over time:

**Chart 3: Bank of Japan's ETF purchases over time**



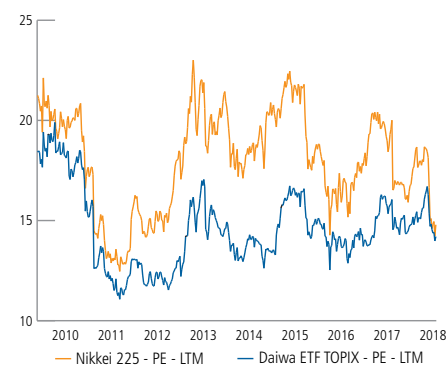
Source: Bank of Japan, Investment Trusts Association of Japan, Bloomberg

As outlined above, the BOJ's ownership of Japanese equity ETFs has pushed past 60% of the total ETF market. Notwithstanding the large holdings of ETFs by the BOJ, this amounts to only approximately 3% of the value of the overall Japanese stock market.

At a high level, the valuations of Japanese equities, from a Price to Earnings perspective, do not appear to be materially affected, in fact they have fallen.

This can be seen in Chart 4 below which displays the valuations (as represented by the Price to Earnings Ratio) of two of the better known Japanese equity indices:

**Chart 4: Price to Earnings (P/E) Ratio of Nikkei 225 Index and Daiwa TOPIX ETF over time**



Source: Factset

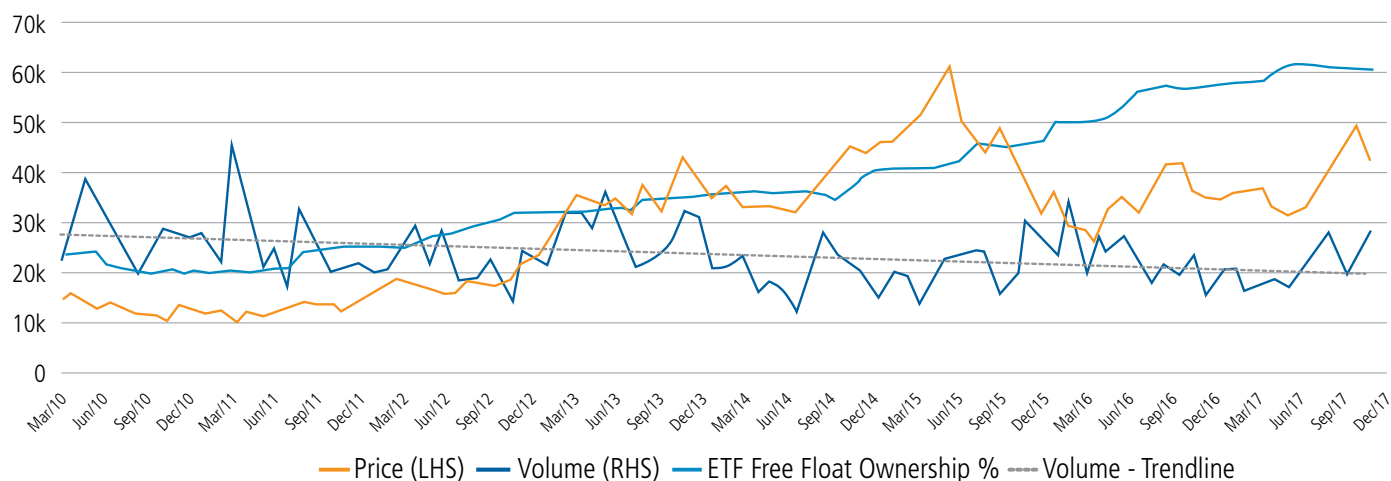
However, when the ownership at the underlying stock level is examined, there have been some significant impacts, especially on companies with lower levels of free float.

Here, we consider the case of Fast Retailing, a Japanese retail holding company, of which Uniqlo is the primary subsidiary. Between 2010 and 2017, the proportion of ETFs comprising Fast Retailing's free float (using the top three Nikkei 225 ETFs as a proxy) increased from approximately 15% to approximately 40%.

Chart 5 below tracks the price and liquidity (as represented by trading volumes) of Fast Retailing between March 2010 and March 2018 against the level of ETF ownership.

The global ETP market has increased more than fivefold since the Global Financial Crisis (GFC) to stand at approximately US\$4.8tn

**Chart 5: Fast Retailing – A Case Study**



Source: FactSet

The key observations from the chart are twofold:

- > There is a positive correlation between price and ETF ownership, and
- > A negative relationship exists between liquidity (as represented by trading volume) and ETF ownership.

These observations are generally consistent with economic intuition; an increasingly large passive owner has corresponded with reduced effective free float and an overall reduction in liquidity levels. These outcomes would appear to suggest that passive ownership (via ETFs in this instance) can potentially distort the risk/return profile of securities, however JANA notes the following caveats to this:

- > The case study of Fast Retailing is an extreme example of dominant ownership from a free float perspective by a passive investor,
- > The global market has been in a bull market over most of the time period assessed, broadly supporting global equity prices, and
- > Part of the decline in trading volumes could be attributed to declining levels of market volatility.

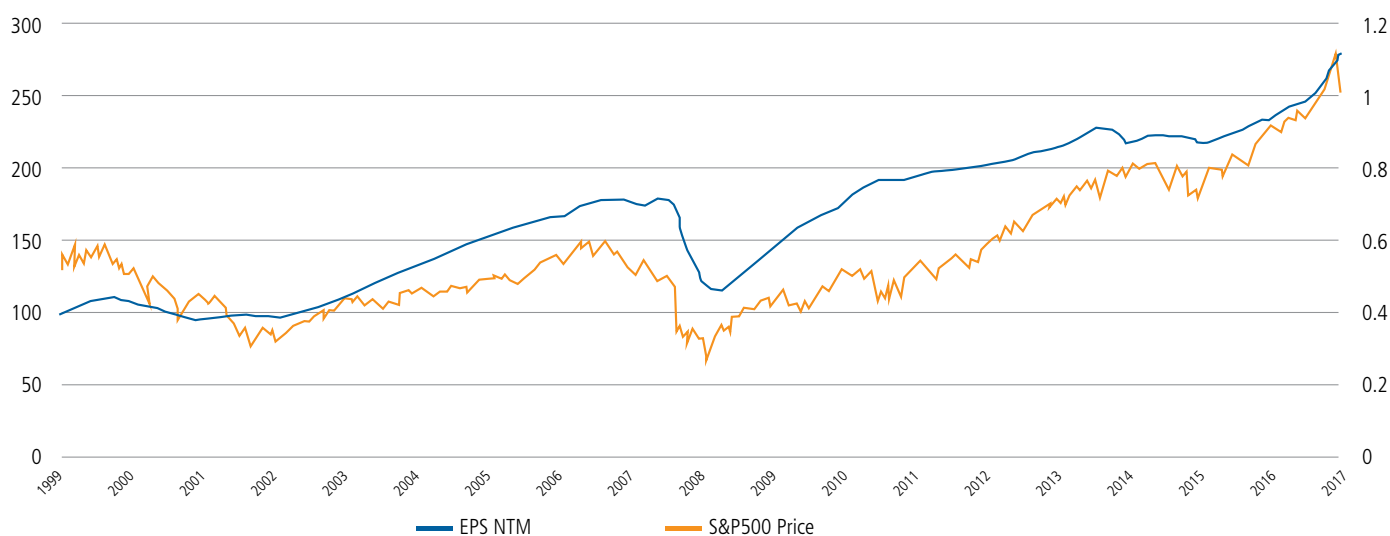
## Return Drivers and Alpha Generation

While the rise in passive investing and ETF ownership might be creating volatility and price distortions for some markets, sectors and stocks, in the context of broad market return drivers, we would consider that there may be many other forces at work, which we outline below.

### Earnings Expectations:

When examining Chart 6 below, it is evident that there is correlation between market prices and next twelve months (NTM) analyst earnings estimates. Over the past 12 months, company earnings have outpaced consensus estimates and the market has reacted accordingly. Chart 6: Relationship between expected earnings per share in the next 12 months ("EPS NTM" in the chart below) and market prices ("S&P 500 Price" in the chart below)

**Chart 6: NTM EPS and S&P 500 Price**



Source: Factset

## Valuations:

Table 1 below shows the relationship between Cyclically Adjusted Price Earnings (CAPE)<sup>1</sup> and average real returns across major global equity markets over the subsequent 10-15 years. While not a perfect predictor of returns, there is an observable relationship between CAPE levels and subsequent returns across various equity markets. In short, this shows valuation driving returns over the longer term i.e. the higher the acquisition price (as measured by CAPE) the lower the expected/realised return and vice versa.

**Table 1: CAPE and average real returns**

Country	Relationship between CAPE and real returns of the subsequent 10-15 years					
	CAPE<10	10-15	15-20	20-25	25-30	>=30
Australia	12,0%	8,5%	7,4%	4,9%	3,6%	
Canada	7,3%	7,6%	9,4%	9,3%	7,0%	5,3%
Denmark	10,3%	9,1%	8,0%	9,1%	11,4%	6,6%
France	13,7%	12,1%	8,4%	8,3%	9,4%	0,2%
Germany	10,2%	10,1%	7,1%	6,3%	3,9%	0,7%
Hongkong	11,0%	8,5%	6,4%	5,2%	4,3%	2,7%
Japan			9,3%	7,3%	4,4%	-1,4%
Netherlands	15,3%	10,6%	6,1%	2,5%	-0,2%	-1,4%
Norway	10,7%	7,2%	7,1%	6,6%	4,7%	
Singapore	9,8%	7,4%	6,7%	4,4%	3,4%	2,3%
Spain	14,1%	11,6%	9,7%	5,1%	3,1%	0,8%
Sweden	17,0%	14,8%	13,0%	12,5%	11,0%	5,1%
Switzerland	10,9%	12,9%	11,4%	9,0%	6,8%	1,3%
UK	12,3%	9,7%	6,2%	1,2%	0,5%	
S&P 500 s. 1881	10,5%	8,0%	6,1%	1,9%	2,7%	-0,3%
<b>All Countries</b>	<b>11,7%</b>	<b>8,7%</b>	<b>7,2%</b>	<b>5,7%</b>	<b>4,1%</b>	<b>0,5%</b>

Source: <https://seekingalpha.com/article/3987114-predicting-stock-market-returns-using-shiller-cape-pb>

The summary of the information presented above is that while the ETF and passive thematic may be impacting risk and returns, there are other considerations that are significant drivers of returns and alpha. Anecdotal evidence from JANA's discussions with investment managers point to instances of increasing acceleration and deceleration of individual share price movements, and while causality is opaque, managers have speculated this being due to the rise in systematic investing (not just ETFs). More recently, we have witnessed the rise in market volatility exacerbated by leveraged and short volatility ETF products, and while perhaps negative for short term price movements, these may create opportunities for longer term, patient fundamental active investors.

<sup>1</sup> Cyclically Adjusted Price Earnings (CAPE): Also known as the Shiller Price-to-Earnings (P/E), is a valuation measure that takes into account the 10 year moving average of earnings, adjusted for inflation. This has the effect of smoothing out fluctuations in corporate profits that can occur over the course of the business cycle.

## Conclusion

Overall, JANA's conclusions are as follows:

- Despite the rapid growth of passive investment over recent years, active management still remains by far the largest part of the overall market, representing approximately 63% of the US equity market as at 2017 for example
- The rise of passive arguably creates opportunities for long-term investors, when the short-term price movements of companies could be exacerbated by various ETF products
- At the extreme, where passive investors have very dominant ownership of individual companies, there may be a distortion of the risk/return profiles of such companies.
- Although JANA is an advocate of active management, we recognise that passive approaches, whether traditional Index funds or Index tracking ETF strategies, have a role to play where investors are seeking cost-effective market exposure.
- Company fundamentals and valuations, monetary policy and inflationary expectations remain a large driver of market behaviour.
- Investment managers adopting an active investment approach should be cognisant of the risks apparent when a significant portion of the issued shares of portfolio stock holdings are held by passive investors.

JANA has also produced a paper containing additional analyses on the topic presented in this month's MyConsultant and is available upon request.

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