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Active Asset Managers Face Asymmetric Risks from Paradigm Shift

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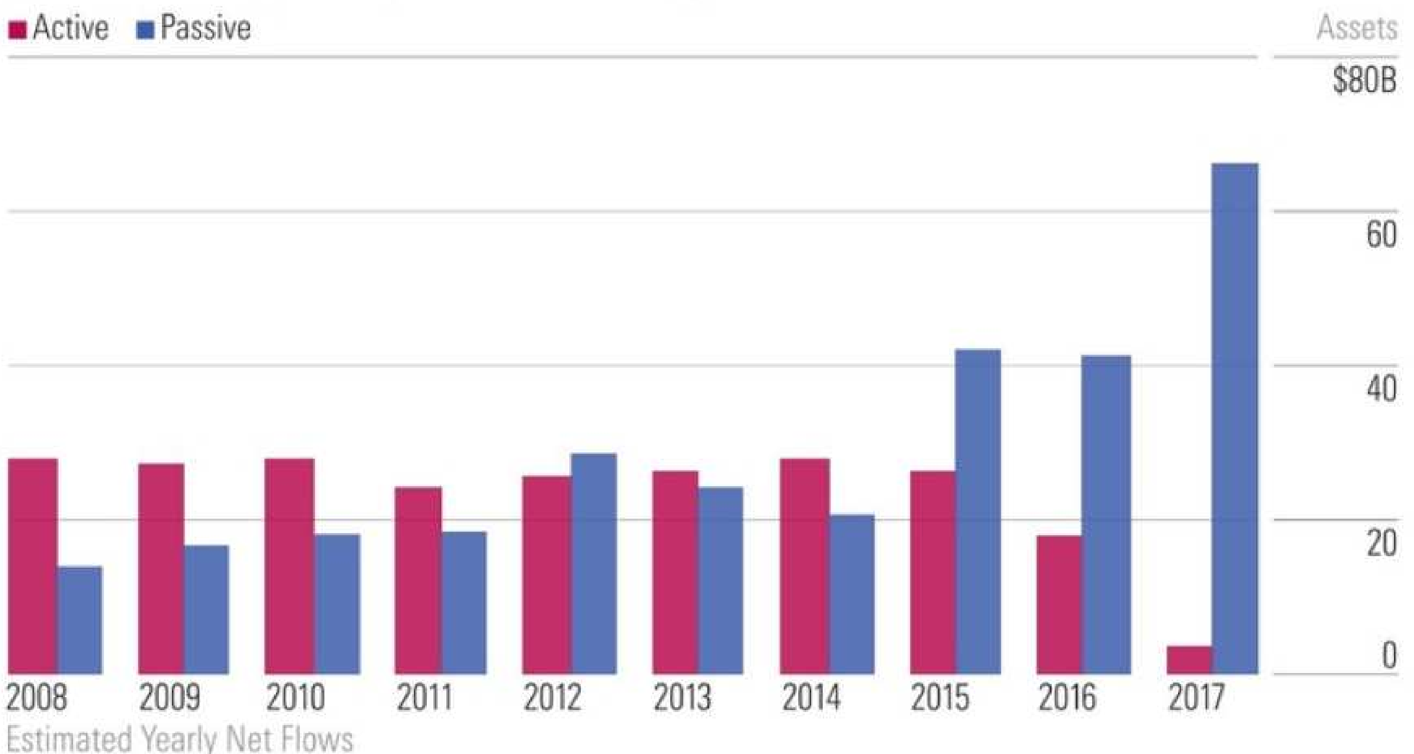
Executive Summary

- Active asset managers face asymmetric risks from a paradigm shift in monetary policy regimes and inflation trends
- As prolonged low volatility channeled flows into passive funds, some active funds increased risk-taking to compete
- A decade of volatility and term premium suppression also led some active funds to adapt a bearish volatility stance
- A steady rise in global debt issuance are being absorbed by bond funds to facilitate "risk transfer" into non-banks
- A growing body of research now point to cumulative policy costs from prolonged unconventional monetary easing
- Aversion to mounting policy costs and retreat from globalization would heighten volatility and financial instability
- A scenario of financial instabilities from non-bank institutions would invite potentially crippling regulatory scrutiny
- Active portfolio managers adept at managing volatility will counterbalance instability risks from passive strategies

A decade of volatility suppression and a "race to zero" in fees

As major central banks persistently maintained emergency policies (in record-size balance sheets and continued net asset purchases) a decade following the onset of the 2008 Financial Crisis, the systemic decline in volatility into year-end 2017 turned the longest equity bull market since World War Two into a pyrrhic victory for active mutual fund managers and hedge funds. While it indeed took sales teams little effort to convince potential investors to participate in concurrent risk asset and fixed income bull markets, many of these investors instead turned to passive funds with low fees (and later "zero fee"). Flows into the fast growing target-date funds have increasingly went to passive managers:



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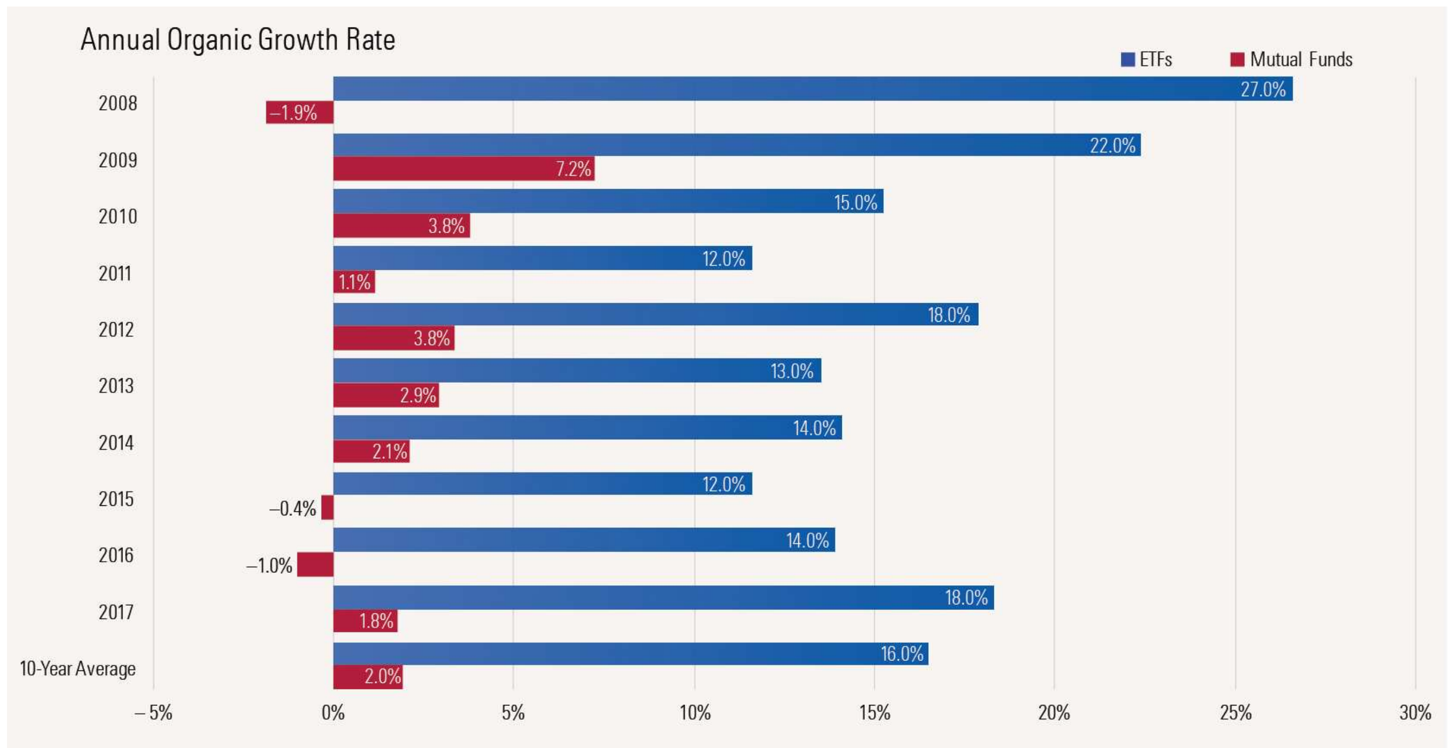
Despite active managers' efforts to highlight superior track record vs. the index, investors of passive funds nevertheless made a rational choice: even the uninitiated can effortlessly generate returns under concurrent "central bank puts," especially when the venerable "Fed put" had become passé compared to ECB President Draghi's "everything it takes" as well as BOJ Governor Kuroda's monetary "bazooka." If the only direction for markets to go is up (and down in terms of bond yields), then investors logically focused on the cheapest vehicle to deliver them the policy-led market bonanza.

Morningstar illustrated lower cost ETF's organic 16.5% average growth rate over the last 10 years easily surpassed mutual funds' 2% growth. This measure strips out the effects of market returns to highlight flow trends:



As low fee's outsized impact on fund flows during periods of low volatility became well understood within the fund community, major fund managers unleashed a "race to zero" in fees, which culminated in Fidelity expanding its zero fee funds with Vanguard and BlackRock closely behind.

This arms race in fees pushed some active managers to take greater risks (hedge funds' consensus leveraged long in FAANG stocks, as well as institutions' exposure in bearish volatility trades via derivatives) to maximize benefits from policy-led volatility suppression. While such strategies would allow the fund managers to beat index ETFs, they also increased said managers' vulnerability to volatility spikes and policy shifts. Unfortunately, these behavior inadvertently reinforced the lingering stereotype that active fund managers are no better at managing market downturns than passive index products.

Non-banks increase risk warehousing amid stimulus fatigue

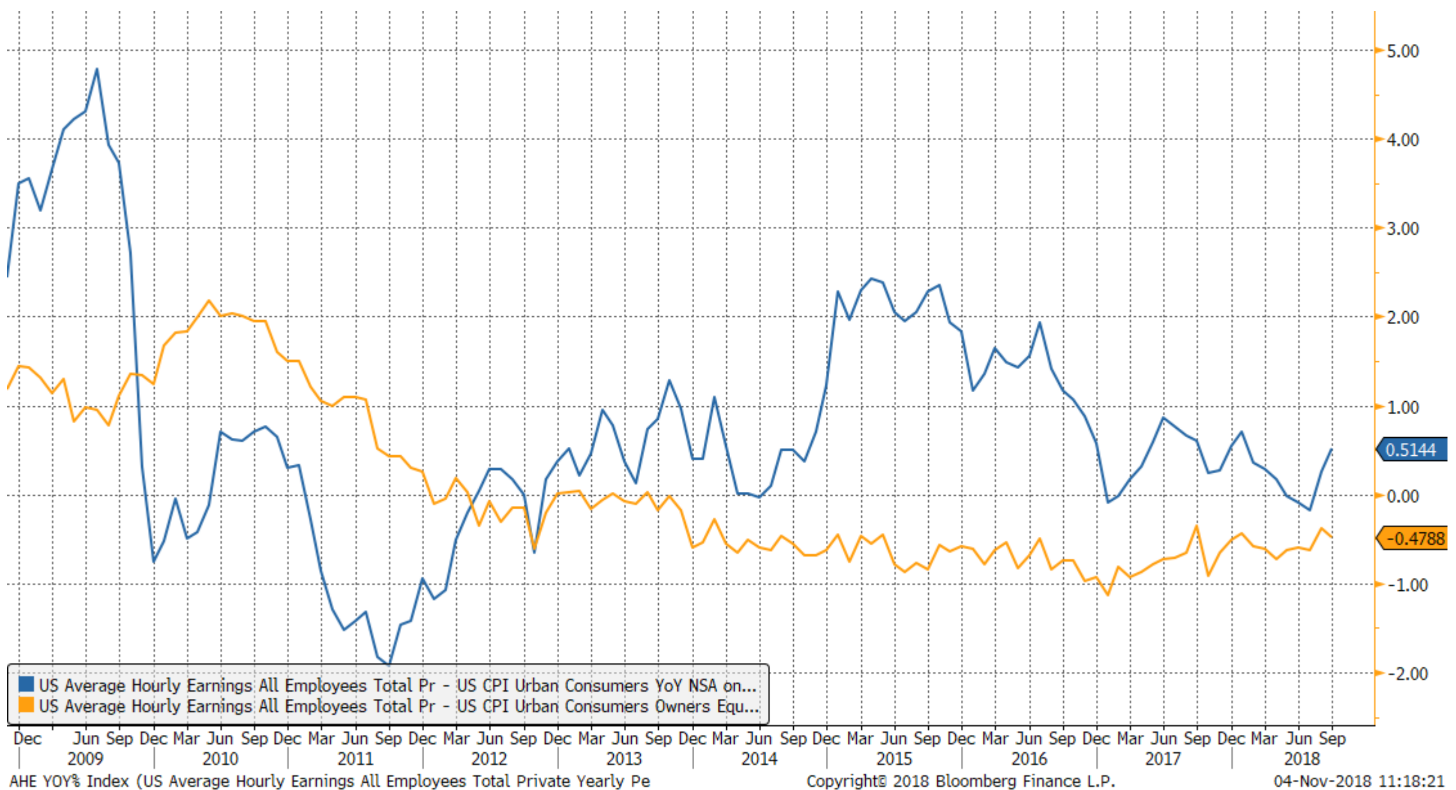
In its latest quarterly review, BIS noted that dollar denominated debt issuances have steadily displaced bank lending in global dollar funding, and the steady rise in debt is being warehoused by "yield-seeking" non-bank financial institutions such as mutual funds, hedge funds, insurance companies and pensions.

By absorbing the dollar debt issuances, non-banks effectively transferred both domestic (such as U.S. corporations) and international risk (EM issuers such as Chinese tech firms and provincial issuers) onto their balance sheets. The rise in credit, duration and liquidity risks on balance sheets also made the respective institutions more sensitive to policy shifts and inflation developments overtime.

In the meantime, past decade's extraordinary easing have sustained both healthy and "zombie" firms, and major monetary authorities are beginning to acknowledge rising policy costs, such that unproductive "zombie" firms crowd out investment in and employment at more productive firms to weigh on aggregate productivity growth. Ironically, this policy-induced low productivity subsequently became the "productivity puzzle" which continue to confound central bankers.

Additionally, BIS also highlighted that monetary authorities' dovish policy bias as a result of disinflationary pressures from globalization have depressed long-term real interest rates, which helped sustain credit booms to trigger misallocation of resources toward lower productive growth sectors and contribute to the rise of debt trap.

Furthermore, ultra-accommodative monetary policies' distributional effects contributed to rising wealth inequality as QE-induced asset price appreciation brought immediate relief to asset owners (at a time when stock ownership rate declined to 52%), while "trickle down" wage growth with a lag was offset by higher asset price appreciation (such as higher rent):



This rise in inequality manifested in the nation's eviction crisis, and market attention on economic hubs (with heavy investor footprints) overlooked the "left behind America," which lost its identity in the wake of globalization. While policymakers have stressed that workers without assets also benefited from monetary stimulus in the form of lower unemployment, tighter labor market conditions and better employment outlook in rural communities do not offset the fact that young workers cannot afford to move to costly metropolitans to explore better opportunities.

As a result of the growing inequality fueled by policy-driven booms in financial and real estate assets, which worsened popular discontent and generated support for anti-establishment political candidates, political incumbents previously uninvolved in the wealth inequality debate are reacting to the rallying cries from political disruptors, that these recoveries haven't been for wage workers, and they deserve a champion."

Non-banks face stability risks amid reflationary pressure

As non-bank financial institutions continue to warehouse credit, duration and liquidity risks, they become increasingly vulnerable from higher volatility as a result of erosion to globalization, which fans reflationary pressure via goods prices.

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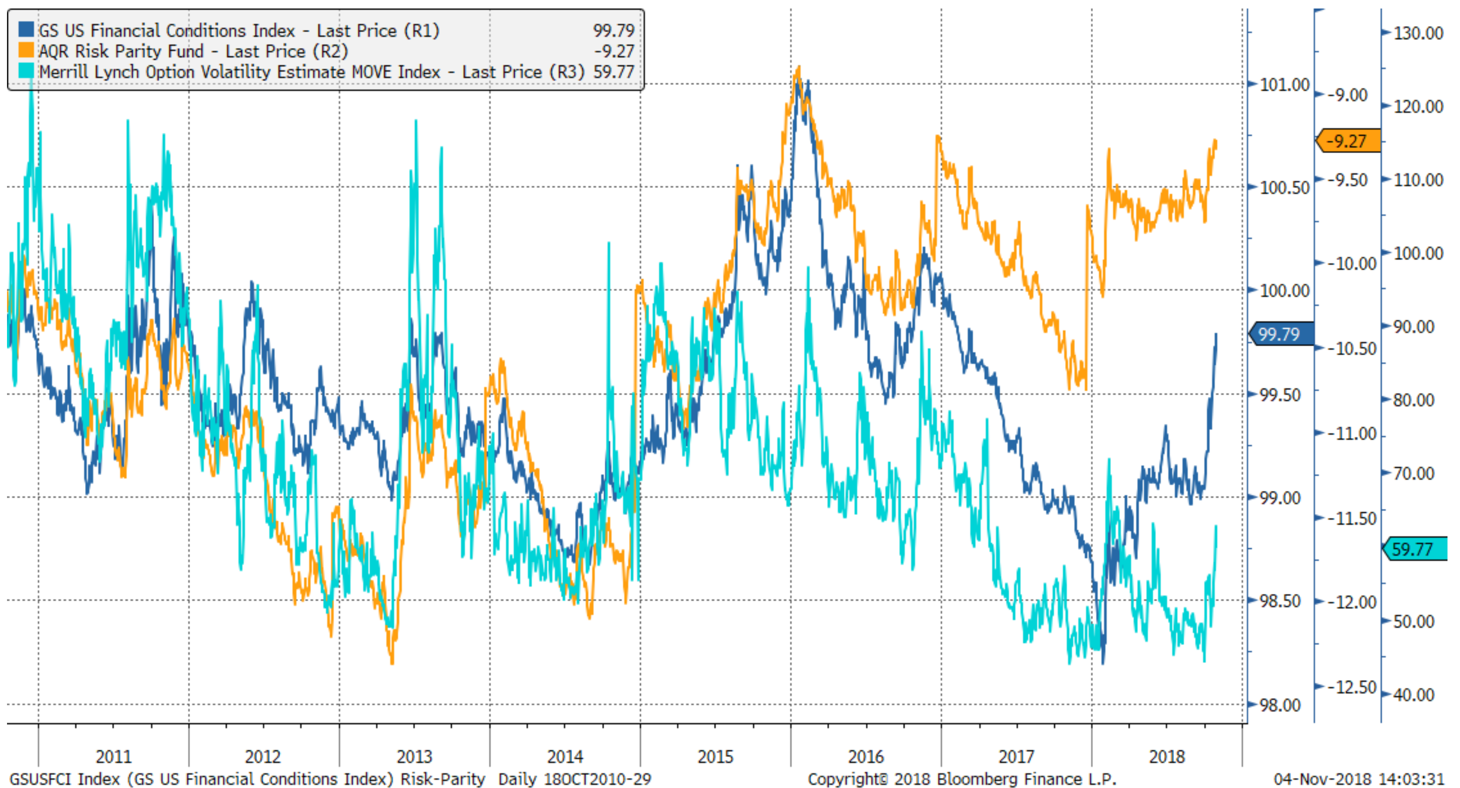
Citing higher inflation and rising policy costs, global monetary authorities have also begun to pare policy support and enacting "quantitative tightening" measures. As volatility and term premium suppressions ease, both risk asset and bond volatilities have risen to effectively tighten financial conditions:



Given non-bank financial institutions have displaced bank lending as a dominant form of post-crisis funding, a rise in fund redemption and further rises in volatility from "snapback" in bond yields would generate risk contagions at the heart of the asset management industry.

If major institutions fail to contain said contagion, damages to the real economy and break-down in global funding markets would likely invite regulatory scrutiny not unlike the post-Crisis response, and measures such as counter-cyclical capital buffers imposed on non-bank financial institutions would lead to crippling impacts and effectively push "hot-money" into alternative financial institutions unburdened by scrutiny.

Thus, active asset managers faced with asymmetric risks from a paradigm shift in inflation trends and changing monetary policy regime have a choice to make:

- Continue to call for policy-driven volatility suppression while struggling against zero-fee mutual funds and ETFs, as active funds become more vulnerable to downturns as a result of "yield-seeking" risk accumulation
- Embrace higher volatility and implement prudent (bearish risk-parity) risk exposures to demonstrate active managers' resilience in both bull and bear markets - a stabilizing factor to counter passive funds' systemic risk

Hence, active portfolio managers adept at managing volatility and market instability can assist regulators in countering systemic risks from passive strategies – thus avoid or diminish subsequent regulatory scrutiny. Conversely, active funds fearful of volatility and biased toward further policy accommodation would inadvertently align their risk profiles to become riskier versions of passive funds.

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