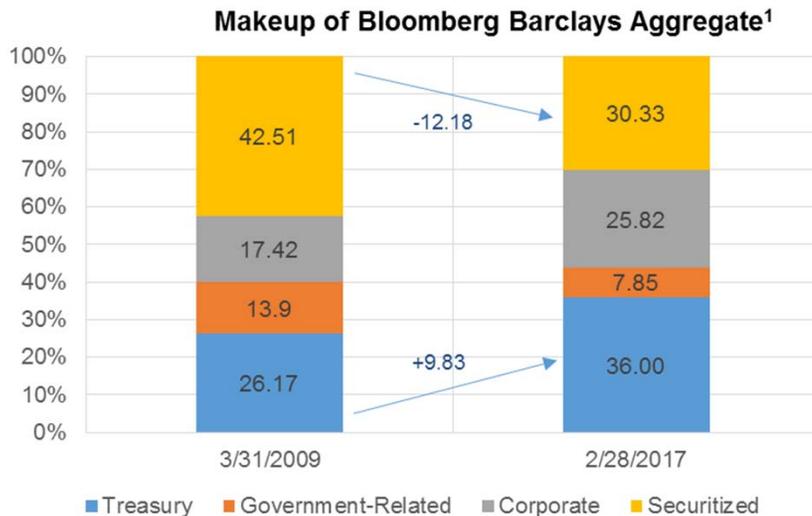


First Quarter 2017 Knowledge College

Passive Investing is Not a Passive Exercise

We have written at great lengths about the benefits of both active and passive investing. As users of both, we advocate for a thoughtful mix of both for our clients. However, we want to make clear that passive investing is not a passive exercise. As with all components of investing, due diligence and care are required to manage risk prudently. In light of the Federal Open Markets Committee's recent action to increase interest rates, we'll use U.S. investment-grade bonds as an illustration of the need for active diligence within passive investing. While there are numerous other risks that investors should consider when investing in fixed income securities, for the purposes of this illustration we will narrow our focus to interest rate risk, otherwise known as duration. Duration is simply the sensitivity of a bond's price to changes in interest rates. Prevailing interest rates are an important component to bond prices and as interest rates goes up, bond prices will fall, all else equal. Duration is expressed in years and is the numerical calculation of that sensitivity. So why does this matter to my passive portfolio?



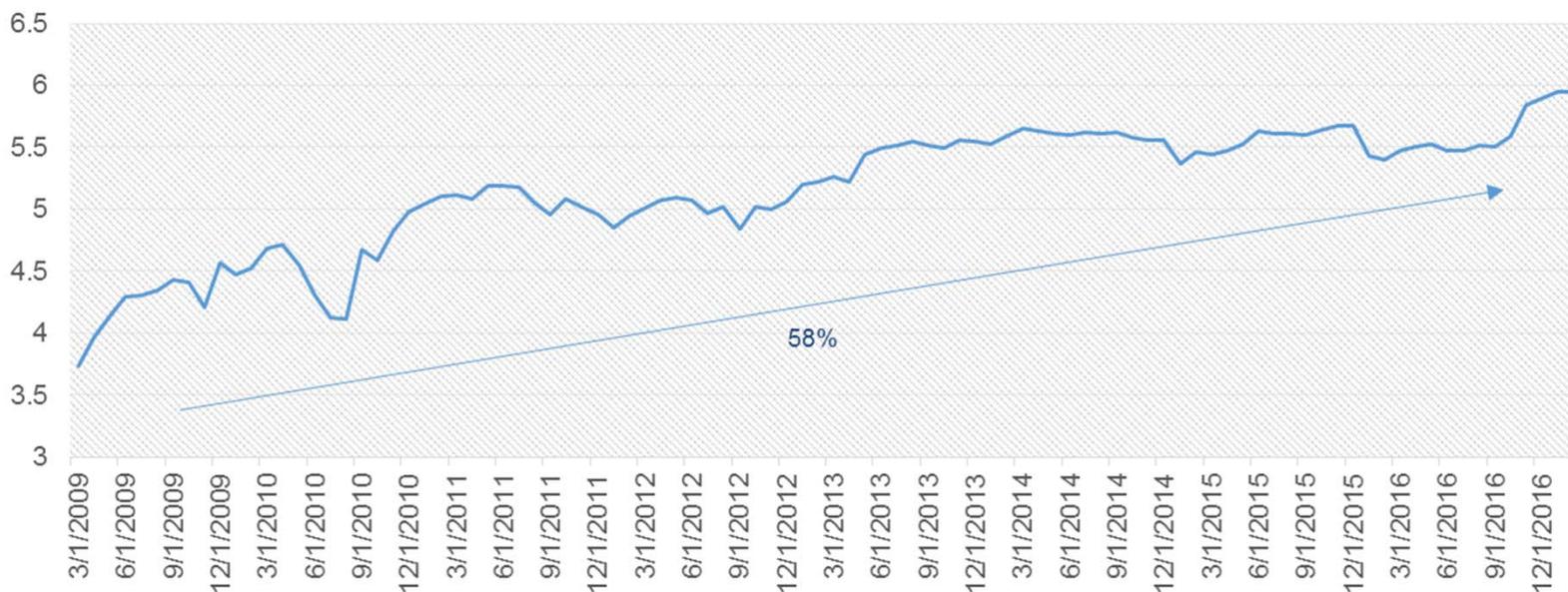
It matters because owning passive investments does not necessitate a passive stance on risk. To illustrate this we will dig deeper into the Bloomberg Barclays Aggregate (the Agg), one of the most common bond indexes in the market. As is the case with all passive investing, the investment seeks to replicate an index as closely as possible with little, if any, deviation from the index. The index itself is constructed mechanically based on an established set of rules. The Agg is no exception to this. The trick here however is that the market is not static. It is changing, repricing and moving all the time. This means risk and return are continually shifting as well. These shifts in the last number of years for the Agg in particular have been meaningful since the financial crisis for several reasons. Low interest rates, accommodative monetary policy from the Federal Reserve and new legislation have all come together to shift the complexion of the market. As a result, the index has performed exactly as designed and mirrored the changes in the market place. In the graph above, you can see sectors represented in the index have changed meaningfully.

Since March 31, 2009 (near the bottom of the financial crisis), Treasury issuance and bonds outstanding have risen materially. Over the same time period securitized securities have lost a considerable amount of market share. As these sectors have shifted, the overall risk and return profile of the Agg has also shifted.

1. Barclays Point

The Agg you bought in March 2009 is not the same as the one you own today. The historical duration of the index shown below since the financial crisis has changed meaningfully. The duration of the Agg index has increased by 58%. Said another way, the Agg today is 58% more sensitive to interest rates than it was 7 years ago.

Bloomberg Barclays Aggregate Historical Duration¹



1. Barclays Point

If we translate that into percentages, if interest rates were to rise 1% we would expect the 2009 Agg to fall -3.75%. In the same scenario for the 2017 Agg, we would expect the portfolio to fall -5.96%. A meaningful difference for investors setting risk expectations.

We are not making the claim the Agg is not a prudent investment or that passive investing is broken. As mentioned before, we believe passive investments can often be the prudent choice. However, we firmly believe there is no excuse for passive diligence, execution and monitoring within passive investments. The shift in the Agg's duration is just one example of why investors need to employ a diligent process to select and monitor investments in their portfolios and not make passive investing a passive process.