

Enduring thoughts

There is no such thing as passive investing

The conventional view serves to protect us from the painful job of thinking.

John Kenneth Galbraith, Canadian-American economist

The economist Hyman Minsky had an uncomfortable thesis: *stability is destabilising*¹.

Long periods of calm tend to change behaviour. Risks that once appeared obvious begin to feel remote and precautions gradually become less important. Confidence rises because risks have not recently materialised, not because they have disappeared.

The longer the period of tranquillity persists, the more comfortable investors become and the more likely they are to underestimate the risks building beneath the surface.

Success has a habit of normalising itself and eventually the calm itself becomes part of the problem.

Minsky was writing about credit markets, but the same challenge often appears in investment portfolios.

One of the more curious features of investing is that portfolios frequently drift furthest from their intended risk profile at precisely the moment investors feel least concerned about risk.

After all, risk rarely feels dangerous during a prolonged bull market. Rising valuations create reassurance and strong performance usually breeds confidence. Positions that might once have appeared concentrated or uncomfortable begin to feel entirely reasonable.

Consider a conventional 60/40 (60% in shares and 40% in bonds) portfolio. At inception, the allocation may have been chosen carefully to reflect a moderate tolerance for risk. The balance between growth and stability was deliberate.

Fast forward a few years and the picture may look rather different. Following a prolonged period of strong equity returns, the portfolio may now derive significantly more of its risk from equities than originally intended. Holdings may have become more concentrated as well as geographic and sector exposures.

All the while none of this necessarily feels remarkable.

No one decided to increase risk or concluded that a more aggressive stance was appropriate. In most cases, no conscious decision was taken at all. Markets simply continued to rise.

The consequence, however, is that the portfolio now behaves differently from the one originally constructed. The investor may still think they own a balanced portfolio because their label for it has remained unchanged. The underlying risk attributes may tell a different story.

This strikes me as one of the great blind spots in modern investing, reinforced by the language used to describe portfolios. The term 'passive investing' is a particularly misleading example.

Passive investing has transformed modern finance. It has reduced costs, improved transparency and made diversified market exposure available to investors on a scale unimaginable a generation ago. But implementation is not the same as judgement. Precisely because passive investing can deliver market returns, sustain calm and provide reassurance, it can obscure the decisions at the heart of portfolio construction.

Think of it as the difference between choosing how to get somewhere and choosing where to go. An index tracker fund can provide an efficient, low-cost means of travel. It cannot decide where an investor should be going, how much risk to take or whether the portfolio has drifted off course.

An exchange-traded fund (ETF) can provide exposure to almost any market imaginable. Its very success can make portfolio drift easy to miss. Steady returns, low maintenance and the absence of alarm can create a false sense that nothing needs attention. The problem is not that passive investing fails to provide efficient exposure. It is that it can work well enough to make active oversight feel unnecessary.

The active-versus-passive debate has largely been fought on the wrong ground. Gaining market exposure efficiently is a different question from whether a portfolio still reflects its owner's objectives and tolerance for risk. The first is about implementation. The second requires ongoing judgement, regardless of how the underlying investments are structured.

Deciding not to review a portfolio is itself a decision. It simply delegates the outcome to market movements rather than conscious judgement.

That does not mean portfolios require constant intervention. It means that choosing not to intervene should follow a review of the portfolio, rather than the absence of one.

Markets do not stand still. They continuously reshape portfolios, often so gradually that the changes go unnoticed until a period of stress reveals what has really happened. By the time those risks become obvious, the portfolio may have travelled a long way from where it started.

Minsky's insight is powerful because it does not depend on irrationality. It explains how intelligent, well-informed investors can become systematically blind to accumulating risk. The process does not feel careless. At each step, it feels entirely reasonable.

There are passive funds but there is no such thing as a passive portfolio.



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¹ Hyman P. Minsky, "The Financial Instability Hypothesis," Working Paper No. 74, Jerome Levy Economics Institute of Bard College, May 1992.

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