Markets

Wall Street Rebels Warn of ‘Disastrous’ $11 Trillion Index Boom

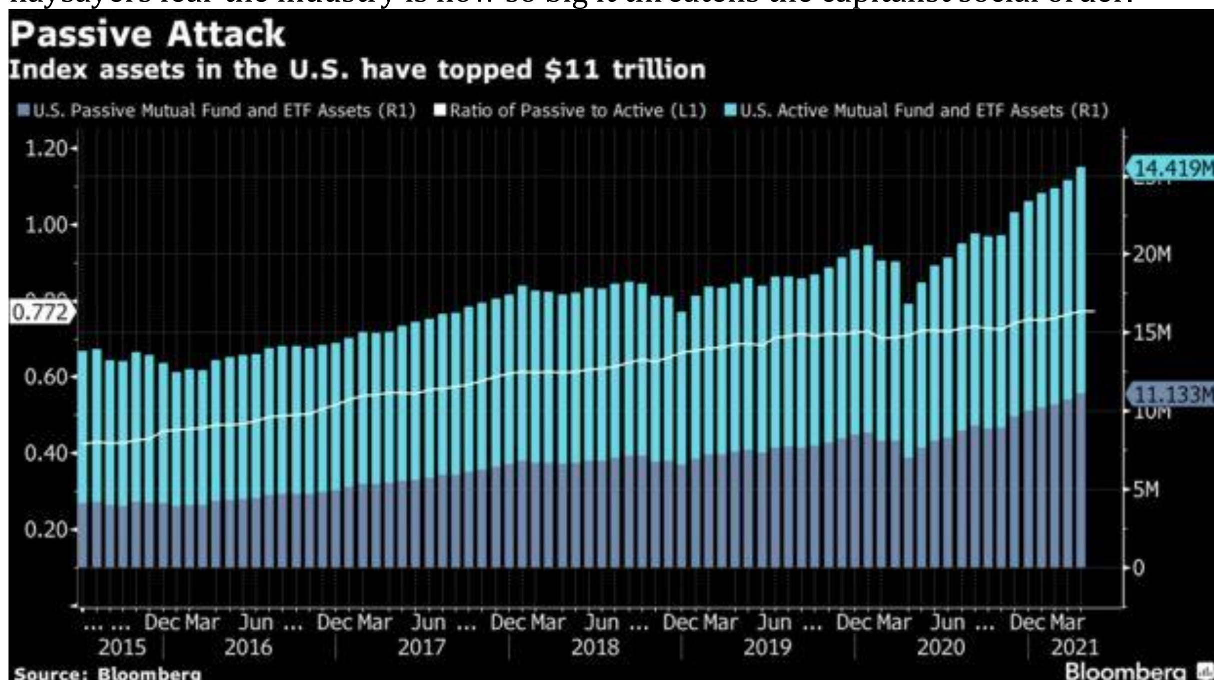
By
Justina Lee and Yakob Peterseil
2 juillet 2021, 14:08 UTC+2

- Fifty years since first fund, critics fear passive is too big
- Worries include ownership, price discovery and volatility

To critics of the $11 trillion passive boom, active management is the original form of ethical investing -- and time is running out to save it from the indexing onslaught.

“On a societal basis, it’s potentially disastrous,” says Michael Green, chief strategist at Simplify Asset Management, referring to the passive frenzy. “There’s an impending crisis that requires people to make changes.”

Fifty years since the first fund was created to mimic the moves of an entire market, naysayers fear the industry is now so big it threatens the capitalist social order.



Yes, it lowered costs, brought investing to the masses and improved returns for many. But the dark side according to the critics: It's funneling money to undeserving businesses, distorting price discovery and intensifying volatility.

"Markets are ultimately not about funding someone else's retirement but instead about allocating capital efficiently within an economy and creating the signals that encourage investment in the better companies," says Green.

His fears over the demise of stock picking are shared by a vocal contingent in full knowledge they're likely fighting a losing battle.

Inigo Fraser Jenkins, head of global quantitative strategy at Sanford C. Bernstein, once declared passive investing to be worse than Marxism. Michael Burry of "The Big Short" fame tweeted that "passive investing's IQ drain" is fueling a stock bubble. Yves Choueifaty, a Frenchman known for his $10 billion "anti-benchmark" strategies, once called it "completely toxic."

Yet investors are pouring billions into index-trackers for good reason: Evidence keeps showing that most active managers fail to beat their benchmarks after fees, while those who do struggle to maintain that performance.

Cue three lines of critique over the unintended consequences, mostly leveled at the predominant form of indexing which weights gauges based on a company's market capitalization.

First, it creates economies of scale that concentrate equity ownership in a handful of passive giants like BlackRock Inc. and Vanguard Group. (One academic estimate suggests the three biggest money managers could cast as much as 40% of the votes in S&P 500 stocks within two decades.) Second, it will ultimately be bad for investors when the largest stocks start to underperform. And third, it's distorting share prices.

That last point is a hotly debated issue. One point Green likes to make is passive has made markets more volatile. In a paper last year, academics Xavier Gabaix and Ralph Koijen argued that the dominance of price-insensitive shareholders -- which tend to include index funds -- means that $1 of inflows can lead to $5 more in aggregate market value.

To the likes of Green, that's why stocks are posting massive moves more often in recent years between bouts of eerie calm, a phenomenon documented by strategists at Bank of America Corp. and Societe Generale SA.

Another implication is that if flows are moving prices, the latter don't just reflect all the information about the present value of future dividends -- as suggested by the efficient-markets hypothesis.

"As a discretionary asset manager I see high prices and high valuation as indicative of lower future returns and therefore I'll try to find alternatives," says Green, who used to work at Peter Thiel's family office. "A cap-weighted index does the exact opposite. They don't change their cash holdings and paradoxically they allocate more of the marginal capital to the most richly valued companies so it becomes a reinforcing mechanism toward inelasticity."

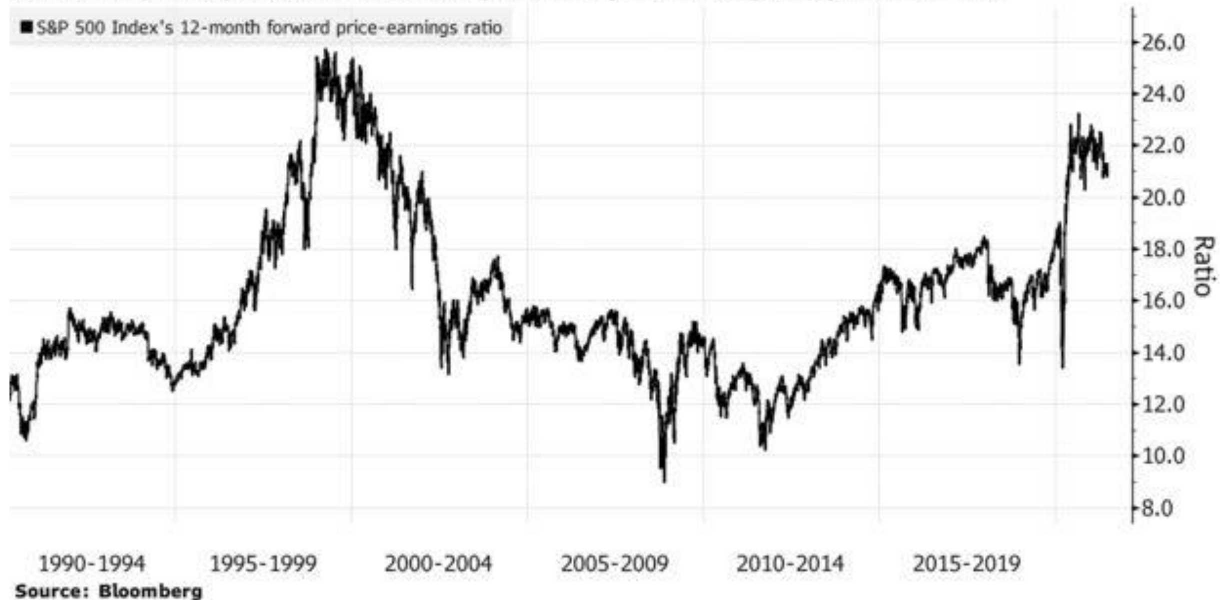
In this line of thinking, it's not that those distortions can never reverse, just that they are exacerbated by indexing. Another recent paper suggested that passive flows into the S&P 500 have disproportionately pumped up prices of its largest members, paving the way for smaller companies to eventually outperform.

Choueifaty, who founded asset management firm TOBAM nearly two decades ago, says that indexes give investors a false sense of security for precisely this reason.

"The market-cap weighted benchmark always allocates to what is already fashionable and already expensive," he says. "Whenever you're passive, you're extremely far away from being neutral."

Firms pitch market-cap weighted index funds to investors as a way to diversify away risks. The pitch goes that if you're invested in 500 stocks, a couple of duds won't hurt you. But to Choueifaty, seemingly neutral index funds are in reality crawling with harmful biases and distortions.

Take the S&P 500. The top five members, all technology names, are weighted as heavily as the bottom 350 companies. Sectors become dominant precisely when they're at their most expensive. For long-term investors, that's a disaster, Choueifaty says.



If you accept the premise that the trillions flooding benchmarks must be having some impact on market plumbing, it becomes easier to draw a line to distortions all over markets in 2021. Think meme-stock madness, stock volatility through the pandemic and tech giants trading at hundreds of times earnings.
Yet that risks simplifying complex and interlocking forces behind modern markets. That's why Fraser Jenkins now says that even though indexing has likely made stocks increasingly move as one, the threat to capitalism he flagged in 2016 is still not imminent.

"Back then, I was wondering if there's a limit that was imposed by a breakdown in the efficient allocation of capital or from correlations jumping and going too high," he says. "I think any limit from those sources is just far, far off."

That said, a stress test for the benchmarking era may be coming if higher inflation undermines balanced portfolios, according to the Bernstein quant.

"If the risk for things like 60/40 goes up because equities and bonds don't diversify the same way, then that's a limit to passive investing and demands an active response," he says.

So does that mean the portion of total assets held by passive would slow in this doomsday scenario? Unlikely.

"It just goes up," Fraser Jenkins says.