

Everybody Was Kung Fu Fighting?

Last week, Finance Twitter erupted over a Bloomberg article about Michael Burryⁱ and how he likened passive investment in equity markets to the bubble in the synthetic CDO market back in 2007, which he famously – thanks to Michael Lewis and Christian Bale – identified.

Burry's word choice here sent a bunch of smart financial thinkers into a FinTwit frenzy. Most folks like Ben Carlson and Cliff Asness made robust points on one side (thinking Burry was nuts), while a few other folks like Ben Hunt and Michael Mauboussin made solid, or at least nuanced, counter-points.ⁱⁱ

Passive investing is not a bubble, but...

Finance Twitter sided with Ben and Cliff, and this audience is broadly pro-passive to begin with. This is for good reason, as passive investingⁱⁱⁱ is a lower cost way for retail investors (at least) to gain exposure to rising equity markets over the long term. In addition – we would point out – investing in a diversified, passive, way mitigates some behavioral biases we all have individually; biases that love to rear their heads when it comes to decision-making about individual stocks.

But I thought the chastising of Burry (and anyone that mildly agreed with him) was a bit overdone. Burry is asking a thought-provoking question, it's just that "bubble" was the wrong word to use. It was wrong, because there is no bubble in passive investing, but the word was so incendiary that it was difficult to stay objective.

...there is a further question which is not silly, nor is it new

Even without passive investing being a "bubble", it's okay to ask if passive flows are affecting share prices. People have been asking these questions for decades, and the volume of analysis here is only increasing. These are interesting, even confusing, times. Money is pouring into passive vehicles, and meanwhile value hasn't worked for over a decade, small-caps are struggling, and returns to large-cap, low-volatility, momentum portfolios are certainly at the high end of what we have experienced historically. All this while the S&P 500 is up 400% since March of 2009 and is trading just 1% off its all-time high (with interest rates on a crash course with zero, I might add).

In this difficult-to-pin-down environment, Burry is simply wondering if the trend toward passive investing is having any impact on the prices of companies that are or are not in these indices. This is a good question. I myself have been thinking about it for quite some time. This is the abstract to my thesis paper I wrote in graduate school (many moons ago).

Fund Flows and Passive Investing: Implications for Index-Fund Returns and the SMB Risk Premium

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Abstract

There has been a marked increase in interest for shares of stocks that are in the S&P 500 Composite Index. This resulting appetite for individual S&P 500 shares has been at the expense of non-S&P shares. This is primarily due to increases in market share for passive equity funds, and likely helped by increases in "closet indexing" by active equity fund managers. The popular press has suggested that the increasing popularity of passive (indexed) investment strategies has contributed to higher returns for those very indices, thus making the job of the active equity fund manager more difficult. A regression of S&P 500 excess returns on passive equity fund flows or other proxies for investment in the S&P 500 composite shares is one test of this theory. If excess returns are evident *and* driven by proxies for fund flows into index funds, this might help to confirm popular notions. We find no evidence of positive alphas for S&P 500 stocks. The variance in returns, even over a relatively recent period, is well explained by the "three-factors" of Fama and French (1993).

My co-author Craig and I turned this in to none other than Eugene Fama himself. I wasn't smart enough to be one of Gene's PhDs (although Craig was, but decided to stay down with us lowly MBAs), and certainly not smart enough to be one of Gene's outstanding PhDs (like Cliff was). But I was lucky enough to be included in a group with a dozen or so MBAs that were able to take his courses (and finish them^{iv}).

And, like myself, people have been asking this question about the impact of passive investing for *years*. Our paper itself was motivated by Andrei Shleifer's "Do Demand Curves for Stocks Slope Down?"^v He asked this question in 1986. So we all already knew there was a one-off inclusion (and deletion) effect for stocks that were added or deleted from the S&P 500; and at the time the debates were about the motivation (was it informational, was it liquidity, market-segmentation, downward sloping curves etc); but whatever the reason, Craig and I reasoned that if passive investing was becoming a larger part of the market, that it could be that the effects were increasing with time.

We thought, even back then, this was a reasonable question to ask. Gene Fama agreed. At that time, in 1998, we concluded that we didn't see anything, but we left open the idea that with more time, datapoints, and more flows into passive funds, we might.

Now, a lot has changed since the good old days, and a lot hasn't. First, some nomenclature.

Each of us is active, all of us are passive

Okay, maybe not each of us, but most of us are active investors. Not just those of us that are making active decisions about what individual things to buy and sell, but the factor-based quant (or robot) making no active human decision to buy or sell a particular basket of securities; he, she or it is also active. So too, by the way, is the 45 year-old married couple with 100% of their equity exposure in the S&P 500, but who needs to take some money out to pay their kids' college bills.

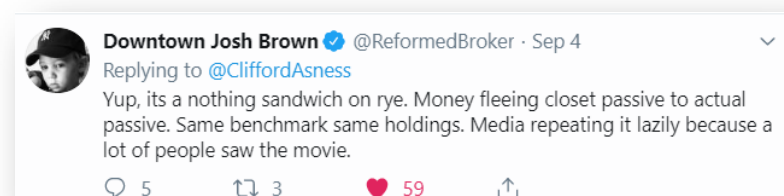
Yet in the aggregate, we're all passive.

Here is a simple hypothetical.

I worked at Fidelity for a little while, and without knowing the precise figures, I would guess that the range of "active" bets vs. the benchmark ranged from 20% to 40% across our range of diversified mutual funds (not of each fund, but in the aggregate). I could be off, but it doesn't matter. Hypothetically, if the good folks over at Capital had the exact opposite active individual bets, well then between the two of us, we owned the benchmark, right?

Silly supposition, I realize, but if you imagine \$100 billion of redemptions from each active fund complex, and subsequent \$200 billion worth of subscriptions into Vanguard's S&P 500 index fund, the net of it all is that there are precisely zero new flows into benchmark securities. I mean, this unrealistic-albeit-illuminating example essentially flows from Bill Sharpe's notion that, in the aggregate, we all own everything - and the mathematical pricing of securities yields winners and losers that offset each other before fees.^{vi}

That was a convoluted example, so perhaps it is better to paste in a quote from Josh Brown, who always does a much better job than I do of getting to the point.



So my conclusion is partly efficient...

Back to the paper above, I ran it past another professor at the University of Chicago, and he'd already won his Nobel Prize nine years earlier (Fama would 14 years later). It was Merton Miller. And on the theory of just how efficient markets were, Merton Miller made Gene Fama look like Dick Thaler (who won *his* Nobel Prize 18 years later). If you had a behavioral spin on anything, Mert was a very tough guy to talk to.

So he scoffed at the idea of downward-sloping demand curves like a New Yorker does a Chicago-style pizza. I actually like both kinds of pizza, which is why we wrote the paper, but I do have a view, even to this day, that individual company security price discovery doesn't necessarily require people to trade a single share.^{vii} Similarly, in Merton's mind, something is worth precisely something, and outside of some very short-term front-running price pressure (in only rare instances) the demand curve for stocks is flat.

So I am sort of aligned with this aspect of Merton Miller's view, as the impact of new buyers for a new stock (absent new, better, information, of course) should not sustainably impact the share price. In other words, if GM has a market value of \$50 billion, it is because it is worth \$50 billion, and no amount of new buyers or new sellers would change that (everything else being equal).

This is an excerpt from one of our posts, called "Equilibrium Happens"^{viii},

"Stock prices are not "made" by investors, whether they are active or passive. Demand curves for shares are generally horizontal, and while things can get out of equilibrium temporarily due to price pressure (e.g. index inclusion), eventually the value of something is the value of something, and not dependent on price pressure. Granted, the market may become depressed or exuberant, but we don't need market participants to actually trade the underlying shares for individual prices (or markets in aggregate) to fade or rally.

For example, imagine company XYZ closes at €40 per share, and overnight agrees to a takeover by company ABC at €55, and issues a press release before the market opens the next day. We don't need an actual buyer to "lift" XYZ toward €55, it just would have happened without a single share trading. In other words, even in the absence of flow, equilibrium eventually happens."

In practice, of course, the market opens up, and true price discovery happens. And these prices are a signal. So the overriding question we are all asking is if passive investing is at the point where there are not enough active investors to correct prices. In other words, are we at the point where the passive free-riders are actually making prices? At least at the broad, market level, I don't think we are. Indeed, Cliff Asness – specifically on the issue of index investing and the "free-rider" issue – points out that accurate prices in many goods happen without so much impact from the "wisdom of crowds" but instead by expert judgment by just a few people.^{ix} And as Ben Carlson wrote this week on this same topic, there is – despite the noticeable mix shift into passive investing – still "plenty of price discovery going on."^x

...and partly behavioral

But where I strongly disagree with Miller is that he also believed that pricing is always unaffected in the intermediate and long-term by behavioral biases. In fact, when Gene Fama went to convince Miller that the University of Chicago should bring the aforementioned ground-breaking behavioral economist (Thaler) on the faculty, Miller famously said to Fama "go ahead, each generation has to make its own mistakes."^{xi}

But as this generation now knows, there are a host of strange behaviours that affect certain subsets of the market (value stocks, quality stocks, momentum stocks, etc). The explanation for these moves – which is not the subject of this article – are either risk stories or behavioral stories, but what if an index like the S&P 500 exhibits some of these biases (or the opposite of them)? What if the S&P 500 is loaded with large cap, low-vol stocks, and what if flows into this index makes them even more large-cappy, more low-vol, and more moey? And what if that, in turn, drives further flows?

I mean, these can't be stupid questions to ask. We ourselves considered a similar notion in "Risk and Portfolio Theory"^{xii}

"The fact is that there are hundreds of well-capitalized actively-managed investment funds out there, and perhaps even more capital in factor portfolios mimicking what used to be called alpha, but now is called smart beta. Perhaps these investors in aggregate may now be the marginal buyer and seller of stocks. The next question, which we have already started discussing a bit in "Robots and Alpha"^{xiii} is whether or not – and at what level – systematic active (aka smart beta) strategies impact traditional alpha opportunities, either by destroying them, or creating them."

In the quote above we are talking mostly about flows into factor funds, but I think we should at least consider the question across broader, more diversified, indices. And to be clear, we are not advocating that simply discovering that flows can impact prices means that you can “market time” any of it. We don’t think anyone can. In “Factor Timing, Should You Try?”^{xiv} we stated:

“If market-timing is flipping silver dollars, then value and momentum timing is flipping quarters, quality timing is flipping dimes, and BAB timing is flipping nickels. And flipping coins probably isn’t a sustainable strategy.”

The primary point above is that we do not believe that any of us have any sustainable skill at knowing when or when not to invest in the overall stock market, even in an index. As we mentioned in “The Futility of Market Timing”^{xv}:

“So don’t get cute. Even if you think you are better than average, you just aren’t going to get much out of it. Stop trying to pick the perfect time to invest, whether it’s your annual IRA/ISA contribution, 401K, or other pension contribution. Just invest, and get back to work.”

So, this was all a long-winded way of saying, at least at the market level, that we do not think that the tail is yet wagging the dog. We do not believe that passive investing is a bubble, nor do we believe that it is to blame for the underperformance of small caps or value, nor even that they deserve credit for strong equity markets in the US.

But is there a bigger question?

This is where it gets even more interesting. Ben Hunt thought it was remarkable and revealing that so many people – including myself - reacted the way they did to Michael Burry’s article.^{xvi} He thinks it is rooted in a constantly-reinforced view – especially lately, that everyone knows that stocks as an asset class always go up, and that passive vehicles are the cheapest way to get there. And the second-order, Keynesian-esque argument is that everyone knows that everyone knows these things.

He then asserts that this results in, and creates the, narrative in which we all are really saying “be long”. And with the S&P 500 up over 400% since March of 2009, it’s no surprise that’s the mantra. Ben then highlighted historical periods when the accepted faith – the things that people believed that people believed – was that markets *did not* go up forever. People operating under *that* common-knowledge regime actually did very well until things changed. And they did change.

And maybe they will change again?

I think Ben is merely asking if the undying love for passive investing will become a little tainted if the markets ever decide not to go up. He is suggesting, in other words, that at least some of this anti-Burry pro-passive sentiment may be a sign of the times, rather than something that we can be certain will always be.

This isn’t an unreasonable perspective, and neither is the view that “passive” investing is not in a bubble. As such, despite the fiery rhetoric from all sides, I don’t believe that these smart friends of mine are actually disagreeing on most of these key points above; and hopefully we are all little wiser for the debate.

Surely not everybody was Kung Fu fighting.



Endnotes

- ⁱ <https://www.bloomberg.com/news/articles/2019-09-04/michael-burry-explains-why-index-funds-are-like-subprime-cdos>
- ⁱⁱ And, btw, none of these guys are disagreeing with each other as much as they sound like they are.
- ⁱⁱⁱ Part of this passive vs. active debate is also buried in nomenclature. To most investors, active investing means making an active decision to buy an individual stock, where a passive decision is to buy some index, or even a factor-based ETF that automatically selects those names. However to quants, and indeed academics, an investment in a low-vol/high-mo 2x leveraged ETF is anything but passive, as it is bet that deviates from a purely passive benchmark, thus is active.
- ^{iv} At least when I was there, Fama's classes were the only ones an MBA could drop at the University of Chicago to the last day of the semester, without penalty; because he would actually flunk you. And if you were going to flunk, he would tell you the day before the final. This is why my friend Dave still had such a good GPA. Hi Dave.
- ^v https://www.jstor.org/stable/2328486?seq=1#page_scan_tab_contents
- ^{vi} <https://web.stanford.edu/~wfs Sharpe/art/active/active.htm>
- ^{vii} At the market level, in aggregate, I do think that it is at least possible that more or less investors having an appetite for equities, or perhaps even for factors, can affect valuations or pricing, broadly – but I also think that at the market level, this is next to impossible to predict what changes to expect tomorrow. It also may be that correlations among index stocks move higher, which could impact individual equity betas (but that is not the subject of this piece).
- ^{viii} <https://www.albertbridgecapital.com/drews-view-archive/2018/4/23/equilibrium-happens>
- ^{ix} <https://www.bloomberg.com/opinion/articles/2016-09-02/indexing-is-capitalism-at-its-best>
- ^x <https://awealthofcommonsense.com/2019/09/debunking-the-silly-passive-is-a-bubble-myth/>
- ^{xi} <https://www.chicagobooth.edu/magazine/spring-2018/features/class-behave-richard-thaler>
- ^{xii} <https://www.albertbridgecapital.com/drew-views/2018/11/26/risk-and-portfolio-theory>
- ^{xiii} <https://www.albertbridgecapital.com/drews-view-archive/2017/10/16/robots-and-alpha>
- ^{xiv} <https://www.albertbridgecapital.com/drew-views/2018/10/1/factor-timing-should-you-try>
- ^{xv} <https://www.albertbridgecapital.com/drew-views/2019/1/29/the-futility-of-market-timing>
- ^{xvi} <https://www.epsilontheory.com/ive-got-a-secret/>

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