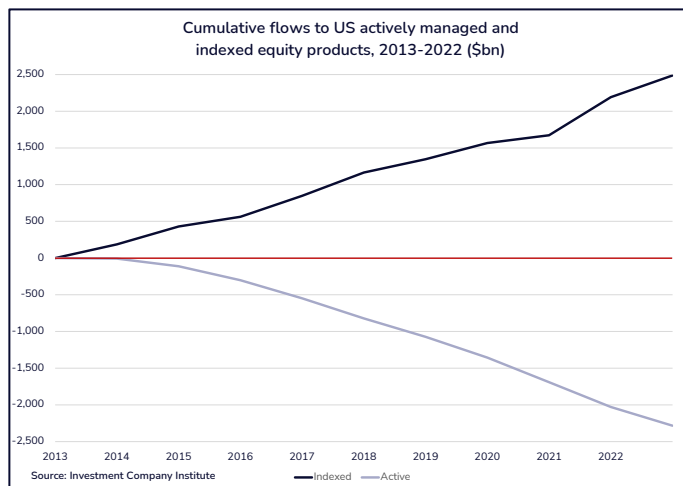
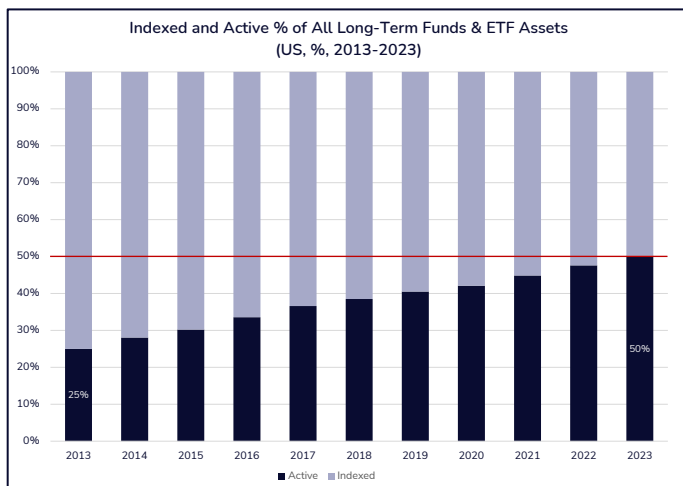


Indexing: individually optimal, systemically risky

- At the end of 2023, indexed strategies comprised more than half of long-term funds and ETF assets in the US (globally: 40%), usurping active strategies for the first time (chart, below left), and more than doubling since 2013 (c.25%). Focusing on the equity markets, this note seeks to quantify the magnitude, momentum and drivers of passive's growing influence and the implications of this trend for market structure and investment strategy. The Efficient Market Hypothesis asserts that deep liquid capital markets are in equilibrium: assets are priced at their respective fair market values as established by participants' frequent transactions. This environment promotes price elasticity, such that changes in demand result in moderate changes in price. Passive's momentum undermines this.
- Within US equities and since 2013, c.\$2.5tr in net new cash and reinvested dividends has flowed into indexed products, with marginally less flowing out of actively managed products (chart, below right). This trend is driven by several factors, including active funds underperforming indexed strategies in aggregate terms, demographic shifts as retirees exit active funds and younger cohorts target passive vehicles (further facilitated by technology), and regulation and fee pressure incentivising advisers to increasingly use cheaper passive products.



- Active investing involves independently assessing an asset's fair market value and taking active bets relative to index weights, attempting to beat the benchmark. Passive investing, conversely, is an indiscriminate and systematic strategy that replicates the benchmark index. While active investing anchors prices to fair value (mean reversion and anti-momentum), passive investing drives asset prices away from fair value (mean aversion and momentum). The marginal dollar, moving from active to passive, closes relative overweights and underweights, typically moving capital from smaller cap and value names to larger cap and growth names, contributing to mega cap concentration. The diminishing proportion of capital wielded by active managers inhibits price discovery and removes friction from order books, exacerbating prevailing momentum and undermining stability. This accelerates volatility in times of market stress. Additionally, hedging actions of market makers exposed to investor positioning in income-enhancing or downside-mitigating derivatives is countercyclical during benign periods (dampening volatility) but procyclical during more volatile periods, amplifying volatility and driving price momentum non-linearly (causing bubbles and crashes).
- The Inelastic Market Hypothesis demonstrates that the rise of passive investing over the past 20 years has reduced the elasticity of individual stocks' aggregate demand curves by c.15%: small changes in market structure effect larger changes in price, undermining stability. Further, demand for megacap stocks has been evidenced to be less elastic than that for smallcap counterparts. Due to this inelasticity, researchers estimate that an incremental \$1 allocated to the capital markets by investors and an incremental \$1 allocated to buybacks by corporate management increase aggregate market value by \$5 and \$2.20, respectively. The implications in the opposite direction are severe.
- While we recognise passive investing's momentum and merits, we're wary of its contribution to optically stable but inherently increasingly fragile capital markets. A shock to expectations would disrupt the status quo and revive investor demand for active strategies, which have demonstrated superior convexity - capital preservation - during crises. We would be delighted to discuss our discretionary segregated strategies and funded solutions with you.

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