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TACTICAL INSIGHTS

IS THERE A PASSIVE INVESTING BUBBLE?

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Since I published the article "The Economic Analysis of Active vs. Passive", I have received a lot of feedback from friends and colleagues. A number of people were very concerned about the potential impacts of increasing passive investments on the health of financial markets. When I did a google search, words like "the greatest bubble ever" or "dysfunction" were used to describe the recent shift to passive investing. The biggest concerns are focused in two areas: (1) Passive investing drives up market valuation and potentially creates a bubble; (2) Passive investing ignores the fundamentals of each individual stock, thus hurts the price discovery and creates dysfunctional financial markets. In this article, I will address these two issues.

Does Passive Investing contribute the current high valuation?

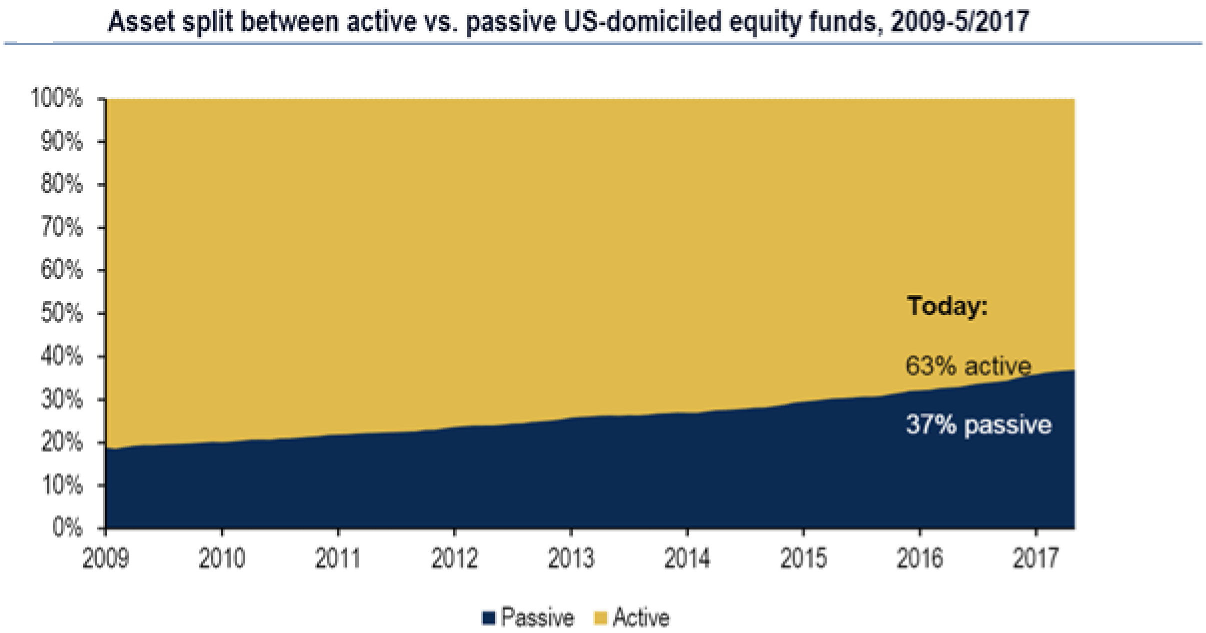
Money has flowed from active managers since the financial crisis amid underperformance and high fees, in favor of exchange-traded funds or index funds. According to Morningstar, for the one-year period ended in March, active equity mutual funds lost $340 billion in assets, while passive funds gained $462.5 billion. Between 2009 and August 2016, the accumulative inflows to passive funds exceeded $1.5 trillion, while active funds lost close to $400 billion, according to Bank of America. Coincidently, after 8 years of bull market, the market valuation reached the level we haven't seen since the tech bubble burst in 2000. The current PE of the S&P 500 Index reached 24.8 and Shiller PE (cyclically adjusted PE ratio) was at an even higher level of 30.5, almost twice as much as the historical mean of 16.8.

By definition, passive funds ignore valuations or company fundamentals, and invest solely on the basis of float-adjusted market capitalization. The critics pointed out that this type of investment would drive the valuation of large cap companies, and thus the whole market higher. They blamed the passive investing for the current high market PE. I would argue the popularity of the passive investing and high market valuation are just coincidence, rather than a causal relationship for two reasons:

(1) The current high PE ratio has a lot to do with low interest rates, improving economic growth and solid corporate earnings. Investors have been increasing allocation to risk assets amid the optimism about the equity markets. The allocations to equities can be made to active funds or passive funds. The stock markets will rise either way. Blaming passive investing for high PE is certainly misguided. The general bullish sentiment on stocks is driving the PE higher.

(2) Majority of equity assets are still managed by active managers. As shown in Figure 1, despite the increasing popularity of passive funds over the past 8 years, active domestic equity funds still account for 63% of the total domestic fund assets. If an active manager believes that market is expensive, he should sell his positions or close his fund. But we all know active managers rarely do that. To be fair, both active funds and passive funds are responsible for the current high RE ratio.

Figure 1: Asset Split Between Active vs. Passive US-Domiciled Equity Funds, 2009 -5/2017



Source: Bank of America Merrill Lynch

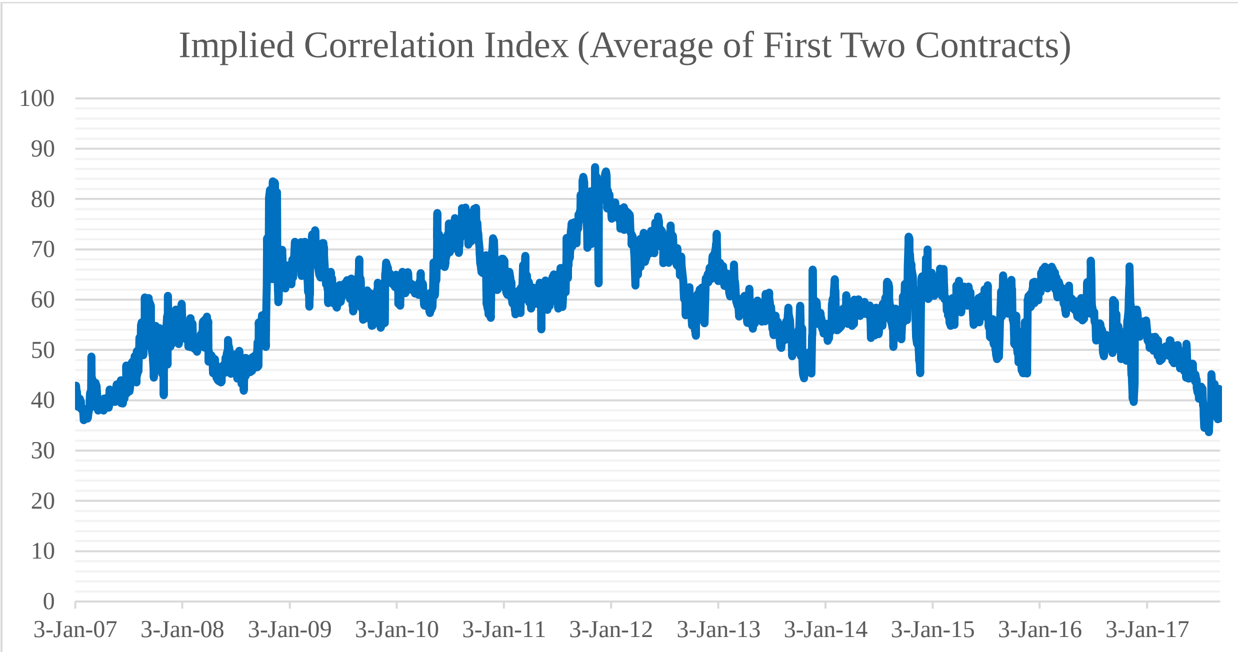
Does Passive Investing hurt price discovery and create dysfunctional financial markets?

The passive investing critics also quickly pointed out that index funds may create a dysfunctional market by marginalizing price discovery. Passive investing neglects company-by-company stock analysis and could potentially create mispricing in the financial markets. Although it is a legitimate concern, the size of the passive investments is not large enough for this to become a significant issue at this point. There are two arguments I would like to make here.

(1) Empirical evidence does not support the "dysfunction" claim. The CBOE S&P 500 Implied Correlation Indexes are the estimate of the average correlation of the stocks that comprise the S&P 500 Index. They are calculated with market-traded option prices of the index and individual stocks. Figure 2 shows that average of the one-year and two-year forward CBOE S&P 500 Implied Correlation Indexes over time. If the index funds are the biggest drivers of market movement, we should expect the correlation of individual stocks to increase as more and more investors move assets to passive funds. However, the evidence points to the opposite. The CBOE S&P 500 Implied Correlation Indexes have been in decline over the last five years. Currently, the index trades at 36%, the lowest level over the last ten years. This tells us that the market is still dominated by the active investors and there are ample opportunities for active investors to generate excess returns. The fear of "dysfunction" caused by passive investing is far-fetched.

(2) Index funds and ETFs provide investors with better tools to actively manage asset allocation or sector rotation. In fact, many investors do use ETFs to manage their asset allocation actively. In this sense, the market may become more efficient at the asset class and sector levels though there may be some potential for mispricing at individual security level (we have not found any evidence yet).

Figure 2: CBOE S&P 500 Implied Correlation Index (01/2007-08/2017)



Source: CBOE

In conclusion, the current situation cannot be described as a "passive investing bubble". The high PE ratio is mainly driven by the bullish market sentiment rather than inflows to the passive funds. The fear of the market "dysfunction" caused by passive investing is far-fetched as well.

Julex Capital Management is a SEC-registered quantitative investment management firm specializing in tactical and factor-based investment strategies. The firm offers a variety of tactical unconstrained investment solutions aiming to provide downside risk management while maximizing the upside potentials using its unique Adaptive Investment Approach.

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