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Passive Breakdown

As a critical mass of valuation-agnostic, passive investors saturate the US stock market, I believe equities have reached an inflection point of extreme risk. Similar to Bruce Banner battling his uncontrollable alter-ego The Incredible Hulk, when passive investors take over, great destruction results. The fight between Banner and Hulk raises the question to comic book readers, where does the man end and the monster begin? What are the consequences of the irrational taking over? As passive strategies now control one out of every three dollars in mutual funds and ETFs that invest in US stocks,* the rational scientists of active managers setting prices are losing control to the chaotic, passive-investing hulks. By foregoing valuation, passive investors sow the seeds of their own demise, but I view the prevalence of passive investors as a tremendous opportunity for stock-pickers.

In 1975 John Bogle started the first index fund, tracking the S&P 500 index.** The percentage of dollars in the US equity markets deemed passive has gone from 0% in 1975 to 33% in 2012.*.Just ten years ago, less than 20% of dollars were passive.* And in the past four years, as active managers have struggled to outpace the market averages, passive investors have drawn blood and the resulting, tidal shift of money out of active strategies and into passive ones has created a self-reinforcing, self-fulfilling prophecy, lifting all passive boats in the market.

The more money coming into index funds and passive ETFs, the more companies within the index benefit. This creates short-term distortions that help indexers and hurt stock-pickers. In his lectures at Central European University, George Soros details his Karl Popper inspired Economic Theory of Reflexivity.*** Soros noticed early in his career the very participation of large players in a market creates positive or negative feedback loops trending towards extreme disorder. This is the antithesis of an equilibrium market, where prices constantly reflect all available information. Rather, with Soros' Theory of Reflexivity, feedback loops create price momentum that result in boom and bust cycles. The more passive dollars there are, the bigger distortions in stock prices will be, until it ends suddenly. As cracks form in the most distorted sectors, the game is near up, as this distortion cannot last indefinitely. Valuations of sectors like utilities are at dangerous highs. This means each additional indexed dollar has less of an effect to drive prices ever higher. Companies with high valuations have little in their arsenal to support their stock price, as stock-buybacks and dividends only have a material effect at lower valuations. We are clearly at the boom part of the passive cycle in this respect.

Meanwhile, stocks lacking the benefits of passive ETF-flow have languished, hurting the stock-pickers that own them, despite their lower valuations and solid business models. The good news for stock-pickers is this: rising dividends, material stock-buybacks, and increased mergers and acquisition activity in 2013 have boosted lagging stock prices. This trend may only be beginning, especially as rising interest rates pressure investors focused on yield rather than valuation.

At the very core, stock prices are backed by actual businesses. Most active managers exist to take advantage when market volatility creates price action wildly different from underlying business health. But, memories are short on Wall Street. Numerous investors have forgotten that those who remained indexed at high valuations in the year 2000 suffered three straight calendar years of declines, with a cumulative loss of 40%. At the same time, numerous active investors posted flat to positive returns by avoiding the distorted, booming, overvalued companies. Indexers were finally made whole ten long years later, little consolation for the lower fees. Indexers telling themselves they would sell should another market like the year 2000 occur are admitting that valuation matters and thus completing the paradox of passive investing. Changes in markets are often volatile and violent, and passive investors claiming the ability to "pull the plug" at the sight of trouble may be shocked by the speed a distorted market can correct.

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* *Morningstar;*
http://online.wsj.com/article/SB10001424127887323869604578368643942370104.html?KEYWORDS=michael+a+pollock#project%3DINDEXchrtprint%26articleTabs%3Dinteractive
** *http://en.wikipedia.org/wiki/Index_fund*
****The Soros Lectures: At the Central European University*