Passive investing leading into a trap

We make no secret of the fact that we are very critical of the current trend toward passive index investing. We have serious reasons for this. This trend is cyclical, and when the cycle turns (as it has several times in the past), it may mean great disappointment for investors who are currently buying expensive equity indices. Moreover, it may cause great dislocation in the markets.

To explain this, we need only take a look into the past. Since the early 20th century, there have occurred five crashes in the US equity market. Each one looked different, but all of these were accompanied by one common phenomenon: An important part of the financial environment at the time and one of the main causes of each of these crashes was some financial innovation, some new product which was a good idea in and of itself but which, once it caught on among the masses and its use was pushed to the extreme, proved itself to be very dangerous. This is because on Wall Street, necessity is decidedly not the mother of invention, and neither is social benefit of any sort. Rather, innovation on Wall Street is driven by the opportunity to sell something.

In the crash known as the Panic of 1907, the critical financial innovation was trusts trying to pose as savings and loan co operatives. The big crash in 1929–1932 involved investment trusts using very high leverage (i.e. borrowed money). The crash in 1987 went hand in hand with the development and subsequent failure of a product called portfolio insurance. In 2008, during the Great Recession, which we all remember, at centre stage was securitisation of mortgages and the infamous credit default swaps (CDS). During the crash in 2010, which literally occurred in milliseconds and therefore was named the Flash Crash, the main role was played by algorithmic trading and the ensuing cascade reaction of computers.

All the innovations stated above can be called good ideas, and the products they contributed to creating essentially succeeded in resolving some problem that investors on the markets were encountering. There always occurred a break in that development, however, when the innovation came into massive use. Two phenomena are always related to mass use. First, in order to sell the financial product to a large number of investors, its advantages are usually highlighted and its risks downplayed. The product is deformed and essentially misused. Second, once the situation gets to a point where a large part of the market is doing the same thing, then these investors find themselves in a situation where they do not have sufficiently large counterparties and so fall into a liquidity trap.

It's like that old joke about a stockbroker: The broker calls his client, recommending him to buy shares in ABC. The client is persuaded and starts buying. The price of ABC shares rises, the client feels satisfied and keeps buying. The share price goes even higher, the client starts to get a nice profit and the only thing he sees is a steadily growing share price. He buys more and more, the stock goes higher and higher, and the client feels rich. When he feels he has made enough he calls his broker and says he wants to sell that stock. "To whom?" the broker asks in response. "You're the only one buying."

Unfortunately, this situation occurs more frequently in the markets than it would seem. Let us take, for example, the crash in 1987 and what preceded it. In the late 1970s, two Americans, Mr Leland and Mr Rubinstein, came up with an idea to develop a product that would help protect investors' equity portfolios from large price declines and essentially would allow them to be more aggressive in their investing. The innovation caught on with the name portfolio insurance, and, simply put, we can say it used options and some other derivatives in combination with the equity portfolio to protect that portfolio from larger declines in case of a stock market slump.

In practice, the entire process (also termed dynamic hedging) created a synthetic put option by combining and adjusting the ratios between cash and shares in the portfolio. The model required, among other things, gradual selling of stocks in a declining market. One of the main assumptions upon which the entire model was based was that these transactions would not influence prices in the markets. In other words, that the market would be so liquid and rational that it would always stand ready to satisfy the requirements of those investors using portfolio insurance.

And it was on the basis of this assumption that everything eventually came crashing down. Leland and Rubinstein tried to offer their product to institutional investors but they had little success. Only after they joined with John O'Brien and founded the company LOR in 1981 did they begin to be successful. By the mid-1980s, the use of portfolio insurance was very widespread. The volume of money using the product from LOR is estimated to have been USD 50 billion, and at least another USD 40 billion was using other companies' similar products. Those were immense numbers for that time.

When the equity market started to decline in 1987, this activated insurance transactions (stock sales) in the insured portfolios. This process turned into a cascade, then into an unstoppable avalanche of forced sales that the market's low liquidity could not satisfy. Paradoxically, a product which should have protected portfolios from a large drop in fact caused one.

In our most recent letter to shareholders, we commented upon passive investing into equity indices and, among other things, we wrote the following:

The massive influx of money into index funds brings even additional risks. The two main risks are those of crowding and low liquidity. When the originally simple and good idea of passive investing is seized upon by the masses and pushed to its extreme, this results in crowding. For example, the Nasdaq index and certain sector indices are places where crowding is presently the most serious.

Every transaction needs two parties: a buyer and a seller. Here, the buyers are index funds into which money is currently flowing, whereas the sellers are actively managed funds out from which money is flowing. As we know, the nature of index funds is to buy especially the most expensive stocks. Actively managed funds are selling them willingly. At present, it still seems that index funds are nothing less than the Holy Grail itself. In fact, index funds are essentially the sole buyers. This is especially true regarding the most expensive companies losing the most money. When this trend reverses itself, to whom will the index funds sell these stocks? To the active funds? Not at those prices – but only when the share prices will be maybe 30% or 50% lower. Perhaps it will be altogether impossible to do so. In a situation where index funds go from the position of sole buyer to that of sole seller and the crowds of investors start pushing to get out the doors, the index funds will encounter an immense problem of illiquidity and an impossibility to sell their stock. The same commentators who are now shouting "Index funds forever!" will start to bellow "Index funds never more!" (End of quote)

Passive investing into equity funds is a product that has properties similar to those of products that have contributed substantially to five crashes. At the beginning, it was a good idea, a useful innovation, and, under certain conditions, it can be recommended to a large proportion of small investors. Today, however, we are in a situation wherein it is misused. A number of Wall Street firms have understood that this is a product which can be sold successfully to the masses. As could be expected, they praise its advantages and gloss over its risks. Those include especially the high share prices of companies in the main indices, their concentration, and the ever-escalating crowding. Investors in index funds are putting themselves into a situation similar to that of holders of portfolio insurance 30 years ago. They are in a liquidity trap and at the same time believe they are investing at low risk.

Markets work in mysterious ways, and it is far from unavoidable that when the current cycle turns around the stampede away from index funds will become the source of a big problem in the markets. Nevertheless, a cautious and conservative investor should closely monitor the development. The probability is nevertheless slim that one will manage to detect the breaking point early and correctly. Prevention is therefore the best defence. We believe this consists of the following points:

1. Avoiding investing into the most expensive indices where crowding is the worst (those would be the US ones).

2. Seeking out active investment opportunities among companies outside of the main indices and potentially in other countries (there are still surprisingly a lot of these).

3. Being patient and sticking to one's investment rules even in the face of great external pressure (this being the most difficult).

Invest with care!,
Daniel Gladiš, 10 September 2017

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