We will pay a high price for passive investing

This morning, as I was reading the annual report of Constellation Software, I came upon a very interesting sentence. It was written in the introductory Letter to Shareholders by the Canadian company's founder and boss Mark Leonard: "(Index investors) buy our stock because we are part of whatever index they are emulating. Their actions are formulaic. Despite the fact that they may be long-term holders, it is difficult to find someone to speak with at these indexing institutions and even if we do, they rarely know much about our company."

This sentence aptly expresses what concerns me about index investing. Index investing further worsens the market's inefficiency by suppressing its price-making function, and, in the end, it thereby diminishes the performance of the entire economy.

The stock market is a place to which companies come to obtain capital they need for their businesses. They acquire that capital from investors by issuing shares. In return, they pay returns to the investors from their profits during their existence. The secondary market is then provided to enable investors to buy and sell their stocks according to their needs.

If the market is to work well, it needs to build in mechanisms that push the individual prices towards their equilibrium values. Capital will always tend to flow to the most attractive combinations of risk and return. If there are large numbers of investors in the market who endeavour to identify attractive investment opportunities, then they will direct their money specifically to these. Thereby, the prices of undervalued stocks will be increased and their originally above-average attractiveness will approach the average. On the other hand, originally unattractive investment opportunities will face an outflow of capital and decreasing prices. Their originally below-average attractiveness will also approach the average.

This process occurs continuously and is one of the main causes of stock price movements. The ceaseless activity of these active investors ensures that the price-making process (i.e. that through which prices seek their equilibrium positions) is sufficiently robust. Capital will flow to where the greatest returns for investors can be expected, and, over the long term, also to those companies which can best grow the value of capital. The greater the returns to capital at the companies level, the higher the productivity of the economy as a whole. The growth of any economy is dependent on just two factors: growth in the number of inhabitants and growth in productivity.

The logic is clear. If we want a rapidly growing economy, we must have rapidly rising productivity. If we want rapidly rising productivity, we must have strong returns to capital. If we want strong returns to capital, we need to have an efficient price-making process in the capital markets. If we want to have an efficient price-making process, then we need to have a sufficient number of active investors.

The question, then, is this: Do we have a sufficient number of active investors? In a work by Ben-David, Franzoni and Moussawi entitled "Exchange Traded Funds (ETFs)" and published in the *Annual Review of Financial Economics*, we can learn that as of the end of 2016 the proportion of passive investors on the US equity market was 38%. Thus, almost two-fifths of equity assets are invested without any thought as to what is bought and at what price. Moreover, the share of passive investors is rapidly expanding. It had been 30% in 2011 and 21% in 2006. If this trend continues, very soon the majority of money will be invested passively (i.e. unthinkingly).

In fact, however, we already are far beyond this halfway point. If we add into the total of passive investors those who appear to be active but who in fact closely track an index, and if we consider that the so-called free float (that is, the number of shares actually available for trading) is substantially less than the total number of shares in issue (and in fact passive investing itself reduces the free float), then we necessarily reach the conclusion that the part of money that is passively managed has been the majority for some time already and has continued rapidly to increase.

How does price-making operate in such an environment? In short, worse and worse. The inefficiency of the overall market is further aggravated by the fact that passive investing skews data on volatility and correlations, thus sending investors misleading information regarding the risks they undertake. All this results in poorer market efficiency and insufficient levels of price-making, lower returns to capital, lower productivity growth, and slower growth of the economy. Passive investing costs all of us in terms of economic prosperity.

Passive investing has yet another substantially negative impact on companies and the economy. It amplifies a problem that occurs within company managements that in economic theory is termed the "principal–agent problem". Company managements are in the position of so-called "agents", which means that they make decisions in the name of another person, the "principal". In this case, the principal is the shareholder. This relationship constitutes a problem because the interests of the two parties are not necessarily (or even mostly) the same. Company managements have interests of their own, and frequently they give preference to their own interests over those of the shareholders.

A mechanism that should – at least to some degree – keep company managements under control is active participation of shareholders (as circumstances allow) in managing companies. In the cases of publicly traded companies, in which ownership frequently is broadly distributed, active participation already is rather difficult. If, however, most shareholders are passive investors who on the one hand know next to nothing about the specific company and on the other whose abilities and ambitions to be actively involved in company management are nearly zero, this cannot be at all good.

If we were to propose an ideal way for the capital markets to function, then passive investors would play only a marginal role and company managements would be under the strict oversight of active investors. Unfortunately, we are straying further and further from this ideal precisely due to today's growing popularity of passive investing. Even this trend will reverse one day, but in the meantime we all will be paying a high price for the present situation.

Invest with care!

Daniel Gladiš, 9 May 2018

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