Brent Sheather's

RESEARCH

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KARMA POLICE – PART 2

In the last column we looked at the rise of passive investing, noting that passive investors buy shares mechanically without considering price or value. With passive getting so popular and its disciples becoming increasingly confident that the strategy will eventually displace active management the story noted that passive had become a "crowded trade" and speculated that some nasty surprise could lurk in the future for passive investing.

I've been concerned about the increased popularity of passive for a few years now and the last column was in part provoked by a recent research note published by Social Service Research Network (SSRN.com). The paper, Passive Aggressive: The Risks of Passive Investing Dominance, was written by Chris Brightman and Campbell Harvey of Research Affiliates. Professor Harvey also teaches at Duke University and is a Senior Fellow of the University of Oxford. There have been many attempts to disrespect passive investing in the past – most have been ridiculous, some embarrassing and all have been premature. The Passive Aggressive (PA) paper could be just another fund manager talking its book (Research Affiliates originate funds based on indices weighted by company fundamentals rather than size, for example) however Professor Harvey is a well-respective academic and is thus unlikely to put his name to something he didn't believe in.

So, what specifically does the PA paper highlight as being the "risks of passive investing dominance?" The authors concerns relate to the following:

1. *Reduced diversification*

   "Stocks with different underlying business models and sectors are increasingly moving together. Stocks with high passive ownership display rising betas (beta is a measure of a stock's relative volatility), whereas actively held stocks have shown a declining trend, a pattern that underscores a structural divergence in market responsiveness.

   Höfler, Schlag, and Schmeling (Passive Investing and Market Quality) documents that passive ownership significantly elevates stocks' exposure to market-wide sentiment shocks and noise and can intensify synchronized movements among stocks by increasing their sensitivity to market-wide shocks and fostering correlated demand.

2. *Fragility from Synchrony*

   As passive products dominate, they become a single, coordinated trade, raising vulnerability to synchronized liquidations. Greenwood and Thesmar (2011) terms this phenomenon "stock fragility" because concentrated ownership means that redemptions in one fund trigger cascading pressures across portfolios holding similar securities. Anton and Polk (2014) finds that overlapping holdings, whether active or passive, amplify correlated selling in stressed conditions. While this effect is not exclusive to passive strategies, the scale of passive flows, combined with their synchronized nature, likely magnifies systemic risks.

   Sammon and Shim (2024) finds that large institutions and firms themselves systematically avoid buying when index funds are selling. The authors' analysis concludes that this collective trading behavior may undermine diversification, exacerbate liquidity risk, and cause more frequent and extreme volatility spikes.

3. *Erosion of price discovery*

Cap-weighted index products abstain from price discovery, neither buying nor selling based on changes in information about the underlying companies. These passive strategies invest their persistent inflows more into stocks whose prices have gone up and less into stocks whose prices have gone down, reinforcing price momentum and diluting security-specific price discovery. The essential function of price discovery—necessary for market efficiency—relies on active investors, who trade based on fundamentals.

When a large fund, or many funds together, attract inflows, they put upward pressure on prices of the stocks they hold (or are overweight). With such powerful trends reinforced by a tide of passive flows, active managers, including short sellers, bide their time—waiting for high tide—before initiating their trades.

The theoretical framework of Bond and Garcia (2022) shows that a decline in indexing costs increases the prevalence of indexing, which reduces the price efficiency of the index. Empirical evidence by Höfler et al. (2025) supports this view, revealing that rising passive ETF ownership systematically diminishes the role of fundamental firm-specific information in determining stock returns, consequently increasing reliance on non-fundamental, transient factors."

The price discovery / market efficiency issue is potentially a big deal as it has implications well beyond the stockmarket: indexing on a large scale could prove to be materially detrimental to the efficient allocation of capital. The reason for this concern is the fact that stock and bond markets, and indeed every investment market in the world, relies on price discovery to ensure assets are efficiently priced. In turn that information is used to calculate the cost of equity and debt for individual companies which corporate finance executives use as inputs to their capital budgeting decisions – like do we buy XYZ company, invest in that new plant or buy back our own shares. In a recent paper, Professor of Finance at New York University, Aswath Damodaran explains how the cost of equity is calculated:

Cost of Equity = Risk-free rate +(beta * risk premium)

Without getting into the detail all three of these variables determining the cost of equity are derived from bond and sharemarket trading data. These are absolutely critical inputs to the efficient allocation of capital and if prices are somehow distorted by the impact of passive investing then the data will give erroneous signals to companies. If the cost of capital of company is understated due to the demand from passive products then that company might be incentivized to invest in projects with returns below its true cost of capital. When sharemarkets, or parts thereof, get overvalued mistakes can be made as regards capex. Japan in the 80s was a classic example – its stockmarket was overvalued and thus the signal to Japanese companies was that capital was cheap with the result that investments were made that might not have been made had the cost of capital been higher. I contacted Professor Harvey by email and, commenting on my report, he said "we contemplated adding your point about the misallocation of capital that could result from this".

There are already some news stories in the mainstream media worrying about the rise of passive; a recent article in the Atlantic "blamed" passive funds for the extraordinary performance of the US stockmarket, since 2008, alleging it has risen "beyond fundamentals". The author gave the example of NVIDIA trading at a 57x multiple of earnings versus the long term market average of 18x. He also cited the fact that the high returns have been "acutely concentrated" in the magnificent Seven. He went on to say that "some experts believe that this shift is the best explanation for the otherwise inexplicably resilient performance of the stock market. 'The move to passive funds is a radical shift in the structure of financial markets,' Mike Green, the chief strategist at Simplify Asset Management, told me. 'To think that wouldn't dramatically impact how those markets behave is just silly.' Active investors are highly sensitive to company fundamentals and broader economic conditions. They pore over earnings reports, scrutinize company finances, and analyze market trends, and will often sell at the first sign of an economic downturn or poor company performance, which causes markets to 'correct.' Passive investors, on the other hand, typically just pick a fund or two when they set up their retirement accounts and then forget about them, meaning they are automatically buying stocks (and rarely selling), no matter what. Thus, whereas a market dominated by active investors tends to be characterized by 'mean reversion' — in which high valuations are followed by a correction—a market dominated by passive investors is instead characterized by 'mean expansion,' in which high valuations are followed by even higher valuations.

The explosion of passive funds over the past 15 years could explain why the market has become less sensitive to real-world downturns, more likely to keep going up no matter what, and dominated by a handful of giant companies. Or that theory could end up being disproved by unforeseen events. It wouldn't be the first."

Whilst the Atlantic's theory sounds reasonable some of the author's conclusions are on shaky ground. Firstly not all passive investors embrace "buy and hold". A recent paper published by The Research Foundation of the CFA Institute shows that the average holding period for an investor who owns one of the largest ETFs, the SPDR S&P 500 ETF Trust, was just 20 days. Secondly, it is not clear that active investors are avoiding the mega cap stocks. By email I asked the FT's global finance correspondent, Robin Wigglesworth, author of Billions, "the definitive book on passive investing", whether he was concerned at the impact of passive on price discovery. His view was that there were lots of hedge funds active in the equity markets which ensured effective price discovery. Looking at their major holdings over the last five years or so many have large weightings to the likes of Apple, Meta, Microsoft, Google, Nvidia etc. Whilst we can speculate as to why hedge funds own these companies – is it due to fundamentals or part of some momentum strategy - it's important to note that big stocks like these have grown their earnings faster than most other companies. Therefore they arguably deserve a premium valuation. The question is, however, whether the premium would be as large as it is in the absence of momentum based buying from passive funds.