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Current Market Environment – Passive Investment Vehicles

Nearly a year has passed since the initial pandemic lockdown, market drop, and subsequent Fed intervention. As financial markets continue their ascent to all-time highs, it is important to assess the current overall market environment. The rise of passive investment vehicles is not a new story, but the potential impact on the underlying "health" of financial markets has become increasingly visible. I have consolidated multiple data points and facts from numerous sources and my notes into this writing, in hopes that it may provide some clarity and perspective on the dynamics in the current market environment.

Traditionally as asset prices rise, discretionary investors sell and provide liquidity to the market. Passive investment vehicles like ETFs, Vanguard Mutual Funds, and customized index products now represent 40%-45% of the market. A problem with such a large portion of the market held in these passive vehicles is they do not exhibit this behavior offering supply to the market. Index funds and ETFs have no choice but to invest new inflows based on the current index allocation regardless of valuation or fundamentals. Funds offered by Vanguard and Blackrock are continually receiving record levels of capital inflows requiring them to invest even as prices rise. This passive vehicle behavior, combined with reduced fundamental trading/analysis, has created an inelastic supply condition in the market - driving equity prices to record levels and expanding the gap between current prices and the intrinsic value of the underlying assets.

Younger market participants primarily hold savings in passive vehicles like ETFs, Index Funds, or Target Date Funds. This is largely a biproduct of the Pension Protection Act of 2006 which requires automatic enrollment of employees into a 401(k) plan. Target Date Funds are essentially funds-of-funds and the default investment option for most 401(k) plans. The Vanguard 2040 or Blackrock's LifePath family of funds are examples. What we observe in passive vehicles is continual inflows from the young working, earning, and contributing to these types of plans. In the active investment space, the owners are disproportionately older and liquidating positions for retirement purposes. Money flowing into passive investing and out of active investing is accelerating the growth of passive as a percentage of the market. As passive grows in float, it becomes the driver of growth resulting in a positive feedback loop. This passive growth and continual inflows exacerbate the inelastic marketplace situation, forcing prices higher resulting in an expanding gap between asset prices and fundamental valuation.

J.P. Morgan has calculated the lack of fundamental analysis in the equity markets. Prior to the 2008 financial crisis it was 90% fundamental. Compare that to today where 90% is tied to ETF creation, mutual fund liquidity fulfilment, index arbitrage, etc. Less than 10% of trading activity is occurring on a fundamental basis now. This reinforces the inflated asset pricing and momentum trading we have seen recently.

At the 2017 Berkshire Hathaway annual meeting, Jack Bogle (founder of Vanguard and index investing) stated that, “if everyone indexed it would be a catastrophe and the markets would fail” (LINK). Indexing accounted for around 20% of the market at that time. He went on to say “we could maybe go up to 50% without any major consequences. But it’s going to take a long, long time to get anywhere near 50% and things will change by a lot in a lot of other ways by then”. We are approaching 50% just 3 years after that interview, and the velocity of growth in passive appears to be accelerating.

Liquidity is the vital component in all these issues.

Turn to the Fed rate cut on March 12, 2020 and the misread that the Fed cut saved the markets. Economic activity was not stimulated from the rate cut. In our view, what occurred was collateral creation across portfolios/funds in the form of bond prices rising. For balanced passive investment vehicles, a rise in bond prices requires them to mechanically start buying equities. The Fed created a condition where balanced funds became imbalanced. Treasury markets had illiquidity events during this time frame due to the measures taken by the Fed. Even with the rate cut and subsequent collateral creation, it still took 11 days (March 23, 2020) for new inflows to build up, options to expire, and funds begin buying to stop the market fall. Passive fund outflows were not the driver of the drop. The initial downward force was from the ever-shrinking base of active managers selling. The same active manager downward trigger played out in February and December of 2018. The Fed will most likely cut to negative on the next trigger, but if passive vehicles experience outflows the bottom could be substantially lower. Negative rates have not worked very well in Europe and Japan in our opinion.

> “Price is what you pay. Value is what you get.” -Warren Buffett

Price matters. The market is functioning in a visibly “unhealthy” manner. The stock markets true core function is to facilitate the allocation of capital to improve the outcomes of our overall economy. The rapid rise of passive investment vehicles has devolved the market into a vehicle used to save for retirement. The market has no fundamental obligation or duty towards us for retirement. It is important to acknowledge this fact. This is not meant to rouse fear but rather inform and instill continued discipline in one’s investment approach. The Fed driven decoupling of markets from the underlying economy, reduces the utility of traditional economic indicators. Maintaining a disciplined value-centric investing philosophy is paramount in the current investment environment.

At the Daily Journal shareholder meeting last week, 97-year-old Charlie Munger answered questions for three hours and reiterated a simple philosophy that we also share and leave you to consider:

> “Value investing, the way I regard it, will never go out of style because value investing the way I conceive it is always wanting to get more value than you pay for when you buy a stock, and that approach will never go out of style.
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> Some people think that value investing is you chase companies which have a lot of cash and they’re a lousy business or something, but I don’t define that as value investing.
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> I think all good investing is value investing. It’s just that some people look for values in strong companies and some look for values in weak companies, but every value investor tries to get more value than he pays for.”

If we can discuss any of the concepts mentioned in this update further, please do not hesitate to contact us.