A Bubble in Index Funds?

October 2019

OVERVIEW

- **Substantial inflows into passive funds over the last decade have led to speculation that a bubble is forming**
- **Key concerns center around the lack of price discovery inherent with passive funds as well as liquidity during market dislocations**
- **While concerns may be valid, empirical data does not seem to support the case for a bubble**

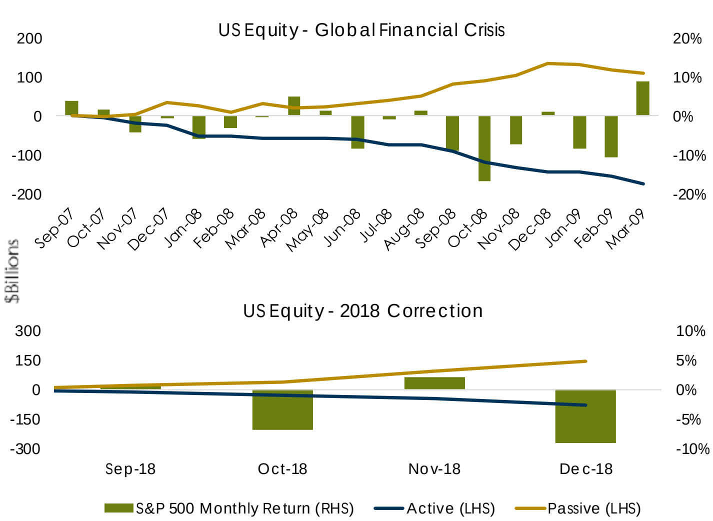
Background

"If everybody indexed, the only word you could use is chaos, catastrophe." So said Jack Bogle, founder of Vanguard, at the 2017 Berkshire Hathaway annual meeting. There is no debate that 100% passive investing would result in a broken market, and some analysts think we have already reached the point where passive investments have created a bubble. In short, the arguments are that the lack of security-level analysis in passive fund purchases has led to distortions in stock prices. Further, the indiscriminate purchasing of Index funds bids up the lower volume securities that make up the far reaches of an index. If redemptions reach extreme levels during a market downturn, there is potential for a serious liquidity shortfall.

Mutual Funds are Not the Market

According to Morningstar data, passive investing now makes up 50% of U.S. equity funds, up from 25% in 2009. However, this headline-grabbing figure fails to take into account large swaths of equity holders outside of mutual funds, such as pensions, insurance companies, and private households. Including these shareholders, passive ownership of the total U.S. equity market is far below that, around 15%. Furthermore, given the low turnover of index strategies, most estimates put the trading activity of passive funds at only 5% - 7% of total market volume. One can look at fund flows during recent market downturns to both get an idea of the impact of passive flows on market prices, and the risks of a "crowded exit" during a downturn. Both during the 2008 financial crisis as well as a more recent market correction in 2018, there were positive flows into passive equity funds during periods of significant drawdowns. This suggests both that active traders are still the ones setting prices, and passive fund flows are relatively indifferent to market stress compared to active funds.

Cumulative Fund Flows During Market Downturns

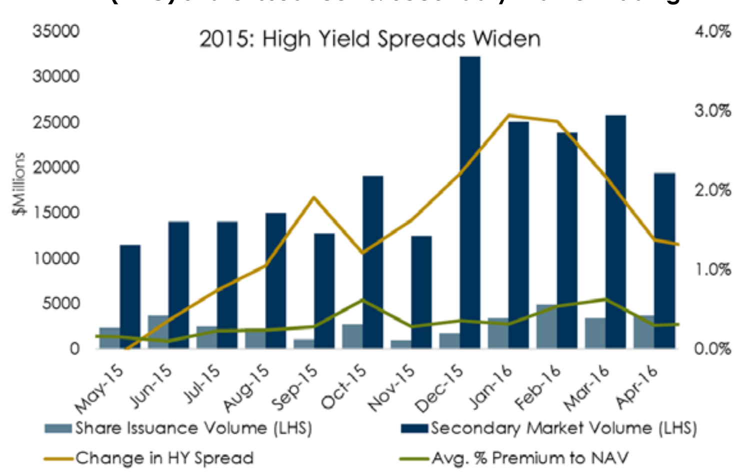


Source: ACG Research, Morningstar

ETF Liquidity - Dual Sources

Illiquid constituents can make certain indices difficult to replicate and contribute to tracking error. But, could illiquid holdings become a contagion during a downturn? These issues are particularly applicable to index exchange traded funds (ETFs), strategies with intraday liquidity like a stock. ETFs have two sources of liquidity: the "secondary market," in which investors trade shares of the ETF through an exchange, and share issuance, in which shares are created or redeemed in response to demand. Only share issuance results in actual trading of the securities that make up the ETF. It is possible for an ETF to have a robust secondary market with very little trading in the underlying holdings. Significant flows into ETFs have occurred during a period of relative calm, so real world testing of liquidity is limited. A recent analysis by the Investment Company Institute found that on average 90% of daily activity in ETF shares occurs on the secondary market, and this relationship has been seen to continue during periods of market stress. One such instance occurred in 2015 when the High Yield Bond spread widened. Using the iShares High Yield Corporate ETF (HYG) as an example, increasing volatility and trading costs in the high yield bond market are reflected in a rising premium to net asset value (the difference between the ETF's price and underlying bonds). Buyers and sellers were willing to trade HYG shares in the difficult market, and a rise in ETF volume relieved the need for share issuance.

ETF (HYG) Share Issuance vs. Secondary Market Trading



Source: ACG Research, Bloomberg

ACG's Position

Eventually a tipping point could be reached with passive market share and its impact on market dynamics. For now, market analysis suggests concerns over a passive-specific bubble are premature (for what it's worth, Jack Bogle thought the market could handle being at least 75% passive). While this is not a general endorsement of passive funds, we still believe there is a place for passive investments as part of a diversified portfolio.

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