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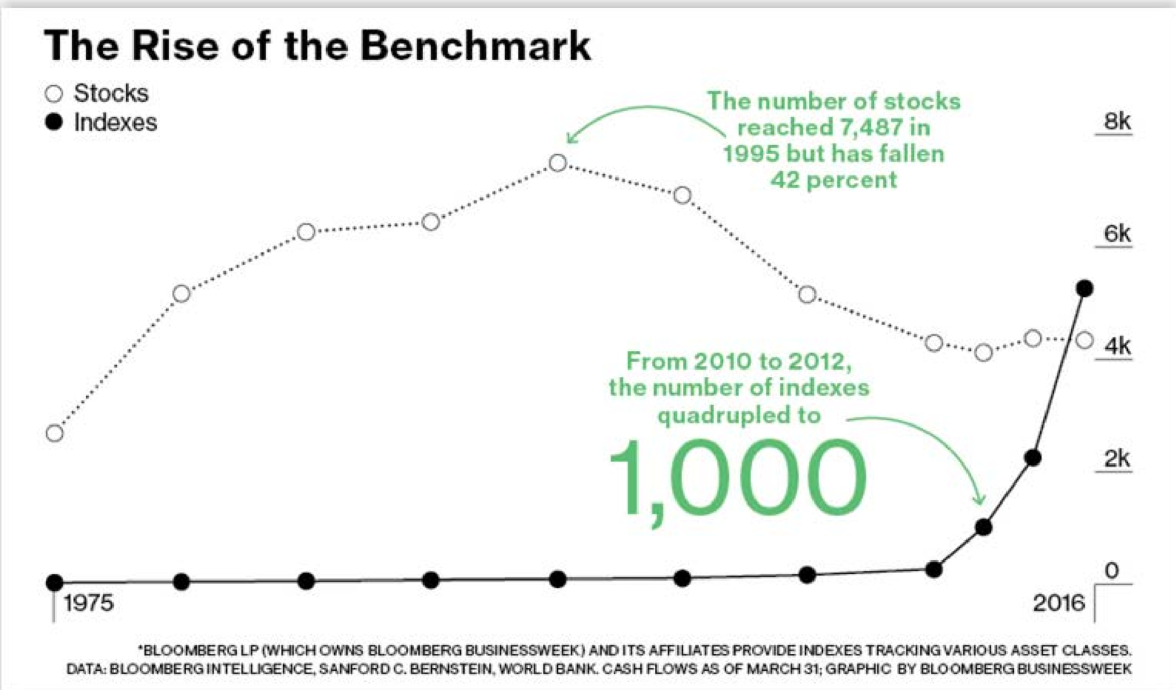
Passive aggressive behaviour

"You look remarkably calm for someone who issues €2.5 trillion out of thin air, especially when your chief economist says there is no Plan B."

- Dutch politician Lammert van Raan to ECB president Mario Draghi, as reported by Zero Hedge.

There is now a new milestone in the history of dismal milestones in financial markets: as Bloomberg points out, the number of market indices now exceeds the number of US stocks. An earlier dismal milestone was passed years ago when the number of US stock funds outweighed the number of US stocks – a red flag raised by the actively managed fund industry. But this new red flag has been hoisted by providers of passive funds (including those active managers trying to have their cake and eat it too). The *de facto* spiritual leader of the mania for passive funds is Vanguard Group, which apparently attracted more inflows in 2016 than the rest of the US mutual fund industry put together. Don't get us wrong – we like low fees as much as the next person. But the Gadarene flood into ETFs partly reflects flawed thinking: low cost is not the same as low risk, as a generation of cheapo investors buying stock markets at all-time highs may be about to find out.



Claude Shannon of Bell Labs explained the link between information and novelty in the 1950s. John Coates in *The hour between dog and wolf* takes up the story:

"According to Shannon, the amount of information contained in a signal is proportional to the amount of novelty – or, put another way, the amount of uncertainty – in it. That may seem counter-intuitive. Uncertainty seems the antithesis of information. But what Shannon meant was this: real information should tell us something we do not already know; it should therefore be unpredictable.. information is synonymous with unpredictability, with novelty. When receiving pure information we are in a state of maximum uncertainty about what comes next."

Buyers of ETFs presumably believe that the markets are efficient – or at least sufficiently so that active management fees are likely to detract from the market return. Thomas Schuster has news for them. Schuster, of the Institute for Communication and Media Studies at Leipzig University, offers the following example of the media shaping price discovery and fostering irrationality.

There is a drugs company called Entremed that has apparently found a cure for cancer:

"Within a year, if all goes well, the first cancer patient will be injected with two new drugs that can eradicate any type of cancer, with no obvious side effects and no drug resistance – in mice."

"New drugs are said to lead to the complete eradication of tumours. The *New York Times* reports the story on the front page of its Sunday issue. The company holding the licence for the active substances is named: Entremed. Its stock price immediately surges by 600%."

As Schuster points out:

"The news is spectacular and exciting. But it is not new. The *New York Times* itself had reported about the new therapy of tumours in animals in an article half a year earlier. Financial economists are amazed by the stock price reaction to the non-event as well. According to the efficient market hypothesis, which says that all available information is always completely reflected in prices, the republication of the story should not have provoked any significant price reactions. But what happens in this case is exactly the opposite. The Entremed stock reacts twice: to the publication of the original news. And, much more violently, to the prominently placed re-run of the research report on the *Times* cover. (Other biotechnology stocks rally sharply too.) The stocks of a whole branch of industry rise, as it seems, because some newspaper journalists have repackaged already known research results a second time."

Jesse Felder suggests that the phrase "passive investing" is an oxymoron in that it denies precisely that which defines an investment: active analysis. Proponents of passives don't seem worried about this inconsistency, he observes, perhaps because most of them believe in the Efficient Market Hypothesis. Unfortunately, the Efficient Market Hypothesis is nonsense.

Wikipedia defines the theory as follows:

"Efficient-market hypothesis (EMH) is a theory in financial economics that states that an asset's prices fully reflect all available information. A direct implication is that it is impossible to "beat the market" consistently on a risk-adjusted basis since market prices should only react to new information or changes in discount rates (the latter may be predictable or unpredictable)."

Jesse Felder:

"I don't think anyone really believes this to be totally accurate anymore. The multiple bubbles we have witnessed over the past couple of decades have served as a real time refutation of the hypothesis. Still, some obviously believe it to be largely accurate. In fact, I would argue that the massive shift to passive in recent years is all the evidence we need to make this assertion. Investors clearly believe that simply buying the indexes, without any regard for price or valuation, will allow them to capture the economic gains of American business over the coming years. To the extent the markets are, indeed, efficient, this assumption would hold true.

"The trouble with this idea today, however, is the fact that the more investors, inspired by EMH, embrace a passive approach the more inefficient the markets become. You see, the EMH rests upon the simple assumption that investors, as a group, are actually investing in the traditional sense. The markets are only capable of being efficient to the extent that investors, as a group, are efficient in their analytical processes and in how they apply them to the markets. Because more investors have abandoned price-sensitive strategies for price-insensitive ones than ever before the markets have also become less efficient than ever before."

Critics of asset managers often assume that we are all trying to beat the market. This is not true, either. Some of us are, in essence, trying primarily to beat cash – but we also have a lingering suspicion that, over time, a policy of capital preservation in active management, successfully deployed, ***may*** end up beating the market, too – especially during, and following, a period of uncomfortably high prices for the broad market.

Ian Lance of RWC points out a number of limitations in passive "investing", but the one we find most troubling is this one:

Passive investing automatically overweights expensive shares and underweights cheap ones.

To value managers, this is kryptonite. Value investing positively requires the avoidance of expensive shares and a fundamental bias in favour of inexpensive ones.

Charlie Munger once remarked,

"If you pushed indexation to the very logical extreme you would get preposterous results."

Jesse Felder again:

"We may not have reached the logical extreme Charlie Munger refers to just yet but we are certainly much closer to it than we were 20 years ago when he first uttered the phrase. One of the most preposterous results of this phenomenon is the fact that investors believe themselves to be acting rationally and efficiently in buying corporate securities that have never been more highly valued. What is most preposterous, though, is that investors are ignoring the blindingly obvious fact that the incredible popularity of their passive investing strategies has totally undermined their most basic assumption.

"Only during a financial mania could investors ever embrace such preposterous rationale as we are seeing today in passive investing. "Euphoria" and "lack of inhibition," part of the definition of a mania, are prerequisites for these sorts of episodes. We have seen it before and recently, too. History is certainly rhyming if not repeating. Ultimately, investors will again learn the hard way that extremely inefficient markets, sometimes called bubbles, created by mass herding and the suspension of reason are not something you really wish to tie your fortunes to."

Many financial commentators have been focusing on the eerily low recent readings for the Vix index. The flood into passives is probably of greater concern, in that the average holding period for these vehicles is already pretty low – and it will become much lower as and when the market eventually succumbs to gravity. For once the *FT* is right on something when it suggests that the stock market is not spookily quiet so much as spookily expensive. We do not believe that the markets today are efficient, nor do we believe that "investors" (more accurately, perhaps, "traders") buying them in the form of the lowest cost collective funds are being entirely rational. And yet the flows into stock ETFs continue. The last word this week goes to Mr Warren Buffett:

"Nothing sedates rationality like large doses of effortless money."

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Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here.