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Passive Investing and Tragedy of the Commons: What if Market Efficiency is Already Melting Away?

The “tragedy of the commons” describes how humans with unfettered access to a finite and valuable resource are often known to overuse it, and thus destroy its value. We intend to argue that market efficiency is a finite valuable resource that may be at risk, creating an investment opportunity.

In 1973, after the heady 1960’s days of the efficient market hypothesis (EMH), Burton Malkiel wrote “A Random Walk Down Wall Street.” He pontificated, what if one could get a “free rider” effect off the market efficiency created by the growing number of professional money managers? Could one buy the common good of an efficient market index cheaply enough to benefit by additionally avoiding professional manager fees? A few years later, John Bogel launched the first index fund. You know the rest.

According to Morningstar, passive funds have now overtaken active funds and are continually taking market share from active managers. On the TSX there are currently more ETFs listed than corporate stocks (TMX Group).

Active managers are discretionary traders, who seek mispriced stocks they believe will add excess returns to their funds. Passive investors are non-discretionary traders, they notionally need not worry about valuation, they believe the market is efficient, and thus perfectly reflects all known information. Their investment strategy is largely irresponsive to the price of the asset. Shiller explained, “Indexing …is free-riding on other people’s work” – in other words, active managers. At what point does there become too many passive players, such that they render the market unmoored from efficiency and thus turn the overall market inefficient?

Some academics and commentators have already observed signs of inefficiency in public markets…

In their research piece, “How Competitive is the Market?”, Haddad, Huebner and Loualiche observed that the rise of passive and the 30% decline of active over the last 20 years, has led to demand for individual stocks becoming 15% more inelastic since 2007. In essence, stocks react less to relevant market news. As the demand for stocks becomes more inelastic, it will likely lead to prices that are more volatile, less informative, and less efficiently priced. Handing the return advantage back to active managers.

In a paper by Randall Morck and Deniz Yavuz with the National Bureau of Economic Research, they found that increased indexing reduces the reactions of individual stock prices to relevant idiosyncratic information, thus appearing to undermine the efficient market hypothesis that supports its viability.

In a recent 2022 research paper, “Passive Investing and the Rise of Mega Firms,” Jiang, Vayanos and Zheng concluded, “Flows into passive funds disproportionately affect the stock prices of the largest firms… and raise prices and price volatility”. They demonstrated that between 1996-2020, passive investing caused the 50-largest U.S. firms to rise 30% more than the stock market overall. The authors also brought into question the widespread use of capitalization weighting in indices, which appears to lead to industry concentration and capital misallocation.

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David Einhorn, one of Wall Street's most closely watched investors, put it more strongly and plainly on a podcast recently, suggesting that passive has fundamentally broken markets. He claims since passive investors have no opinion about value, the value industry overall has "gotten completely annihilated, as value gets redeemed." To invest in passive, investors are essentially buying what has already been performing, raising their prices and increasing their weight in the index. So, value stocks get cheaper yet again.

Studies suggest the trend to passive is a shift of 3% per annum, and this trend could continue. This could lead to the market overall becoming inefficient, and active managers will finally have an opportunity to outperform again.

Action: Simply Diversify.

Hedge this growing risk by keeping experienced active managers or by adding actively managed funds to your asset mix.

By definition, active managers seek to reduce portfolio risks in some fashion. Thus, at the minimum, investors should consider adding more active strategies to their portfolio as both a diversifier and risk moderator to act as a ballast for risk-agnostic passive investing. Given that indices have recently become tilted to the Growth/Momentum styles as outlined above, adding styles such as Value, Income-Focused, Small Cap or Owner-Operator firms with low market cap weights and low volatility, within international and non-U.S. equities may offer investors attractive diversification opportunities.

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