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Passive aggression

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America's shareholders settle for guaranteed mediocrity

HOW many professional stockpickers beat the market? This week, Standard & Poor's (S&P) released its “scorecard” for 2005. Of the 1,137 “large-cap” mutual funds (which trade the shares of big companies), 55.5% beat the S&P 500 stockmarket index last year. Bill Miller's Legg Mason Value Trust Fund beat it for the 15th year in a row.

The cult of equity loves its idols, such as Mr Miller. But Wall Street also has its anti-heroes, who are attracting a growing following. Harry Markowitz and William Sharpe, for example, shared the Nobel prize in economics (with Merton Miller, a corporate-finance theorist) in 1990 for laying the foundations of a disenchanted style of investment, which puts its faith in probabilities, not personalities.

Mr Markowitz showed that it is the portfolio you select that counts, not the stocks you pick. How shares move in sympathy (or antipathy) with each other matters as much as how each performs on its own. Mr Sharpe demonstrated that the best way to escape the quirks of individual shares is not to choose among them at all. Rather, investors should hold all the stocks on the market, in exact proportion to their weight in the market.

To their detractors, this passive style of investing offers nothing more than “guaranteed mediocrity”. Investors aspire only to match a stockmarket index, never to beat it. But the guarantee of mediocrity may be more alluring than many suppose.

One gauge of the popularity of passive investing is to add up the dollars devoted to it. According to Financial Research Corporation, an investment research firm, passive funds (some of them exchange-traded) held $879 billion in November 2005. This was a bigger total than ever before, but still just 16% of the sums managed by active funds.

But in a recent working paper*, Utpal Bhattacharya and Neal Galpin, of the University of Indiana's Kelley School of Business, take a different approach—with strikingly different results. They start with the following thought experiment: suppose everyone were a passive investor, slavishly tracking the market, what would share-trading look like? The gap between this hypothetical world and the observed reality of Wall Street provides their measure of how far passive investing has come.

If everyone is a passive investor, holding a portfolio that mirrors the market, the volume of trade in any particular stock should reflect the company's heft in the market—and nothing else. In other words, the market capitalisation of a stock would explain 100% of its dollar trading volume. The intuition is simple enough. Suppose the stockmarket lists just two companies, a small one with a market capitalisation of $25m and a bigger one worth $75m. A passive investor, with $1,000 to venture, will spend $750 on the larger-cap stock and $250 on the smaller-cap. Likewise, if he were to liquidate a part of his portfolio, he would sell the stocks in the same proportions (three-to-one) to other passive investors, who would buy them three-to-one. Only in this way can the weight of each stock in every investor's portfolio remain the same.

Messrs Bhattacharya and Galpin owe this thought experiment to Andrew Lo and Jiang Wang, of the Massachusetts Institute of Technology. But the two Indiana professors turn the theoretical insight into an empirical measure. They estimate how much of the volume of trade in a share is explained by the company's size. And in so far as size explains volume, passive investing can be said to prevail, they say.

Heroic the assumptions might be; but the results are interesting nonetheless. They imply that American shareholders are giving up the battle to best the market. In 2000-04 passive investing explained at least 76% of the trading volume on the country's stockmarkets, compared with about 64% in 1995-99. Even the tech-heavy NASDAQ, which used to attract the most hyperactive of day-traders, is now as somnambulant as the New York Stock Exchange, with active investing accounting for at most a quarter of trading. Indeed, there is now more guaranteed mediocrity in American stockmarkets than in any of the other 42 countries the authors study, although Belgium, Italy and Sweden are not far behind. In Britain, by contrast, stockpicking may explain half of trading volume; in Germany, as much as 69%.

Quirky and costly

These results pose a puzzle. How can passive investing account for such a big share of American trading, when passive funds hold such a small share of investors' assets? The answer may be that actively managed funds are less active than they claim. Many may be closet trackers, departing from the index only at the edges of their portfolio. There are good reasons for such caution. A stockpicker, if he is to distinguish himself from the herd, must expose his funds to the idiosyncratic risks that rock individual companies and sectors. A passive investor, on the other hand, is vulnerable only to systematic risks that sway the market as a whole.

Despite its rapid progress, the passive revolution will always remain unfinished. As it gains in popularity, it paradoxically loses its appeal. Passive investors free-ride on the efforts of others. They never bother to kick the tyres of the companies they own because they assume someone else has already done so—thus anything they might learn from their toe-poke will already be reflected in the price. But if everyone thinks this way, tyres will go unkicked and prices will cease to reflect all the information they should. This will tempt latent stockpickers back into the game, in the hope of profiting from their private insights. It is only their earnest efforts to beat the market that make the market so difficult to beat.

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* "Is Stock Picking Declining Around the World?": www.kelley.iu.edu/ubhattac/