KIM: Beware the rise of the passive indexing “machines”

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The following is an excerpt from Kirr, Marbach & Co.’s second quarter client letter, available at www.kirrmar.com

We see parallels between now and the technology stock mania of the late 1990s. You probably have seen references to the strong performance of the “FAAMG” stocks (i.e. Facebook, Amazon, Apple, Microsoft and Google) and their impact on stock market performance. While the FAAMG stocks comprise 13% of the market capitalization of the S&P 500, they were responsible for almost 40% of the S&P 500’s year-to-date return through June 7, 2017.

Amazon’s market capitalization increased by $125.1 billion in less than six months, equivalent to the combined value of UPS *and* Kroger. Clearly, if you didn’t own those five stocks, it was almost impossible to keep pace.

Terminator 3: Rise of the Machines was released 14 years ago this month. Machines, in the form of passive index investing, are clearly on the rise and we think are responsible for much of the overvaluation for these large-cap technology stocks.

It is well-known that active managers have underperformed their benchmarks since the financial crisis. Passive index funds offer to match index performance, minus fees (which are much lower than for active management). We certainly understand the elegant simplicity of the index fund sales pitch, which investors have responded to in droves.

According to a research report from Bank of America Merrill Lynch, “The ETF-ization of the S&P 500, Part 1,” the percentage of U.S. equity fund assets that are passively managed has ***nearly doubled*** since the crisis, from 19% in 2009 to 37% today. In fact, Vanguard (the largest passive index fund manager) owns more than 5% of 491 of the S&P 500 stocks, up from “just” 116 in 2010 (and more than 10% of 80 S&P 500 stocks, up from six).

Passive index investing “machines” mechanically and mindlessly “invest” this torrent of cash pouring in by buying stocks in the same proportion as in the indices they happen to track, with no regard for company fundamentals or stock valuation. Thus, every index fund tracking the S&P 500 will buy enough Amazon every day to make it a 1.9% position (AMZN’s current weighting in the S&P 500), regardless of its P/E of 187x earnings for the last twelve months or prospects going forward.

If this constant buying pressure causes AMZN’s weighting to rise to 2% of the S&P 500, the index funds just keep buying more.

Our fear is this “virtuous circle” of constant buying leading to higher stock prices leading to more buying will continue—until the music stops at some point for whatever reason. The resulting index fund *outflows* could cause the virtuous circle to turn vicious as indiscriminate buying turns to indiscriminate selling. Index funds haven’t been tested under extreme market stress since they’ve reached gargantuan size.

Trading liquidity is like air—you take it for granted, until it’s not there. With index funds simultaneously selling the same positions, the question becomes—sell to whom?

Passive index investing is a pure form of follow-the-crowd behavior. We can’t say if passive index investing is a fad, but the herd mentality of investors has certainly caused it to become a crowded trade. We’ve seen many fads over the past four decades plus. All have ended badly.
