Has Passive Investing Become Fraught With Risk?

Considering hedge fund savant Michael Burry's problems with passive investing, point by point.

By John Divine, Staff Writer  Nov. 14, 2019, at 4:55 p.m.

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Hedge fund legend Michael Burry warns that passive investing could be another dangerous bubble.\(^\text{1}\) (ASTRID STAWIARZ/GETTY IMAGES)

**INDEX FUNDS AND ETFS**, the hallmarks of passive investing, have overtaken Wall Street.

In 2009, active funds had nearly three times more assets under management than passive. This year, for the first time, passive funds overtook active funds by market share, with more than $4.2 trillion invested in these low-fee vehicles.

And why wouldn't they? Index funds and low-cost market-tracking ETFs are widely considered the simplest, safest and cheapest ways to diversify your risk, sit back and stop worrying. Plus, active funds as a class have proven unable to beat low-cost index funds over time.

So the fact that a Wall Street legend is warning of a bubble in indexing and passive investing, replete with unseen risks, is concerning. Especially when this Wall Street legend is known for his uncanny ability to spot market tops.

**The Fury of Michael Burry**
Michael Burry, the hedge fund legend whose prescient bets on the subprime mortgage crisis led to a silver screen depiction by Christian Bale in “The Big Short,” has earned respect.

He began his investing career earning extraordinary returns shorting overvalued tech names in the dot-com bubble; his hedge fund returned 55% to the S&P 500’s 12% loss in 2001, its first full year. He again noticed irrational exuberance in 2005, when he began buying credit default swaps to bet against subprime mortgages, which were bundled up in obscure instruments called collateralized debt obligations (CDOs). Again, Burry made a fortune.

Recently, Burry stated publicly that he sees the frenzy around passive investing as another dangerous bubble, and that when the massive inflows eventually reverse, “it will be ugly.”

Here’s a look at his biggest criticisms:

**Passive Investing Eliminates Price Discovery**

“The simple theses and the models that get people into sectors, factors, indexes, or ETFs and mutual funds mimicking those strategies – these do not require the security-level analysis that is required for true price discovery,” Burry said in a recent interview with Bloomberg.

“This is very much like the bubble in synthetic asset-backed CDOs before the great financial crisis in that price-setting in that market was not done by fundamental security-level analysis, but by massive capital flows,” Burry continued.

“I think that Dr. Burry is 100% correct, which is very unusual for someone in the ETF industry to say,” says Phil Bak, the founder and CEO of Exponential ETFs.

“Running a DCF or securities valuation analysis has not been rewarded in recent years while the market’s moved away from the value factor,” Bak says. “That’s hurt price discovery. There’s no question that it’s hurt price discovery.”

Shyam Sunder, an economics professor at Yale University, has been studying issues like price discovery, efficient markets and high-frequency trading for over three decades. He thinks the trillions flooding into passively managed funds may be distorting prices.
“If 5% or 10% of the market is invested in indexes, I don’t think it makes much of a difference. But once that percentage becomes high – 40%, 50% or higher, then obviously it begins to have an effect,” Sunder says.

“Price discovery is what we call a public good, like a broadcast signal from a radio station. The question is, who should pay for it?” Sunder says. “Everybody benefits from an informed market, but the cost of informing the market is paid by people who do the hard work.

“Price discovery cannot take place if Shyam doesn’t do any homework – doesn’t do any digging, has no expertise, doesn’t learn about the products and competition and price and technology of the firm, and just says, ‘Oh! The price of this firm should not be $50, it should be $75,’” he says.

When trillions of dollars are invested in S&P 500 index funds, then this vital digging isn’t being done.

“And when more and more people start free-riding, the returns to digging increase,” Sunder says.

This leads to an interesting phenomenon, according to the Yale professor. Like oil or gold prospecting, the outsized profits that stock pickers scouring these mispriced markets earn end up attracting more bottom-up stock investors, who put in time and effort to find the inefficiencies.

Eventually, the inefficiencies are arbitraged out of the markets. The juice isn’t worth the squeeze. The gold rush ends.

So, while Sunder does acknowledge that there may be short-term price distortions arising from the passive investing bull market, the self-regulating aspect of capital markets will smooth this out in the long run.

For this reason, Sunder brushes off any insinuation long-term index investors will be on the wrong end of a bubble bursting. “The net return to the investor is going to be the same, approximately, in either case,” Sunder says.

**There Are Liquidity Concerns**
Burry’s bearish stance on index investing and ETFs centers around the assumption that, after decades of net inflows to passive investing strategies, eventually the tides will turn, and outflows will cause issues.

The pace of growth has been remarkable. Vanguard Group, which launched the first index fund in 1976 with $11 million, now has $5.6 trillion in assets under management.

In the first quarter of 2019, Vanguard enjoyed net flows of $62 billion, almost half of the $136 billion of net flows into ETFs and mutual funds.

Burry’s key assumption is that these must become outflows eventually. In his interview with Bloomberg, Burry noted that 266 of the 500 stocks in the S&P 500 had less than $150 million in trading volume that day.

“That sounds like a lot, but trillions of dollars in assets globally are indexed to these stocks. The theater keeps getting more crowded, but the exit door is the same as it always was,” Burry said.

Market makers will always be incentivized to facilitate liquidity due to the bid-ask spread. In times of illiquidity, this spread increases, and the profit incentive creates the same sort of self-regulation at play in the price discovery example.

**Takeaways for the Individual Investor**

Burry is a phenomenal investor with a proven track record, and an apparent knack for spotting bubbles. It’s disconcerting to hear him allege that such widespread and seemingly innocuous products as index funds and ETFs could be primed for a grisly end.

But the prospect of people being unable to find willing buyers for mainstream stocks is simply unrealistic. Market makers aside, Burry’s nightmare scenario seems to also require a situation where everyone is selling at once. Long-term investors should never give way to their emotions and surrender to such panics in the first place.

Such behavior is hardly compatible with the idea behind passive investing.
One legitimate concern: investors should be cognizant of how liquid any given ETF is (as opposed to the underlying stocks), since low volume could legitimately mean you’ll have to unload shares at a discount.

But long-term investors in low-cost, liquid funds – as long as the fund is following a sensible, sound benchmark – don’t have much to worry about.

And that leaves the issue of price discovery.

Ironically, Burry’s steadfast conviction that markets aren’t conducting enough price discovery is the very belief that guarantees efficient pricing isn’t an issue for long-term investors.

Why? Because Burry himself is hard at work picking stocks. The unloved, undervalued ones. The under-indexed. Small-cap names, value names, international stocks – he’s got these companies under the magnifying glass.

He’s digging.

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**John Divine** is a senior investing reporter for U.S. News & World Report, where he’s been ... [READ MORE]

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