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"No plans set in stone yet, but I'll probably spend some time getting on my wife's last nerve, maybe hyperfocus on the lawn."

Since inception January 1993 (by State Street Global Advisors who created an index that tracked the S&P 500) trillions of dollars of capital have moved from actively managed investment funds into those that simply track market indices. As much as 60% of net assets overseen by American equity funds are in such passive vehicles, estimates the Investment Company Institute, an industry group.

Most investors know that most active managers fail to beat their benchmark index, while the passive alternatives hug theirs closely and charge rock-bottom fees. Absent from this unfavourable comparison however is volatility, a factor which is determinative of long term investment outcomes. Higher passive returns assume investors stay the course when Markets are lower, something that may not be the case where sharp declines undermine investor's confidence.

What's more, passive investments are anything but harmless. The social function of Markets is to direct capital to where it will be used most effectively, and passive funds make no attempt to do this. Their indiscriminate buying pulls share prices out of whack with underlying earnings. Pulling in the opposite direction are the arbitrageurs, such as hedge funds, which can take the other side of tracker funds' trades and profit from bringing prices back into line with fundamentals.

Yet a much-discussed working paper—at least among active fund managers—makes a compelling case that the arbitrageurs have a far weaker effect than is commonly thought. If so, then flows of assets into passive funds really could be distorting share prices and helping inflate a bubble.

The paper, by Xavier Gabaix of Harvard University and Ralph Koijen of the University of Chicago, sets out their "inelastic-markets hypothesis". This contradicts the textbook argument that money flowing into stocks should barely raise prices, since if it did, demand would fall and return prices close to their starting level. In fact, the paper's authors find that stockmarket demand is not "elastic" in this way, where stocks do not fall much as share prices rise. As a result, an investor who buys $1-worth of stocks using fresh cash (or the proceeds from selling other assets such as bonds) pushes up aggregate market value by $3-8.

In 2024 Vanguard (a trillion dollar passive-investment giant), estimates that two-thirds of Americans' pension-pot contributions went into "target-date" funds. These split their portfolios between stocks and bonds in proportions determined by the dates when savers hope to retire rather than by market prices. If

Messrs Gabaix and Koijen are right, each dollar of this steady flow drives up stockmarket value by several more, regardless of what investors think about firms' future profits. As investors retire, inflated stock prices may correct to reflect falling demand and the true value of these stocks, leaving them with (far) less of a nest egg for their retirement needs.

Our view is that combining active and passive investment vehicles offers investors the best of both worlds. Lower cost passive assets offer higher longer term performance, while passive assets serve to mitigate portfolio volatility (as managers have the discretion to be very different than what stocks the Market is comprised of). Shallower pull-backs in portfolios are conducive to investors staying invested across all Market cycles. As has been written here so often, it is time ***in*** the Market, not tim***ing*** the Market that sees investors capture more of the upside of capital markets over the long term. And that makes for a more financially secure retirement - the end reason why money was invested in the first place.

Thanks for reading!

Martin

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