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How indexation killed growth

Charles Gave | GaveKal | 15 April 2015

Indexing, as I have written before, is a form of socialism, since capital is allocated not as it should be - according to its marginal return - but rather according to swings in the market capitalisation of the underlying assets. It is hard to think of a more stupid way to allocate this scarce resource.

In this new world, the goal of every money manager is to achieve a performance as close as possible to the index against which s/he is benchmarked. As a consequence, the dispersion of results among money managers has become smaller and smaller over the years. Today, you can even buy programs telling you how much IBM stock you should buy versus Johnson and Johnson in order to control your tracking error. As always in economics, there is what you see and what you don't. What most people don't see is how the spread of indexation has led to a collapse in the growth rate of the economy.

Building a portfolio is a very complex exercise. In a perfect world, one would start with the "expected" marginal increase in the return on invested capital of different investments. Once satisfied with a given position, one should try to ensure that the increase in the marginal return is not too correlated with other positions in the portfolio. The name of the game is to find assets with the same ROIC over the long run, but a negative correlation over the shorter term (for example, US shares versus US government bonds over the last 20 years).

This aims at the Holy Grail of money management, which is to achieve a decent long-term return, together with a low volatility of that return. As one can see, this involves a massively complex price discovery exercise, starting with an examination of the marginal variations of ROIC, followed by consideration of the prices at which one can buy the available assets, and finally ending with portfolio construction.

In such a world, one would expect the distribution of performances to be very wide. Indeed, a large dispersion of performances should reassure us that capital has been properly allocated. After all, not everybody can win the jackpot.

Alas, today's world is not perfect, and this is not how capital is allocated. Instead capital is allocated according to the market capitalisation of the assets under consideration. So nowadays, capital is directed to an investment if it outperforms. In simple terms, this means that capital is channeled to companies enjoying an increase, not in their ROIC, but in their share prices. In a world in which investments are made according to the marginal ROIC (i.e. the past), these two tended to overlap. As a result, indexation worked, but only as long as no more than about 5% of assets were managed by "free-riding" indexers.

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Not in today's world. Today, indexing has become the dominant asset management style, and investments are dictated by market cap and changes in market cap - which is simply another way of saying that capital is now deployed according to momentum-based rules. This was very visible in 1999-2000, and is almost as visible today.

Intellectually, the old method of investment was based on a "return to the mean" approach. When the price movements of an asset became excessive compared to its expected ROIC, then one bought - or sold - the asset. Today, capital is allocated only according to marginal variations in the price of the asset. The more it goes up, the more money managers invest in it. The more it goes down, the less managers own.

A return to the mean methodology leads naturally to a stable, but moving, equilibrium. Momentum-based investing inevitably creates an explosive-implosive system, which swings wildly from booms to busts and back again. And, if monetary policy is as silly as it has been since 2002, these swings will be even more pronounced.

The closer we get to a bust, the tighter the performance dispersion among money managers, as the poor fellows trying to manage efficiently and professionally lose their clients to benchmark optimisation algorithms. I don't have the necessary data, so cannot prove it, but I would not be surprised if a sharp fall in the dispersion of money managers' results is a reliable warning that a bust is approaching.

The goal of every socialist experiment is for everybody to earn the same salary. In the world of money management, we seem to have achieved this remarkable ambition. Hurrah!

Of course, if everybody gets the same results, then no one is going to get fired for underperforming, which is great news for the people administering the capital (I hesitate to call them managers). But - and here is what we do not see - our capital is being massively misallocated, all the time.

People ask me why we have no economic growth. Why on earth do they expect economic growth in a socialist system?

Charles Gave is Founding Partner and Chairman of GaveKal Research. GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.

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