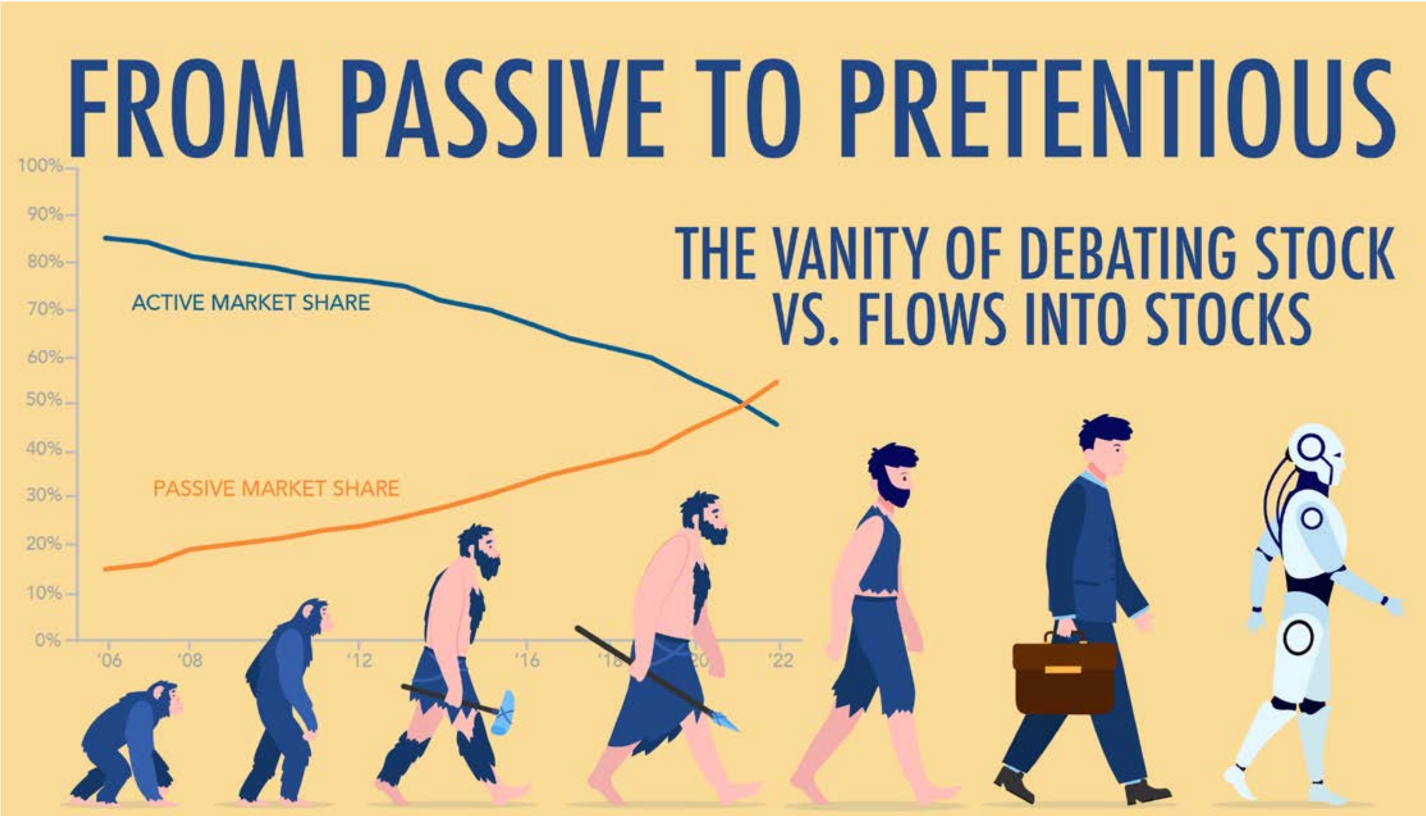
The Weekly Quill

October 6, 2021




# From Passive to Pretentious

## The Vanity of Debating Stock vs. Flows into Stocks

*"The learned among them confess the absurdity of this doctrine, but the practice still continues, in compliance to the vulgar."*

Lemuel Gulliver, 1726

Pet names that started with the letter 'V' were decidedly bad luck for would be marriage candidates to Jonathan Swift, the Irish satirist and author of masterpiece *Gulliver's Travels*. Though born seven months after his father's death in 1667, Swift's young life took several fortuitous turns that led to his meeting the love of his life. His journey started with such poverty and poor health as to land Swift with Meniere's disease, which causes dizziness, vertigo, nausea, and hearing loss affecting the inner ear. At a tender age, he was sent to live with his uncle, Godwin Swift, who supported him and gave him the best education possible. This was the first critical departure his life would take, allowing Swift to eventually study at the Trinity College in Dublin where he earned a B.A. degree. The Glorious Revolution of 1688 cut short his aspirations to further his higher learning.

The political unrest prompted a move to Leicester, England, where he came under the employ of his life's most important connection, Sir William Temple, a retired diplomat. Living at his home in Moore Park, Surrey, Swift was placed in the pathway of many politically influential people. But it was also in his new home that he, all of 22 years of age, was introduced to Stella, the daughter of a fellow employee who was only six years old at the time, and her younger sister Anne. Their friendship was fast, and Swift became her tutor and mentor. In the meantime, Sir Temple used his influence to help Swift gain admission into Oxford University. In 1692, Swift graduated with a M.A. degree and was swiftly deposed to a one-year stint as an Anglican priest in the parish of Kilroot near Carrickfergus in Antrim in Northern Ireland.

Being of a suitable age, he became engaged to marry the sister of a friend, Waring Swift, whom he met in his capacity as rector. Alas, the union to his affectionately named 'Varina' was not to be, and the two mutually consented to part ways. 'Vanessa,' whom he met in 1707, would prove to be a more formidable challenge. Hesther vanHomrigh, whom he met in 1707, would prove to be a more formidable challenge. This strong willed young woman was the wealthy daughter of a merchant who had passed some time before she became acquainted with Swift at the age of 20; she was 22 years his junior. As for her personal riches, the success of King William's war in Ireland in the early 1690s afforded her dearly departed father the opportunity to build a fortune from a series of land and property forfeitures.

So enamored was the young Hesther, she followed her heart, relocating to a house called Marley Abbey, about 15 miles outside Dublin, to be close to the man of her dreams to whom she (modestly) declared she was his for the having should he be inclined to propose. While their relationship would span 17 years, regrettably, for 'Vanessa,' Swift was decidedly disinclined after her insisting that he sever ties with his beloved Esther Johnson, known as Stella to her friends.

Long before becoming acquainted with Vanessa, Swift's friendship with Stella, started so many years earlier, had prompted her to buy a house in his parish of Laracor. There, she resided with her constant companion Rebecca Dingley, who was diligent to always be present in the company of Swift and Stella to preserve decorum. While it is said that they secretly married, no proof to such effect was ever found. In 1727, Swift abandoned his promoting *Gulliver's Travels* to rush to Stella who had fallen ill. A year later, she died, leaving him mentally destitute.

But we will always have Swift's sage words, which convey a wisdom that all of time cannot render irrelevant. Above all, he valued the learned soul who never felt secure enough to stop learning. "Blindness in addition to courage conceals dangers…," he warned, "…affecting greater import than is possessed."

In no field has such hubris more played out than that of investing. We've secured our collective fortunes by losing our way en masse. There was a time that random applied. The riches of inefficiencies effectively exploited and arbitraged were rewarded to the best in class among fundamental analysts. Cheapening valuations amidst the known knowns among this closed coterie of Wall Street gods invited buying opportunities that ultimately manifested in value-add, or alpha, a trite concept in today's financial markets. Richening induced opposite moves as the denizens of outperforming portfolios, once known as the 'smart money,' pocketed profits before the hoi polloi caught on to trimmed expectations.

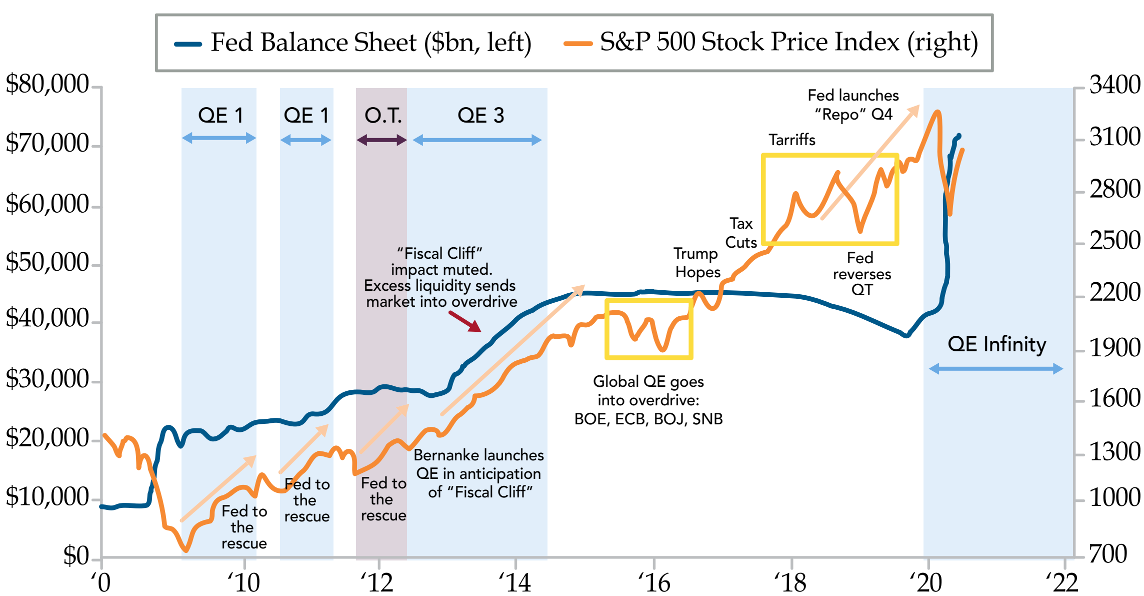
While there may be a distaste left in your mouth after reading such a depiction, you're no doubt familiar with the construct. As "unfair" as active management once was, we would not openly mourn its demise if the way of yesteryear's world was still intact. Alas, the ballsy combination of brain power and bravado is somewhat passe, at least in the sense of being odd man out in the not-brave new world of passive investing.

The bogeyman is not, however, a beast that feeds on itself to grow ever stronger and, well, bestial, though there is an element of that dynamic at work. The power of passive investing entails more than blind buying begetting more blind buying yet at ever-higher prices – monies into coffers that must be deployed. Multiple elements that must converge, have united, and continue to congregate in greater numbers, to afford the means by which the bulk of today's investing **appears** to be such a resounding success.

Nosebleed valuations begetting crazier higher valuations via fresh money inflows are but one element. Demographics also play a key role, though not in a way you'd readily suspect. Portfolio planning on autopilot performs a stealthy, but even bigger function given the growing dominance of 401k investing. And finally, there is the dominant overlord reign of central bank liquidity -- no single element holds similar sway over the others to power the prices of risky assets higher. The counterfactual is that an infusion reduction is, by far, the most powerful force in risky asset prices.

We've all seen versions of this chart that shows when the Federal Reserve flipped the switch from conventional to unconventional monetary policy by deploying Quantitative Easing (QE). While not the most current, this version from QI friend Lance Roberts happens to be delightfully detailed. Note that the two times the Fed stopped growing, or worse, began to shrink its balance sheet that markets went sideways. The exception to this post-QE rule is the period between Trump's election and the launch date of the tariff war, when the stock market was flooded with share buybacks via repatriated profits that were given a tax "vacation."

## Growing Federal Reserve Liquidity is the Dominant Flow




Source: Real Investment Advice

The process of assessing the inherent risk in stocks trading near all-time highs despite U.S. fiscal spending and the global credit impulse having both turned negative entails three steps. The first two contextualize the importance of the passive wave that's washed over U.S. stock holdings, beginning with identifying **what** those stock holdings drive and by **whom**. This simple exercise ends with putting into a historical framework the level of vulnerability given stocks' relative size to that of the U.S. economy.

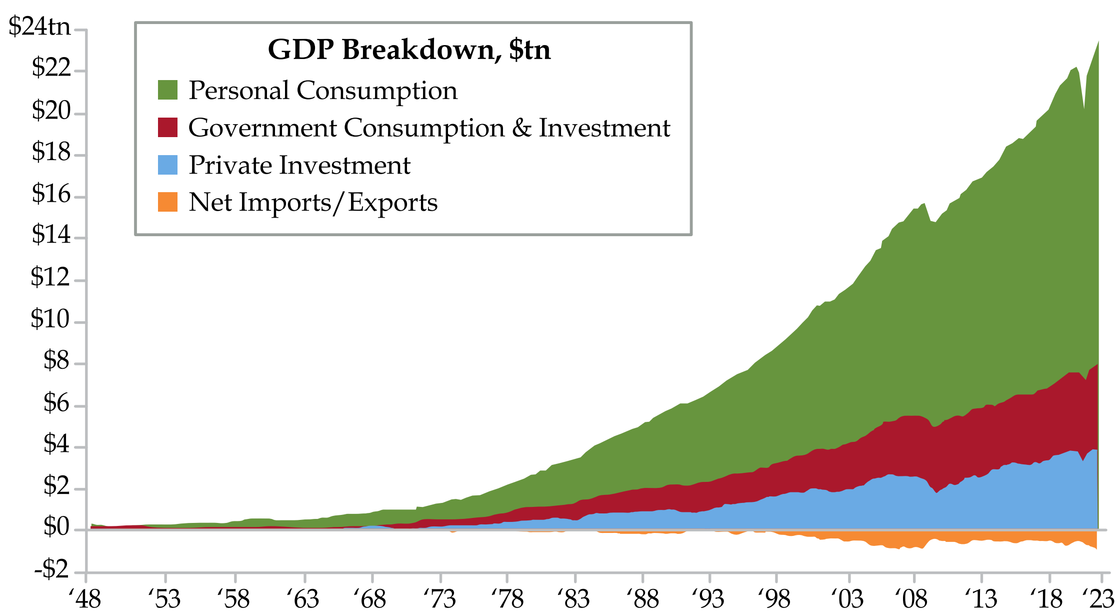
With a hat tip to Axonics' Peter Cecchini, in August, the dollar-level of savings fell below that which preceded the pandemic for the first time. The onus to maintain economic growth via consumption, which has risen to 69% of GDP since stimulus monies began flowing, is visibly critical as that same stimulatory impulse has begun to contract. Signs have already begun to emerge as different forms of emergency programs created in the pandemic's aftermath have ended. According to the U.S. Census, in September, the percentage of Americans reporting they had no difficulty paying their bills fell to 48.4%; it's been ticking down since May's 49.9%. After starting out just north of 6% in late July, the Atlanta Fed's GDPNow tracker has fallen to 1.3%.

Flip the math on its head and you see that the 51.6% of Americans who cannot cover their bills will rely increasingly on those who can. For the purpose of this discussion, let's boil down the "haves" to those making $100,000 or more, who are responsible for nearly half of that U.S. consumption that makes the world economy go round. As you see in the green bars below, this same cohort owns more than 80% of U.S. stocks. The media has a field day with the increased concentration of stock holdings. While this is starkly reflective of the inequality divide widening, for purely the sake of GDP math, you can deduce that this same small coterie of investors is reliant on those stock holdings to maintain their value to support their big spending habits.

Peel the demographics back one last layer to age and you see that those over the age of 55 own 72% of stocks. This group is also, and remember this point, the most inclined and exposed to actively managed stocks. Moreover, the pandemic expedited the proclivity to retire – after meandering up by nearly four percentage points to 19% in the decade to 2020, the percentage of the population that is retired rose by nearly a full percentage point in the space of 18 months.

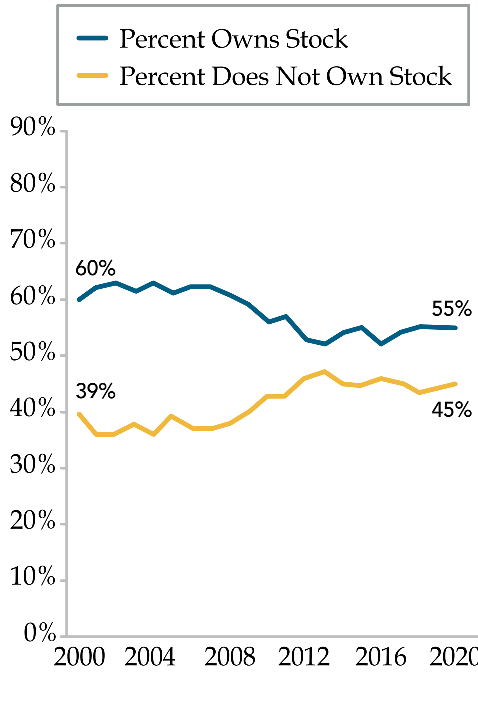
Finally, the Fed's flow of funds second quarter revealed that, as a percentage of assets, household holdings of 50% equities are at a 70-year high and have surpassed the 48% prior peak recorded in 2000. Shown in the third panel below, households' equity holdings have also surpassed that of their real estate by nearly $7 trillion. Note that it's been the norm in the postwar era to see the reverse, which stands to reason – a home is supposed to be households' biggest holding. For the briefest of moments in 2000, today's uncharacteristically flipped dynamic took hold, but by nowhere near the magnitude that prevails today.

## Contextualizing U.S. Households' Equity Ownership

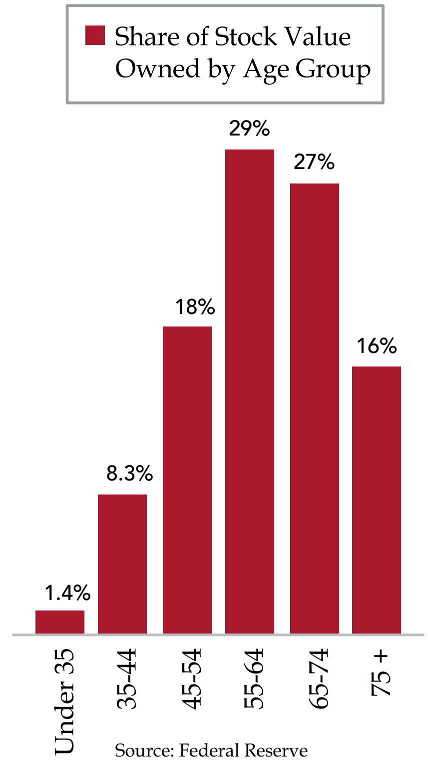



Source: Bianco Research, Federal Reserve

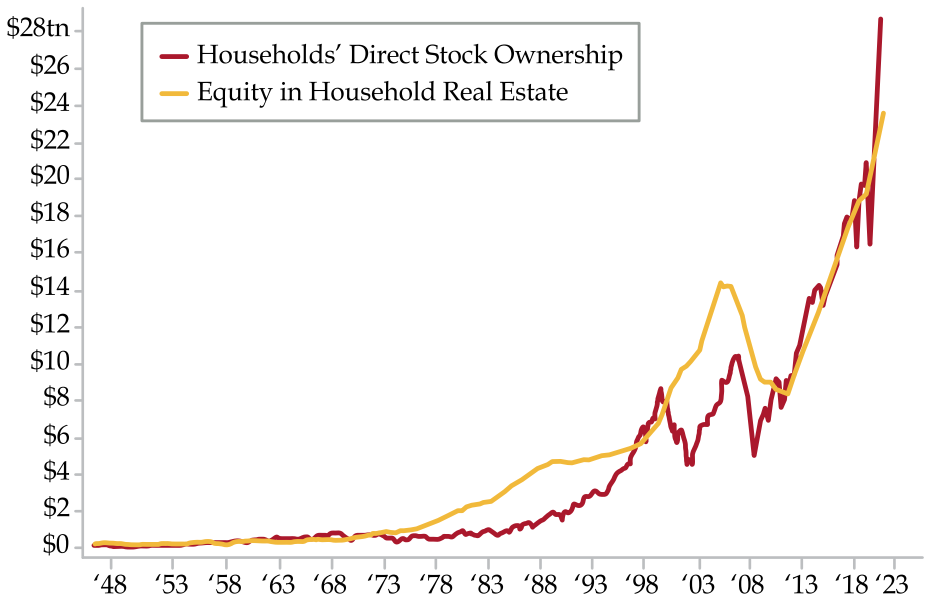

Source: Quill Intelligence, BLS, visualcapitalist.com




Source: Gallup, U.S. Federal Reserve Survey of Consumer Finances (Sep 2020)




Source: Federal Reserve




Source: Bianco Research, Federal Reserve

Add it all up, and it's fair to say that a major stock market correction is not even an option with 20% of global GDP at risk should U.S. consumption stumble. The element of inflation adds a fresh wrinkle to what is already a dilemma of historic proportions for policymakers.

Michael Green is Chief Strategist with Simplify Asset Management. In the world of investing, he is also held as one of the preeminent experts on passive investing. In his view, the role of inflation, which is behaving in sticky fashion, is thorny for the Fed because of the pivot taken with the bailout of the hedge fund Long Term Capital Management in 1998: "The Fed shifted to trying to manage the inflation expectations channel by preventing collapse of asset prices." That's all good and well as long as the global economy is in the middle of a 40-year run of secular disinflation, which it was then. Today, the Fed is boxed into a corner with the choice of committing one of two policy errors – it can tighten and take down the markets or it can fail to tighten to rein in persistent inflation. At a minimum, investors should be prepared for an earnings recession tied to margin compression and declining revenues as U.S. households cut back on discretionary spending.

And yet, stocks are insouciant, seemingly bolstered by an inexplicable source of support. Resolving the disconnect between valuations, which are in the 99th percentile across a myriad of measures, record leverage hyper-driving speculation and the real prospect of rising inflation, requires folding the structure of passive investing into the intellectual mix.

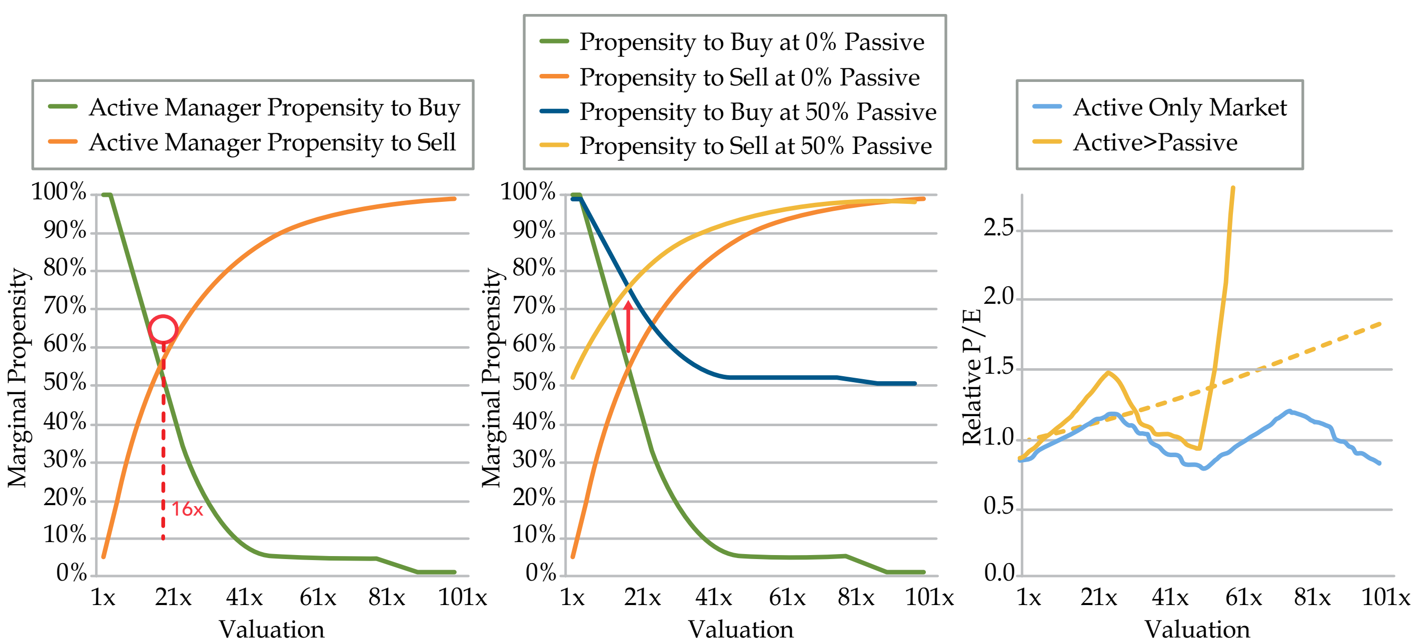
In the era that preceded passivity's supremacy, portfolio managers who woke to find cash had been infused into their funds bought stocks based on the fundamental analysis they'd undertaken on a given area of the stock market. Every marginal dollar of inflows prompted a purchase, but only up to the point at which value was still to be had. After that break even, the manager would be inclined to be a seller and raise cash. The price-to-earnings ratio thus oscillated around a mean as a factor of time.

As Green observed in a recent conversation, "The marginal supply/demand curve was based on valuations." Prices changed according to all available information, which underscored the long-held tenet that markets were efficient. Though a handful of denialists may beg to differ, markets today have precious little to do with fundamental analysis and are anything but efficient.

If there is a singular word that should stand out when it comes to the essence of passive investing, it's **flow.** Turning on its head the sanctity of valuations, passive investing dictates prices based purely on flows. Passive managers – which are, by the way, always active as flows are received around the clock – buy more when prices rise and sell less when they fall. The marginal supply/demand

curve has been destroyed as passive has grown its share and changed the way markets operate. Nowhere is the effect as pronounced as relative price-to-earnings ratios, which have vaulted upwards as flows that are agnostic to price and value drive valuations far above what logic dictates.

## Passive Flows Electrify Valuations



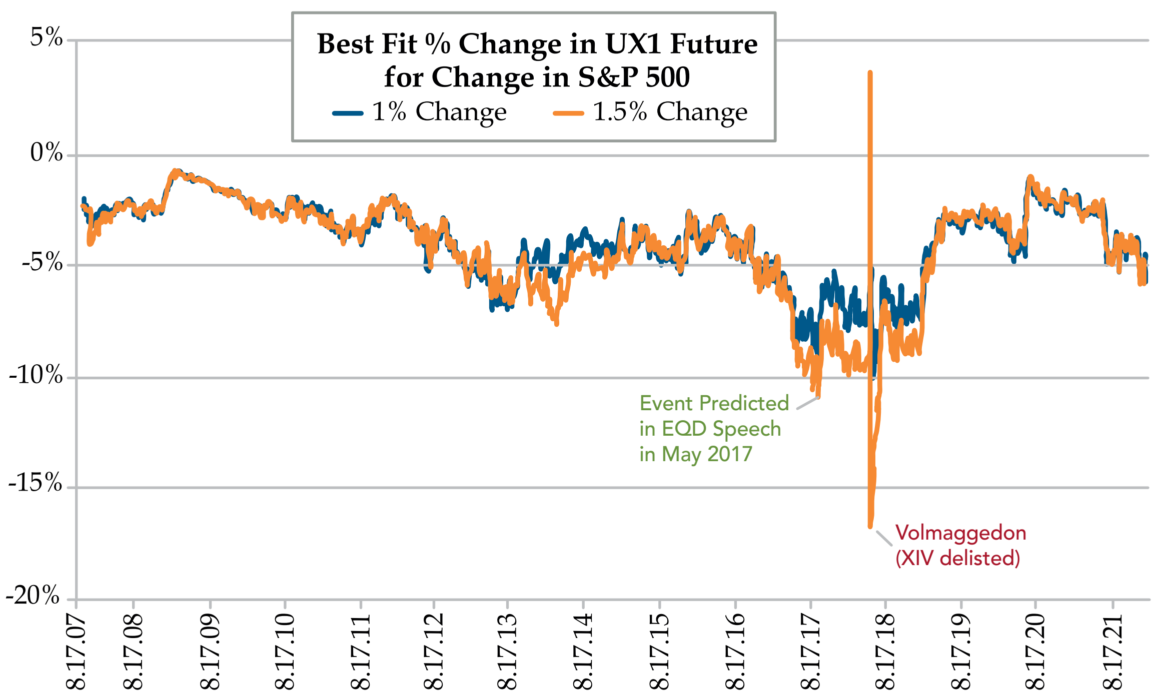

Source: Simplify Asset Management Inc.

Green's work on flows arrived in 2017 with the revelation that because passive funds take in fresh inflows constantly, they are not only active at calendric points of rebalancing, but every time they take in fresh monies. The dynamism of flows, which makes them constantly active, is a concept that can be limited in scope to a single fund. How concentrated passive flows are in a given market vis-à-vis the level of volumes determine their ultimate influence. Green refers to this gauge as "penetration."

Four years ago, when he began to delve deeper into the structure of passive investing, the highest passive penetration was in short volatility, the poster child of which was the now notorious (and defunct) XIV exchange traded fund in the space. Though passive was roughly a fifth of the stock of securities in which the VIX could be sold, the VIX ETF complex accounted for around 70% of all VIX futures.

Per Green, they were 2017's answer to 1987's portfolio insurance. Such was their sway, the vehicles began to be exploited as broader hedges for S&P 500 hedging. In his words, this phenomenon manifested, "in the 'rising beta' of VIX futures to the S&P 500. Historically, a 1% change in the S&P equated to a 2% change in the UX futures. This had risen five times by May 2017 when I made my public pronouncement." That "pronouncement" was when he warned that this strategy was a ticking time bomb, which it was.

## High Penetration of ETF Flows Heighten Asset Class Vulnerability




Source: Simplify Asset Management Inc.

"Penetration" demonstrated that the key issue was the **dominance** of flows. When Volmaggedon hit, there was not sufficient liquidity to accommodate the surge in flows. After XIV's delisting, there was a normalization of sorts in the volatility market, but evidence has begun to re-emerge of something amiss in the broader equity markets. The good news is the "stock" of equities in passive is 44% but only around 15% by flows, as in actual volumes. Again, for perspective, that compares to the VIX complex, which in 2017, was around 20% by stock of passive, but 65% by flow as the strategies required daily rebalancing.

Whether some passive managers acknowledge, or even perceive it to be the case, the structure of passive management has changed how market players behave. Further academic studies into the space have revealed the powers of passive investing as it's grown over the past two decades.

One of them is how much less elastic markets are due to flows and eventually penetration.

A single passive dollar of inflows has such thrust it increases market's aggregate value by five times. This effective leverage, not in the traditional sense of debt, but power, has influenced the macroeconomy. As I've noted on multiple occasions, in the post-QE era, the correlation of CEO confidence to the S&P 500 has risen to 70% from 60%. Though the transmission mechanism may not be as obvious, what happens in the stock market does not remain contained in the stock market, a reality that's been catalyzed by Fed liquidity and greatly amplified by the growth of passive investing.

The mother of all conclusions emanated from a December 2020 paper, ***Tracking Biased Weights: Asset Pricing Implications of Value-Weighted Indexing:*** "We show theoretically and empirically that flows into index funds raise the prices of large stocks in the index disproportionately more than the prices of small stocks. Conversely, flows predict a high future return of the small-minus-large index portfolio. This finding runs counter to the Capital Asset Pricing Model and arises when noise (read: momentum) traders distort prices, biasing index weights. When funds tracking value-weighted indices experience inflows, they buy mainly stocks in high noise-trader demand, exacerbating the distortion. During our sample period 2000-2019, a small-minus-large portfolio of S&P 500 stocks earns ten percent per year, while no size effect exists for non-index stocks."

Because of equities' current relatively low persistence, one can reasonably ask if stocks can ever fall given they exist within a positive feedback loop that magnifies every marginal dollar of inflows. After all, as younger investors continue to pile into 401k vehicles that automatically inject flows and rebalance when stocks decline to a sufficient extent, it would seem a sure thing that stocks cannot fall, regardless of existing inside a vacuum in which valuations are detached from fundamentals.

In the next five years, demographics will become meaningful as boomer outflows increasingly act as an offset to passive investing. It bears noting that this could be yet another coffin in active investing as older investors have a disproportionate footprint in the active space. In addition, at the risk of being overly simplistic, valuations don't rise indefinitely. If they were to collide with central banks being forced to withdraw liquidity, a combination of these factors could finally render negative the current positive feedback loop.

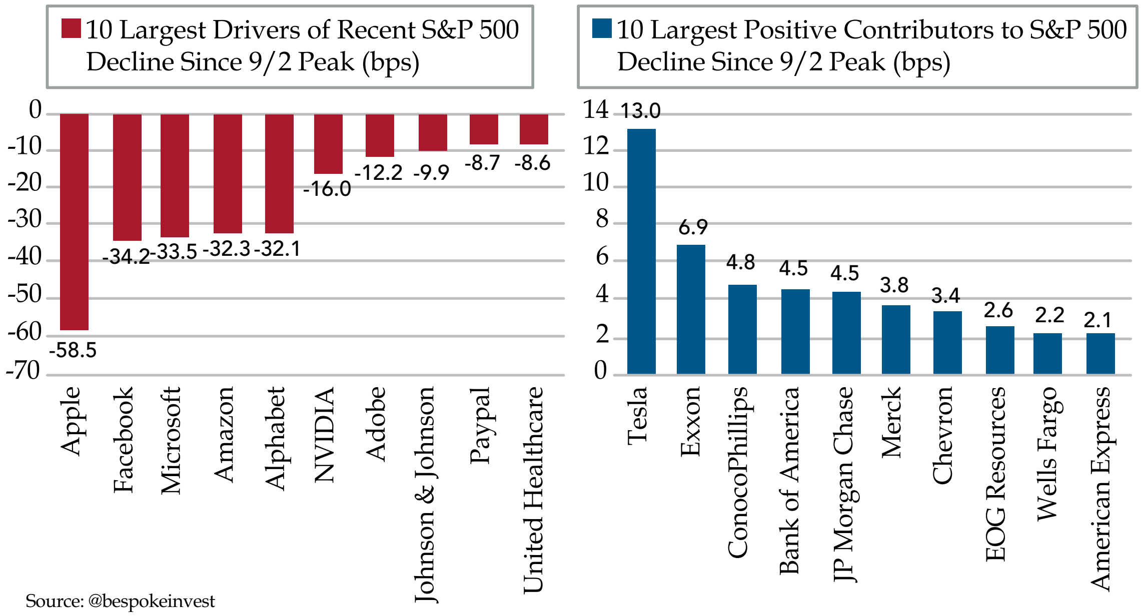
What we pay attention to in the near term is departures from pattern that flag a possible rise in penetration that overtakes other factors driving stocks. This last quad puts on display those other factors. It stands to reason that the darlings among tech stocks would be the hardest hit if liquidity was to truly turn tail – that's how negative feedback loops operate. Riddle me this: Why has Tesla, the mother of all momentum stocks, been the biggest positive contributor to the S&P 500 since its September 2nd peak?

There could be any number of explanations, with a large short position topping the list. That said, short interest on Tesla has just hit 1.1%, the lowest since it went public in 2010. Could it be Bitcoin? The electric vehicle manufacturer and innovator extraordinaire has been criticized for its crypto investing, which many see as a diversion from buybacks that could have generated more value creation. Is this reflective of life after being added to the S&P 500? While up year to date, the stock price of roughly $783 a share is $100 lower than its late January high after it entered the index. This may be a case of no explanation other than there being more buyers than sellers. How very old-fashioned.

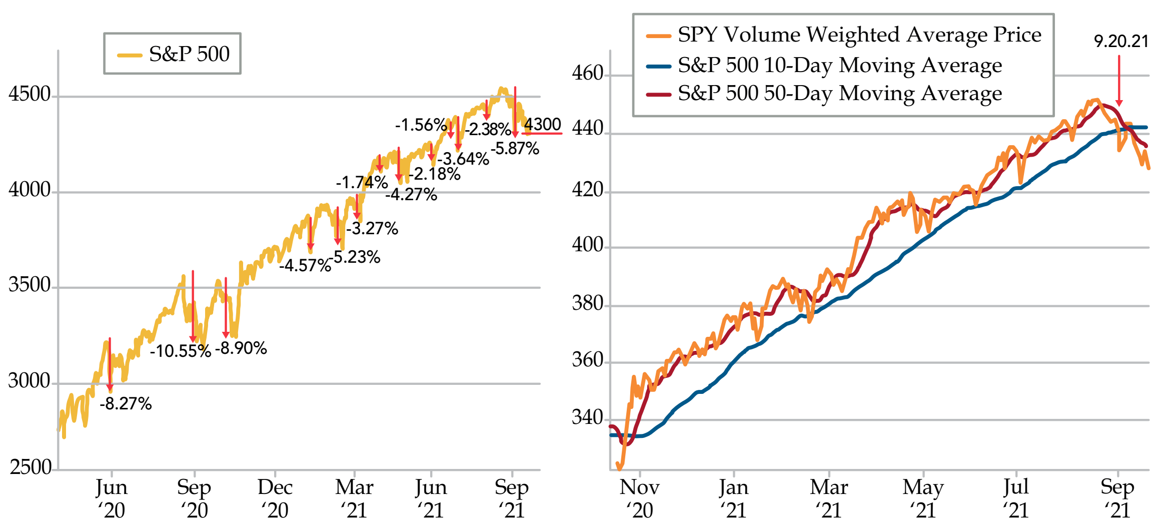
That said, especially given the precedent of the expatriated-profits driven surge in stocks, there's no denying the power of share buybacks, especially in the midst of 2021's record-breaking corporate debt issuance with which to reserve dry powder to fire up the buyback machine.

With a hat tip to Brian Reynolds, while the price of the stock market is little changed since late September, "the 10-day moving average has fallen below the 50-day moving average for the first time since November, when buybacks were still on hold due to the pandemic." Though corporate buy orders may not be imminent, the preconditions are aligning.

## Big Swings in Momentum Stocks Drive Indexes, but Exceptions Nix Generalizations




Source: @bespokeinvest




Source: Reynolds Strategy, Bloomberg

The distinction, once again, is that chief financial officers have parameters that signal when to engage in buybacks. Green's words from when we visited months ago resonate in differentiating from any kind of framework the means by which passive investing maneuvers within the financial markets: "When you move away from the discretionary investor, who's thoughtful about what valuation means; if you fire them and give money to passive investments that simply assume whatever price is is the right price, you're going to change the market itself, how it behaves. You're going to change the value, the values at which markets transact. You're going to change the value of cash." A dollar is not what it appears to be depending on whose hands it drops into – an active or passive manager.

If something cannot go on forever, it will not. One can only venture that when coupled with algorithmic trading, passive investing has done much to soften the recent blows to the market of a fiscal nature. To quote Swift's *Gulliver's Travels* once more, "You have clearly proved that ignorance, idleness, and vice are the proper ingredients for qualifying a legislator." We get fresh installments of such legislating "acumen" on a daily basis in the United States. The market's violent swings are flashing danger round the bend; of what ilk, we won't be alerted until the factors converge just so, or don't.

It's likely we will never be privy to what's really taking place behind closed doors inside the Beltway. Some things can never be known, including why Swift's Stella asked that her body be laid to rest under the floor of the aisle of St. Patrick's Cathedral in London. The beginning of the tribute he wrote to her is as gorgeous as his satire was biting: "The truest, most virtuous and valuable friend that I, or perhaps any other person, was ever blessed with." Upon his passing, some 17 years later, Swift was buried by Stella's side in the cathedral, next to the love of his life to whom he was never betrothed.

***Housekeeping Note: I will be out of the country next week. The Quill and Intelligence Briefing will thus be taking a much-awaited week off.***

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