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Is Passive Investing Making Markets Dumb?

A new white paper from Acadian Asset Management examines the impact of passive investing on market efficiency.

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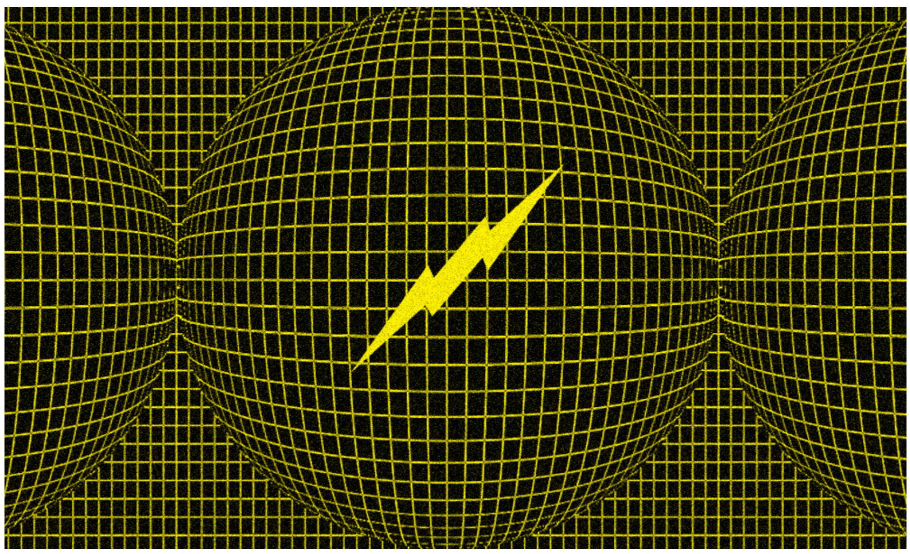
As more investors funnel assets into passive investments, markets are becoming less efficient, according to a new white paper from Acadian Asset Management.

The popularity of passive strategies has reverberated through the investment community and ultimately decreased active managers' ability to outperform when screening for certain factors of stocks like "momentum," according to the paper by Acadian, a quantitative investment firm based in Boston with more than $96 billion in assets under management at the end of June.

Investors have flooded the passive market, possibly due to mistakes active managers made with their money, according to Malcolm Baker, the director of research at Acadian. The firm analyzed North American stocks with high passive ownership, finding that as passive ownership in a stock increased, the alpha efficacy, or ability to achieve strong returns, decreased for active managers.

"Passive investing is not about price discovery," Baker said in a phone interview. "It has the possibility to harm markets. More passive ownership could make markets work less efficiently."



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When Acadian broke the stocks out into factor groups, it found that the ability of "momentum" to deliver strong returns deteriorated by 43 percent in developed markets between January 1998 and March 2018. Over the same period, "growth" saw a 10 percent deterioration in the factor's ability to produce excess returns while "quality" showed a 12 percent decline in alpha efficacy and "value" had an 11 percent drop.

"These results are consistent with a view that the rise of passive largely represents a 'dumbing down' of investment activity in a way that might exacerbate mispricings but also increase their persistence," Acadian said in the report.

Still, there are reasons to take a positive view of passive investing, according to Baker, who says the rise in popularity of exchange-traded funds and index funds may have pushed out less successful active managers. Removing their poor decision-making from the market could help make it more efficient, he said. II