EQUITIES

How Index Trading Increases Market Vulnerability

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Passively managed index funds and exchange-traded funds (ETFs) have experienced accelerating growth in recent decades. The level of passively managed assets now reaches more than half of the level of assets within actively managed mutual funds. Importantly, by 2010, trading activity of ETFs accounted for roughly one-third of all trading in the U.S.

This increased level of trading associated with passive investing comes with important consequences. More indexed equity trading corresponds to increased cross-sectional trading commonality, in turn precipitating higher return correlations among stocks. Consistent with the accelerating growth of passive trading, we discover that equity betas have not only risen but converged. In this paper, we establish that the rise in popularity of index trading contributes to higher systematic market risk.

From this the authors infer that the ability of investors to diversify risk by holding an otherwise well-diversified U.S. equity portfolio has markedly decreased in recent decades. They adds that their research demonstrates this is so because U.S. equity portfolios have become less diversified. At the same time, they add, returns for all subsets have become more correlated leaving no areas for investors to improve diversification and thus mitigate risk.

Put another way, the authors contend that investor equity portfolios are increasingly moving in lockstep with swings in the overall market. Importantly, all equity investing — indexed or otherwise — is thus a riskier prospect for investors.

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