Limited Resources
How Passive Investing Interferes with Our Free Market System

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Each country has to decide how to allocate its resources; land, labor and capital. Given these resources are limited, they are precious and need to be allocated in an efficient manner. An efficient allocation promotes maximum employment and minimal inflation. An inefficient allocation can lead to gluts and unemployment, and/or shortages and inflation. What if society wants housing but excess resources are devoted to making more blue jeans than needed? Home prices skyrocket and workers at blue jean mills get laid off. What if society needs more shoes but resources are used for making dog toys? There would be a shoe shortage but a lot of happy dogs. So, how do countries decide how to allocate their limited resources?

In China a group of “really smart people” do it. They decide what will be made and how much of it will be produced. Resources to make bicycles, automobiles, blue jeans and food are all allocated by a central committee. In the United States, we let the free markets do it and the stock market has a critical role. Here’s how. Let’s say two homebuilding companies, A & B, go public (issue stock in the primary market) at the same time. They are the same size and issue the same number of shares at $20 per share. Five years later company A has been very successful at building and selling houses. Investors realize company A’s success and its stock is trading at $40 (in the secondary market). Company B has not been successful, so its stock is trading at $10. If both companies want to go back to the primary market and issue more shares to raise capital, the secondary stock market has set the terms. Capital is relatively cheap for A, as it will receive $40 for every new share it issues in the primary market. Capital is expensive for B as it will get only $10 for every new share it issues. Thus, the stock market has set the terms for allocating our country’s limited resources.

In part because of the critical role the stock market plays in allocating our limited resources, and because an efficient allocation of resources is critical to minimize inflation and maximize employment, the stock market has been regulated over the years. It bothers some that the regulations have not taken more of a consumer (investor) protection angle. Instead, to promote efficient allocation of resources, the regulations have been designed to promote participation and stock prices that reflect all public information. For example, the Securities Act of 1933, often referred to as the act of full disclosure, attempted to make sure investors in the primary and secondary markets were getting accurate information. Why? Because in order to protect the integrity of the market, and assure that all investors have equal access to information to make an informed decision, everyone should know the same information at the same time. Basically, Congress decided that it is important that all investors know all the material facts before making an investment decision. This regulation is necessary to help investors set prices in the primary and secondary markets that will ultimately allocate our country’s limited resources in an informed and efficient manner.

Since the passing of the Securities Act of 1933 and the Securities Exchange Act of 1934, market regulation has generally been based on the belief that maximum participation promotes fair and rational pricing, and maximum participation requires full and equal access to information so important for setting terms for allocating limited resources. The rules against trading on insider information are intended to make sure that the market is not rigged or fair only to those with inside information, because it would prevent or at least discourage everyone else from participating. Lack of participation leads to inefficient pricing.
In short, equal public access to information leads to efficient markets which in turn leads to maximum participation. Maximum participation leads to fair pricing that leads to an efficient allocation of society’s resources. Diminished participation leads to mispricing and an inefficient allocation of resources.

Professional money managers and do it yourself investors do not go to the market place every day thinking, “I'm helping society today by setting prices that will ultimately allocates our limited resources.” Of course they don’t. They are just trying to maximize their returns by investing in the future, but at the same time they are providing a valuable service to society. Index funds and ETFs which attempt to mirror indexes, do not. In fact, I believe they are hurting society by contributing to an inefficient, wasteful allocation of our limited resources. When investors put money into market-capitalization weighted indexed investments, big companies' share prices are boosted, putting them at an advantage in raising more capital. Even “smart beta” ETFs that tilt toward anomalies or factors, such as momentum, interfere with our allocation of resources. Just because a company’s stock has momentum does not mean it should have its stock boosted further by inflows into momentum based ETFs, therefore giving it an advantage in raising capital.

In using the free markets to set the terms for allocating our limited resources we accept the fact that humans are humans, which means they can be wrong, jump on bandwagons, be subject to peer pressure and chase hot trends to ridiculous levels. We reason that despite these occasional deviations from rational, efficient prices, this system is still better for allocating resources than some other system such as a centralized committee. Index funds and some factor funds may magnify and exaggerate the occasional emotional-based deviations, however. For example, the Information Technology sector has been on average 17.8% of the S&P 1500 Index based on annual data back to 1995. In 2000, at the height of the tech bubble, that sector was 31.5% of the S&P 1500 Index. We believe that investors putting money into index and momentum based funds were helping red-hot, money losing, concept-hopeful technology firms get capital on very favorable terms. Fortunately, we did not have the magnitude of index funds then that we do now. If we did, in our opinion, Information Technology sector stocks would have been priced even higher and contributed to an even worse allocation of our resources.

Another example of index funds magnifying and exaggerating emotional based deviations relates to the Financials sector. When the S&P 1500 Index began in 1995, the Financials sector was 8.5% of the broad index. By 2006 it had grown to 20%, and in 2007, at the peak before the financial crisis, it was 18.7% of the index. We believe that at the peak, money flowing into index and momentum based passive funds was supporting stock prices of Financials so they could get capital on very favorable terms to underwrite and resell more and more sub-prime, bad mortgages. The proliferation of index funds and factor ETFs since the last peak sets the potential for an extremely wasteful allocation of our limited resources at the next peak.

We believe that over the long term, index funds and index-based ETFs generally do not provide superior returns to other investments and that they perform a disservice to society by aiding in a potential inefficient allocation of resources. So how can we curb the impact these index funds have on our resources? We could tax them to offset the costs of inefficient allocation of resources. Or, perhaps the size or the amount of indexed investing could be limited, either for the total market or for each mutual fund manager. After reaching a certain level, index funds could not accept new money. Or maybe, in this age of increased emphasis on transparency, passive funds should be required to provide disclosure that “investing in this vehicle could cause irreversible harm to society by contributing to increased inflation and unemployment.” Of course we are just having a little fun with these suggestions, but we do believe that, at the very least, the use of these indexed products should not be incentivized by regulators.

Many in the financial industry believe the recent ruling by the Department of Labor has the effect of promoting index investing. Perhaps the DOL wants to form a central committee like China to allocate limited resources. The move toward passive investing is threatening our free market system of allocating our limited resources. A product with lower fees may be chosen over a product with superior performance or the potential to outpace the broad market. This could lead to some firms getting improved access to capital while others find capital prohibitively expensive, potentially resulting in shortages and inflation and/or gluts and increased unemployment. Active management and research rewards and promotes innovation. Passive investing blindly sets prices. Regulations need to return to basics; promote participation in our equity markets, provide full and accurate information and let pricing in our secondary markets set terms for efficiently allocating our limited resources.
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Dr. Callahan created a valuation model that advances the investment methodology originally developed by Benjamin Graham, the “Father of Securities Analysis.” The combination of industry rotation and bottom-up valuation of securities distinguishes ICON from other investment managers. Dr. Callahan received a bachelor’s degree in psychology from The Ohio State University and a doctoral degree in business administration with emphasis in finance and statistics from Kent State University. He holds FINRA Series 7, 24, 63, and 66 registrations.

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The unmanaged Standard & Poor’s Composite 1500 (S&P 1500) Index is a broad-based capitalization-weighted index comprising 1,500 stocks of Large-cap, Mid-cap, and Small-cap U.S. companies.

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