MUNRO

Comment

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QE and index funds have deformed the stock market as predicted by Goodhart's Law.

Goodhart's Law states that when a measure becomes a target it ceases to be a good measure. It was conceived in the 1980s when monetary policy was used to try and control inflation but the relationship between the two quickly diverged contrary to expectations. Subsequent examples have proliferated; most recently during Covid when the imperative to save the NHS resulted in more deaths at home. Again, not what was intended. However, the most glaring example has been staring us in the face for the past decade but has gone unrecognized.

Passive funds have existed since the 1970s but they have really only taken off in the last decade as the drive to cut costs and reduce risks has become more widely accepted. The concept looks harmless enough. If the bulk of the returns from an asset class, known as the beta, come from the asset class itself, whether that be UK, US equites or similar, rather than from the uncertainties of trying to pick stocks that might beat the market, known as alpha, why not just ditch the attempt to seek alpha and buy beta cheaply.

Indices themselves are of course a relatively recent phenomenon. There will still be a few market practitioners around today who remember the FT 30 before it was replaced by a variety of FTSE indices in the early eighties. Old indices like the DOW and the FT30 were designed just to give participants an idea of what was going on across the market as a whole but were really just a selection of the biggest names. At least the new indices, like the S&P and the FTSE, had the merit of having some rules and math's behind them, although their composition can still be somewhat arbitrary. Nevertheless, like the indices they superseded, they were primarily designed to give a simple measure of what the market was doing overall. True, it wasn't long before the real time aspects of the indices were captured by derivatives traders to make more money and, arguably, to add more liquidity to the system. But these indices were never designed as the target for an investment product. Because they were weighted by market capitalisation, they gave the largest positions to those companies with the highest value with no consideration of any underlying fundamentals such as balance sheets, cash flows or business prospects whatsoever. They gave a measure of what was most popular rather than what was most profitable.

So as index funds started to develop to follow these indices they followed the same process. New money coming into the fund was allocated in proportion to the size of company in the index. The largest companies received the largest allocation of new money invested with no consideration to fundamental factors.

Arguably this set the scene for some misallocation of funds. But the issue was small initially. Then came the financial crisis of 2007/8 when, to avoid multiple bank failures, the Bank of England, the Federal Reserve and most other central banks turned on the taps and printed money at a rate that can only be defined as stupendous. Once the banks had been "saved" the clear aim of that policy was to reinvigorate the economy by pushing investors out into longer duration assets such as long-term bonds and equities. And it worked. Long-term interest rates fell and equity markets reached new highs.

Then the Covid crisis hit and central banks once again reached for the only tool they had; printing money. The precise amount created is hard to quantify but it is nearly a trillion pounds for the UK and about nine trillion dollars for the US.

This ocean of money had to go somewhere and clearly much has gone into equity markets. The UK market is worth £2 trillion so it has benefitted from the marginal pound invested. The same argument applies, but more so, in the US where recent volatility in the share prices of some large companies shows that there is now a very loose connection between the economic prospects of a company and its market value.

Quantative Easing, and its sister policy of Zero Interest Rates, mean that the opportunity cost of investing in growth stocks is low. Indeed, the popularity of meme stocks and green themes, like electric vehicles, has made some areas of the market more an avenue for virtue signaling than investing. More than ever growth stocks flag a company's popularity more than its profitability which further disconnects its value from its economic fundamentals. Once that link is broken the valuations can swing wildly as sentiment changes, as recent market moves have demonstrated.

The idea that investors, and intermediaries, can simply invest their assets across the asset class by allocating funds according to price is logically flawed. And the consequences of it are only just being revealed.

The danger of market capitalisation index funds is that they are disconnected from financial reality, and they echo Oscar Wilde's quote of knowing the price of everything but the value of nothing. Something that surely could not be said of Professor Charles Goodhart. Tying an investment product to a measure that was not designed for such a purpose is unlikely to end well.

And this is where Goodhart's Law shows it true brilliance. Proponents of cap weighted indices can argue that allocating money by price, leading to generous valuations for the larger "growth" companies, is just how the market works. However, the impact on those with fiduciary duties who see funds with a bias to value lagging the index, now distorted by index funds, is pressure to move money away from value funds to those with a growth bias. And that further exaggerates the effect. So now the index has indeed become the target, the index itself has become less meaningful.

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