Passive Flows and Wheelbarrows

A nightly sort of the most active US names is usually dominated by ETFs. Earlier this month, we took a peek at the most heavily traded names on one particular day. In that session, four of the top ten (by value) were ETFs. The most active individual equity security was Google, and yet it traded over 70% *less* than the S&P 500 ETF (the "SPYDERS"). The least active single-issue name in the S&P 500 that day was News Corp, which managed less than $20 million worth of volume. Meanwhile, the SPYDERS (of which NWSA is an implicit constituent) traded over $12 billion.

Folks much smarter than us are thinking deeply about this, and wondering if it is at least possible that these flows (whether purely passive or diversified-ish "systematic active" ETF flows of any type) are impacting cross correlation between individual securities, or perhaps even volatility across the entire market. It is not a foregone conclusion that this is the case – however there is also a significant chance that the tail is wagging the dog here over some time horizon.

Alphalanche?

But even if this is the case, there may be a silver lining. All of this activity, to use an extremely technical term, may or may not put security prices out of whack. If so, they won't stay out of whack forever.

As Mr. Market pushes that wheelbarrow of idiosyncratic risk up the mountain, a great deal of potential energy is building. The higher he goes (aka, the more correlated things become), the more the energy builds. Eventually, the alpha will come cascading down the mountain. We don't know when it will, but we know it will. This of course doesn't guarantee success for the stock-picker (there will be as many winners as there are losers, broadly), but increasing passive flows do not necessarily spell the end of stock-picking opportunities.

They may even spell the beginning.