

Index Investing Supports Price Discovery

Index funds have democratized access to diversified investment for millions of savers around the world who are investing for long term goals, such as retirement. However, the popularity of index funds has drawn critics who claim that index funds and exchange-traded funds (ETFs) may affect markets. Skeptics of index investing have questioned whether the proliferation of index funds may increase the correlation between asset returns, or cause stock prices to move in lockstep. Another common hypothesis is that the buying and selling of index funds may blunt the price signals of underlying securities, or diminish the value of information that could be derived from the prices of securities included in an index. Each of these concerns is not supported by the data on asset correlations or price discovery.

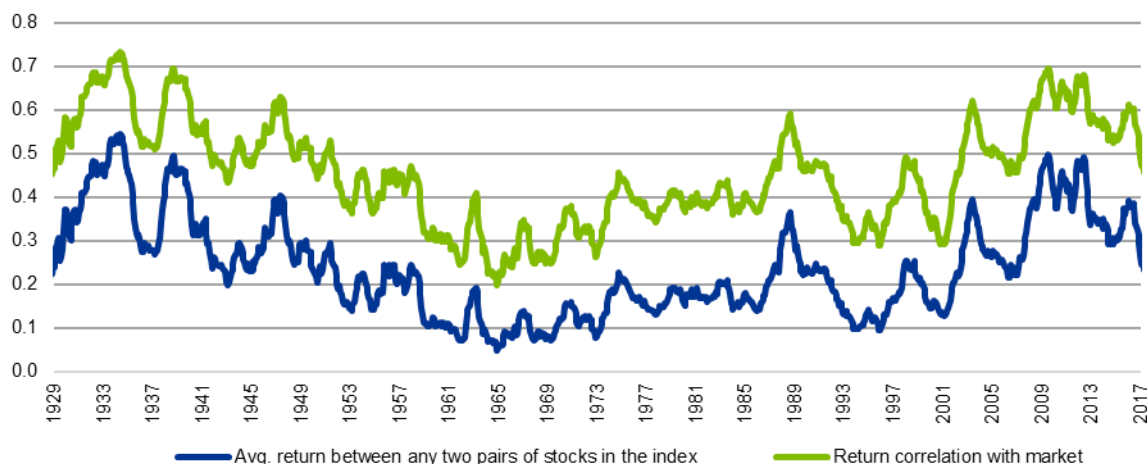
Drivers of correlation in asset prices

Correlations in asset class returns are driven primarily by factors related to the macroeconomic environment. Common factors that investors point to as drivers of asset correlations are global interest rate policies, changes in aggregate demand for assets, and the prices of raw materials.

While many people have suggested that index funds might be drivers of increased cross-stock correlations, this claim is not supported by the data. As shown in Exhibit 1, cross-stock correlations were higher in the 1930s – before the advent of index investing – than they are today. Exhibit 1 also shows a decrease in stock return correlations between 2015 and 2017, a period when index funds were achieving record growth.

Exhibit 1: Average Stock Return Correlations from 1929-2017

12-month trailing moving averages



Source: BlackRock, based on data from CRSP, Bloomberg. As of May 31, 2017.

Price signals and index investing

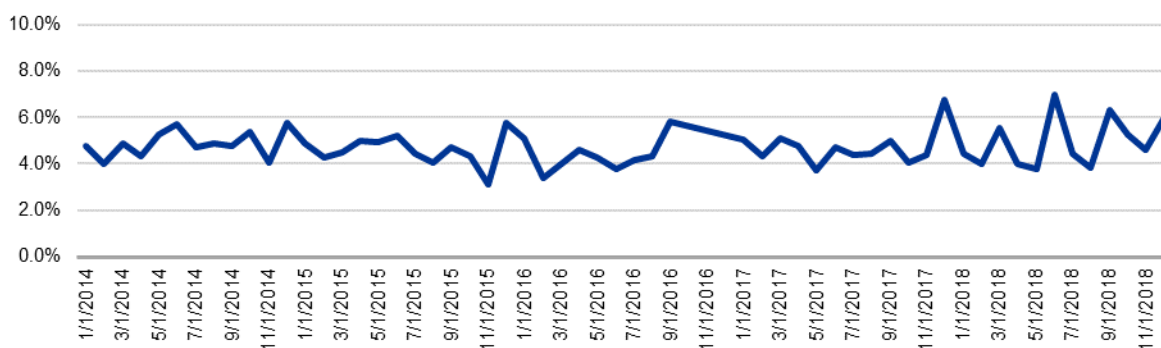
Another hypothesis is that the rise of index investing might be driving security prices away from their fundamental, or intrinsic, values. The premise of this hypothesis is that index funds might be detracting from the information that security fundamentals (like cash flows and price-to-earnings ratios) provide to the market, because the buy and sell decisions of index funds are based on benchmark index weights and not on fundamentals.

In reality, index funds add information to the market. As the number of investors utilizing index funds to express their views grows, flows into and out of these products may be good indicators of investor sentiment. For example, flows into less risky products may provide insight into how investors feel about the strength of the market. This information can be useful for portfolio construction and risk assessment.

Many investors buying emerging market equities and selling developed market equities, for example, should translate into changed valuations for these sectors, regardless of how investors are gaining this exposure. In the absence of index funds, investors could express these views through other market access vehicles – like mutual funds, single stocks and derivatives – and the change in valuation should still occur. Index funds simply offer a convenient wrapper for investors to express their views in a cost-effective and efficient manner.

This hypothesis is made more unlikely by the fact that the impact of ETF flows on the underlying stock market is still very small. In 2018, global ETFs amassed \$515 billion in inflows.¹ Despite these record inflows, the impact on underlying stock trading volume was small, totaling approximately 5% of average daily trading volumes, as shown in Exhibit 2.

Exhibit 2: Monthly ETF Imputed Flows



Source: BlackRock, Bloomberg as of December 31, 2018.

Price Discovery: Role of ETFs

Contrary to the rhetoric, index investing, particularly through ETFs, actually contributes to price discovery. The trading of ETFs on stock exchanges is an important contributor to price discovery across markets, sectors and individual stocks. International ETFs traded during US market hours contribute to price discovery every day when local markets are closed. For example, during suspensions of international stocks or markets, US-domiciled ETFs may be the primary source of pricing information available to market participants.

Additionally, ETFs have been tested in numerous stressed markets and have exhibited generally tight bid-ask spreads, heavy volumes and high liquidity under volatile market conditions. During times of market uncertainty, ETFs have acted as ‘shock absorbers’, allowing market participants to transact in the secondary market at real-time prices.

Bottom line:

There is no evidence to suggest that index investing increases asset correlations or blunts stock price signals. Index investing, and particularly ETFs, support price discovery and have demonstrated their role as ‘shock absorbers’ during market stress events.

This commentary is one of a series of Policy Spotlights on asset management topics available at www.blackrock.com/publicpolicy.

Notes

1. Source: BlackRock, Markit. As of December 31, 2018.

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