Indexation = Parasitism

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The role of financial markets is to evaluate in real time the marginal return on capital of different assets. This is done through a 'price discovery mechanism', with the 'right price' found out through a system of constant trial and error. To discover this price calls for a community of active money managers, each doing his or her due diligence before buying and selling. This price is a function of the return on capital and of the expected growth rate of this return. It has nothing at all to do with the *size* of the investment under consideration. What's more, if the price of an asset has been going down for the 'wrong' reasons, then active money managers should buy *more* of it. Over time this process will help to stabilize the system.

The price of investments should have nothing to do with their size

Active money management is essentially a 'mean reversion' strategy. That's not so for indexation. In the indexation process, there is no attempt at price discovery. The only thing that matters is the relative size of the asset: the bigger the market capitalization, the more an investor should own. This means if the price of a large asset goes up more than the market as a whole, indexers have to buy even more of it.

Thus indexation is a momentum-based strategy. Worse, it is a form of socialism, since new money is allocated not according to the expected return on capital but rather according to the current price of an asset relative to other assets. The bigger an asset, the more one should own…

Indexation is a momentum-based strategy

In a true capitalist system, the rule is the higher the price, the lower the demand. With indexation, the higher the price, the *higher* the demand. This is insane.

Where it becomes really ridiculous is in the bond markets. Over time, the government bond market of a very badly managed country (like France) will become much bigger than the bond market of a well managed country

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
Eurozone industrial production rose 0.5% YoY in May, from 1.4% in Apr	In line with expectations; IP fell –1.1% MoM; still 12.6% below 2008 peak	May bank holiday partially blamed for weakness but still signals fragile EZ economy
UK like-for-like retail sales fell –0.8% YoY in Jun, from 0.5% in May	Worse than 1% expected	Along with weak construction & IP, GDP to slow; rebalancing & raising productivity crucial
India CPI rose 7.3% YoY in Jun vs 8.3% in May; **core CPI at 7.3%** vs 7.7%	Below expected 7.7%; easing food inflation (8% in Jun vs 9.6% in May) drove headline CPI lower	Reprieve in food inflation may be short-lived if monsoon continues to disappoint
China social financing grew by RMB2tn in Jun, vs 1.4tn; implies YoY credit growth at 16.6%	Higher than expected rise of RMB 1.4tn; non-bank loan financing grew particularly fast	China is in easing mode which will support growth; but it raises concerns of rising leverage

(like Sweden). As a result, over time indexers have to buy more French bonds than Swedish bonds. The bond vigilantes of yesteryear are now condoning the very crimes they once condemned… and they have no choice about it.

Zero interest rates will only exacerbate boom-bust swings

Any economic system based on momentum must be extremely unstable, moving relentlessly from boom to bust and back again, which over time will cause a massive waste of capital. The swings will only be reinforced by zero interest rate policies, since these suppress the cost of capital against which returns on capital should be measured.

The deep thinkers on the *New York Times* bestseller list all wonder why our economies are moving ex-growth. May I offer a simple explanation?

We cannot have economic growth without a proper cost of capital, nor if capital is allocated, not according to the marginal growth rate of the return on invested capital, but according to the market capitalization of the existing capital stock. What matters is the expected changes in the ROIC and *not* the current value which the market puts on that return.

Indexers are parasites

Indexation could work if it remained a satellite strategy, with say 10% of the money being managed through indexation, the rest being managed by active money managers. As such, it would be a parasitic strategy. Indexers would benefit from the price discovery work done by others without paying the costs associated with the process.

But a system where everybody wants to be a freeloader cannot work. The real problem here is that investment 'consultants' (read failed money managers) have defined risk as a deviation from the index against which the money manager is benchmarked. This is idiotic. It forces even mean reversion managers to become closet indexers.

Let me be clear: in a properly managed capitalist economy there should only be three returns—in real terms—to worry about:

1) 1%—if one buys 3 month T-bills and does not want to take a duration risk
2) 3%—if one buys long government bonds and is willing to take a duration risk
3) 6%—if one buys shares and accepts the risk one may not get all of one's money back

There is only one benchmark equity managers should follow

Over the long term, equity managers should be measured against the 6% real target. All other benchmarks will lead to the misallocation of capital and create a deeply unstable financial system together with a much lower growth rate and higher unemployment.

In effect, by pursuing indexation we have introduced a socialist way of allocating capital in the heart of the capitalist system. As we all know, socialism is the ultimate form of freeloading. It has never worked, and it never will. This indexation is one of the most obvious forms of parasitism I have ever encountered.