Strategist's Corner
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Indexing Dilutes Capitalism

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In brief

- While capitalism has its downsides, no system allocates resources better.
- The result is a complex and adaptive economy.
- But indexation has amplified the disconnect between valuations and fundamentals.

While every economic system has its drawbacks, capitalism, since its inception several hundred years ago, has outperformed the alternatives. While many have been left behind at various points in time, capitalism has demonstrated its merit in allocating society's resources better than the decisions of a collective few.

But capitalism's edge in efficiency doesn't come without costs. One of its downsides is the unpredictable nature of business cycles. It seems to me that before the first quarter ends each year, most economic and financial market forecasts produced at the end of the prior year end up in the recycling bin as forecasters react to new and differing circumstances.

While this is one of the prices paid for living in a market-based system for allocating resources, why does it happen? And more importantly, what can we learn from it and why is it relevant?

A complex and adaptive system

While predicting rational decisions is possible, it's the unexpected or surprising decisions of some and the subsequent effects on the many that typically upend economic and financial market predictions.

Capitalism requires unsuppressed price signals for resources to be allocated efficiently. Those signals help create equilibrium between natural market forces, specifically supply and demand, for everything from the price of gum to the price of automobiles, to borrowing costs, to stock and bond prices. Society, from consumers, to business owners, to investors, is constantly altering its behavior based on changes in prices.

Economists would call this a complex and adaptive system. It's complex because hundreds of millions of people make dozens of choices a day. It's adaptive because changes in prices lead to changes in behavior. More interestingly, given humans have emotions and subconscious biases, sometimes our choices are made simply based upon the behavior of others, influencing what may have otherwise been a rational decision. The combination of capitalism's complexity and adaptiveness often leads to radical and surprising outcomes.

Relevance for today

The policy response by global policymakers to the global financial crisis in 2008 was to reduce interest rates and inject capital into financial institutions. Rates were suppressed to historically unnatural levels for over a decade as money velocity fell and deflation risks mounted. None of this is new to you.

However, it's important to remember that interest rates represent the price of time and the cost of capital. Rates are the first hurdle that must be cleared in every capital allocation decision. Yet their price was not a function of natural supply and demand.

Years of interest rate disequilibrium blunted capitalism's price discovery process. But while we've yet to realize overdue corrections in the economy and financial markets, that doesn't mean we won't.

The socialization of capital losses in the post-GFC period beautifully paved the pathway for the massive growth of indexation. Investors are willing to pay a fee for the prospect of active managers limiting their downside but they see no reason to do so when central bankers do the job for them.

That probably reads like a whiny, biased perspective from an active manager who's lost share to passive vehicles. Fair enough. However, with passive vehicles today representing over half of investable assets and the bulk of incremental investment capital, inefficiencies continue to grow.

When unencumbered by suppressed interest rates, financial markets push money toward enterprises with the highest risk-adjusted return on capital prospects and pull it from the weakest. This is Wall Street's version of natural selection, and it's capitalism at work.

But that isn't what's happening today. A lot of capital is being allocated based on market cap rather than on which opportunities may offer the best risk-adjusted returns. Indexing is momentum investing, accelerating the accrued financial market and economic inefficiencies leftover from the 2010s and pandemic-led stimulus.

Yes, some of the largest index constituents are high-returning businesses. But that doesn't mean they aren't wildly overvalued due to the new plumbing of finance and the growing disconnect between price and fundamentals. Perhaps more importantly, many of the companies attracting the most capital may face a significant risk of obsolescence from artificial intelligence.

Conclusion

Our capitalist system has proven the most efficient means of resource distribution. However, it requires untrammeled market forces to deliver correct price signals. When those signals are distorted, it creates problems.

Humans sometimes make irrational decisions, and as business cycles age, people tend to make more of them as they seek to get rich quick. It's important to consider that factor when managing other peoples' wealth.

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