HORIZON RESEARCH GROUP

The Hidden Assumptions of Indexation

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THE HIDDEN ASSUMPTIONS OF INDEXATION

In principle, the theory behind indexation is very much like the theory of perfect competition. In perfect competition, the idea is that no participant is sufficiently powerful or sufficiently large to influence the price of the product. The product is assumed to be homogeneous, and shares are designed to be homogeneous. In the theory of market efficiency, no one has an information advantage over anyone else, and there is always enough liquidity. It seems reasonable to make those assumptions. Yet, it is worth making some observations about them.

The participants actually engage in trend-like imitative behavior. For example, in the gold market, many people bought gold not because of the fundamentals of gold such as they are, but merely because the various asset allocators wanted to have a hedge against the possibility of inflation. Simultaneously, they bought long term bonds as a hedge against deflation, and long term bonds and gold actually did well together.

The fact that asset allocators were willing to do that changed reality by changing the equity cost of capital for the various gold producers. Inclusion of the gold companies in indexes caused a rise in the gold companies' share prices and allowed them to be issuers of equity. The cost of capital for financing projects was relatively low and, therefore, projects were financed. I might even say that to the degree that people were investing in gold projects indirectly via the exchange-traded funds, that in and of itself had an influence on the price of gold.

The participants were not making asset allocation decisions based on price, value, and internal rate of return considerations. They were merely hedging for different outcomes. More importantly, they were willing to accept uneconomic results—even losses—as the cost of diversification. To make an investment meant to guard against the possibility of inflation, even if it loses money, is considered a prudent activity, because it is the portfolio that is analyzed, not the individual investments that comprise the portfolio.

The index—or, alternatively, the exchange traded fund, if one wishes to take the more narrow view—is the meeting place between the buyers of investment possibilities in the hedging sense and sellers who are making economic internal rate of return decisions, as in the case of gold projects because, for every buyer, there is a seller.

The interface of those two groups is an instance of asymmetrical information, which is the very opposite of the desired perfect competition or the efficient market. One has informed sellers of assets and securities meeting those who choose to be uninformed, or are unconcerned with information, because they have a completely different objective. They will say the price at which the securities are being offered is intrinsically fair, because everything that could possibly be known is, in fact, known.

This situation does not exist only in gold. We have seen it in the case of other assets as well. For instance, there are informed sellers of debt instruments and uninformed buyers who are financing pipeline assets and refineries as well as non-pipeline, non-refinery master limited partnerships. We have many examples of companies that use stock to pay expenses simply because their stock trades at an egregious, astronomical valuation. Examples include Amazon.com, Workday, and SalesForce.com. If those shares did not trade at astronomical valuations, it is arguable that the reality would be very different for those companies.

Various professional participants in the public securities domain are discovering the existence of a guaranteed bid that is assumed to be fair within the indexation process for all types of assets, and they are taking advantage of it. A variation on Gresham's Law is at work in the process of indexation.[1] Those companies that take greatest advantage of the low cost of capital ultimately will have the greatest supply of securities issuance and they will have the largest weight in the index. This process might take a quarter of a century to play itself out, and we are only in the initial stages.

[1] Gresham's Law is an economic principle that is commonly stated as: "Bad money drives out good." If a government overvalues one type of money and undervalues another, the undervalued money will disappear from circulation into hoards or leave the country, while the overvalued money will flood into circulation.