Passive Investing and the Rise of Mega-Firms

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Overview

- Why I liked this paper:
  - Topic right up my alley.
  - Interesting new mechanism that combines investor/size/multidimensional shocks.
  - *Lots* of results.
- Where I struggled:
  - Placement in the literature.
- What's coming:
  - Overview of mechanism/results.
  - Shameless plug.
  - Context

Simple Version

- Suppose there are two firms in the index, A and B.
- $\eta_A = \epsilon$, $\eta_B = 1 - \epsilon$ where $\epsilon \approx 0$.
- Dividend process, utility, information, etc same.

Mechanism: Increase in non-experts (entry)

1. Reduction in idiosyncratic and systematic supply $\Rightarrow P_A \uparrow$, $P_B \uparrow$.
   - D^i_{At} not priced, because A is small. b_A assumed to be big.
   - Price increases because PV of systemic component increases.
   - D^i_{Bt} is priced, because B is large. b_B assumed to be small.
   - Price increases because of both (less from systematic, more from idiosyncratic).
2. Reduction in idiosyncratic and systematic supply $\Rightarrow$ increased vol $\Rightarrow P_A \downarrow$, $P_B \downarrow$.
   - Lower idiosyncratic and systematic supply.
   - Dividend shocks have quadratic vol, so both scale.
   - Higher vol means lowered expert demand, price increase attenuates (less for idiosyncratic).
   - Larger attenuation for A, as priced risk is systematic and they're high b.

Additional Results

- Passive flows raise stock return volatility (especially for large firms)

- Passive flows matter most for overvalued firms.

- Passive flows drive up aggregate market.

Asset Pricing Implications of Passive Investing

- Price Informativeness: Disagreement

  Bond and Garcia (2017), Malkov (2019) Sammon (2023), Kacperczyk et al (2023)

  Kacperczyk et al (2021), Buss and Sundaresan (2023), Lee (2022)

- Price / Return Levels: Increases

- Price / Return Volatility: Increases

- Cross-sectional implications less well understood!

Alternative Hypothesis: Buss and Sundaresan (2023)

- Passive investors reduce cost of capital and increase stock price.
- Firms use passive investors' presence to increase investment.
- Increased investment raises stock returns and volatility.
- Increased volatility attracts active attention.
- Increased attention increases prices (lower risk premium) and price informativeness.

Key assumption: cross-sectional variation in passive investment within an index.

Empirical variation within index

Abid (2020)

- Passive investment increases significantly with size (10.1% to 30% in S&P 500)
- Passive investment not restricted to firms in any one index. (8% for S&P 500-600).
- Which predictions are unique to the setting?
  - Price level, vol, index level, vol *could* be cross-sectional variation in passive levels.
  - Over/undervaluation results are unique to this setting!
  - Cross-sectional implications are testable once passive investment is controlled for.

State of Play

- Excellent paper with a novel mechanism and lots of interesting results.
- Large literature on passive investing that covers a little of the same ground.
- New results on the impact of noise traders on passive effects!
- Highly recommend reading and look forward to the next iteration.