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The impact of passive flows and the role of active management

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- **Impact of passive management**
  Passive management, which now accounts for more than half of assets under management, fundamentally changes the structure of financial markets, increasing systemic risk due to the lack of arbitrage.

- **The paradox of passive investing**
  While rational and cost effective for individual investors, the widespread adoption of passive management weakens the overall system, amplifying the inelasticity of markets.

- **The role of investors in the conversation**
  In a context of extreme risk concentration, where the marginal investor delegates his or her view to that of others, the importance of active investor engagement becomes crucial.

- **Active diversification opportunities**
  An active approach to diversification, putting risk at the center of the allocation, can be decisive for navigating an environment where the dominance of passive flows can lead to prolonged rotations.

Nearly fifty years ago John ‘Jack’ Bogle, founder of the Vanguard Group, transformed investing with the launch of the first index funds in 1975. This innovation, arguably the most significant in finance in recent decades, has profoundly changed the way investors approach markets. Shortly before his death in 2019, Bogle warned of governance risks associated with an oversized market share of index funds. At the time, passive strategies accounted for 40% of assets under management. According to a recent Bank of America report, this proportion reached 54% in 2024.

Recent years have seen numerous studies, often contradicting classical theory, exploring the links between flows and asset prices. The dynamics of today's markets are now inextricably linked to a marginal flow that invests passively, agnostic to fundamentals or risk, with market capitalization as the sole reference. Understanding the structural implications of this dominance is key for every investor.

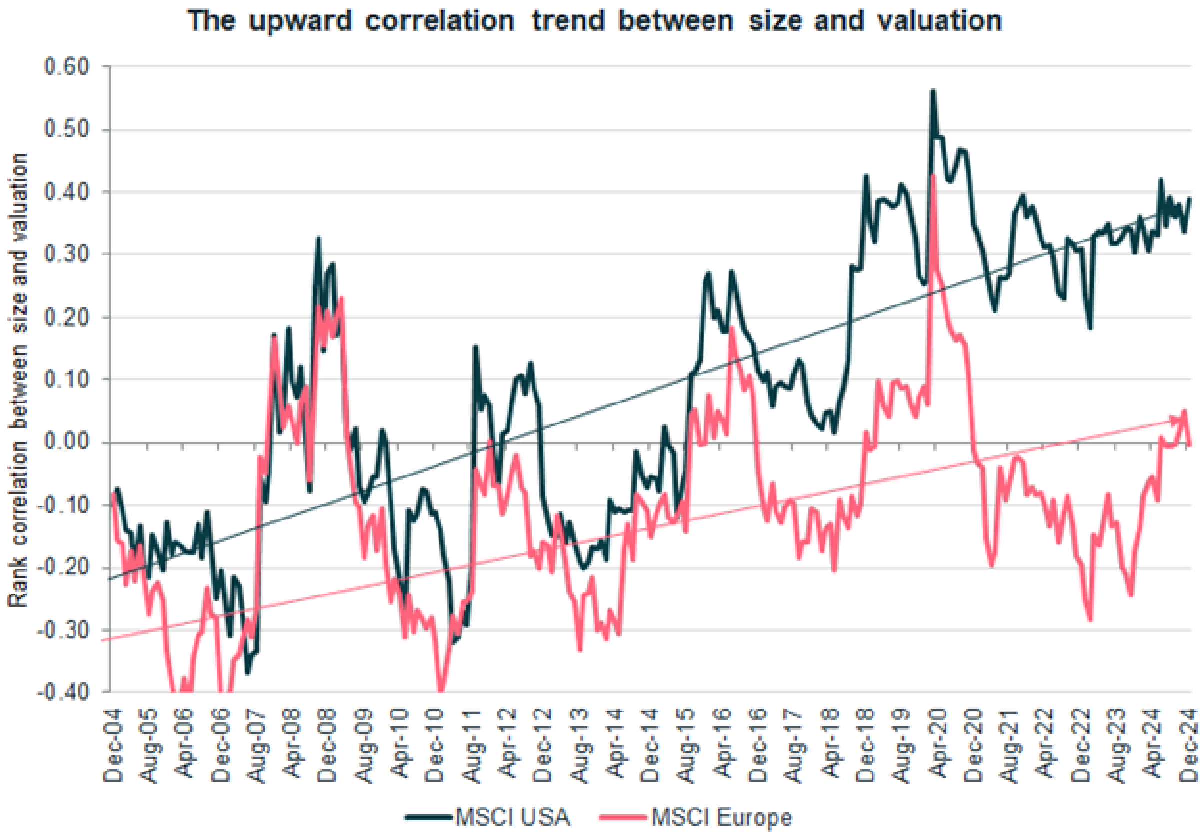
The paradox of passive investing

For investors, the shift from active to passive management is driven by various factors: relative risk aversion, lower fees, and a belief in market efficiency. Bogle's genius lay in his understanding that financial markets are a zero-sum game, where the difference between the market and active management equates to total fees. In other words, active management as a whole can only underperform. Thus, creating funds that replicate indices with increasingly reduced costs proves to be a flawless strategy. Vanguard has grown from managing $2 billion in 1975 to $10 trillion in 2024.

But markets are collective systems. When liquid, the price of a stock results from the balance between supply and demand. Indices are deemed efficient when they embody this aggregated judgement of all investors. Initially, passive investment means relying on the implicit views of *other* investors. The astute reader will have anticipated the question: What happens if a growing number of market participants adopt the same approach? What happens when the majority of market views mirror a consensus view, regardless of fundamentals or risk? In other words, what happens when we all become, often inadvertently, free riders?

This is the central paradox of asset management today. On one hand, the rational and individual decision to expose oneself passively and at low cost to the market. On the other hand, a global system weakened by the lack of arbitrage. Many academic researchers and investors have been studying the impact of flows on market structure for some years. Economists Xavier Gabaix and Ralph Koijen, affiliated with Harvard and Chicago universities respectively, published their 2021 Inelastic Market Hypothesis[1], already considered one of the most disruptive works in financial economics. Their conclusion? Today, one dollar invested raises market valuation fivefold. In other words, even as prices rise, aggregate demand does not necessarily weaken. More recent studies go even further: contrary to what one would assume, these impacts increase with the size of the stocks in an index. Concretely, the bigger a company, the less active management is capable of rebalancing the price distortion that results from the dominant passive flow[2]. The valuation distortions observed over several years are a direct consequence. (Fig.1).

[1] Gabaix, Xavier and Koijen, Ralph S. J., In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis, http://dx.doi.org/10.2139/ssrn.3686935
[2] See for example Haddad, Valentin and Huebner, Paul and Loualiche, Erik, How Competitive is the Stock Market? Theory, Evidence from Portfolios, and Implications for the Rise of Passive Investing, http://dx.doi.org/10.2139/ssrn.3821263

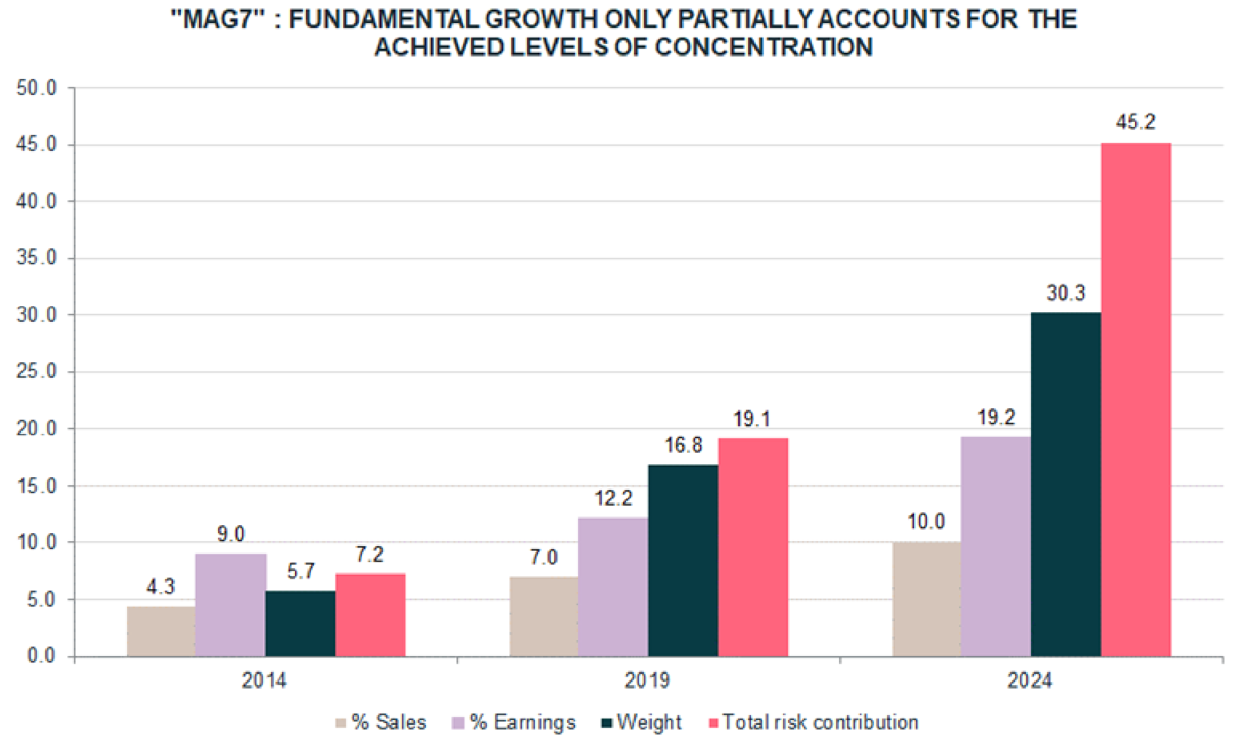


Sources: Ostrum AM, FactSet, Bloomberg, MSCI

Figure 1 - By ranking European and US stocks according to their valuations and size, a rising trend of correlations between the two rankings is observed, particularly in the United States. The link between a company's high price and its market capitalization is increasingly evident

We must take a moment to appreciate the magnitude, and also the irony, of these results. We are worlds apart from the Efficient Markets Hypothesis, which posits that market prices reflect all the information available, and according to which the impact of flows can only be marginal. This hypothesis underlies Bogle's genius and the very utility of passive investing.

Suddenly, all questions about the atypical recent behavior of equity markets converge: concentration, weak arbitrage forces, the impact of share buybacks, large-cap domination, overvaluation. In a world in which active management weakens, where passive management relies entirely on imposed capitalization weights, demand elasticity relative to price dissolves as well. The marginal buyer continues to purchase at any price. The lack of relative risk taking by the majority of investors leads to an increase in systemic risk (Fig.2).



Sources: Ostrum AM, FactSet, MSCI

Figure 2 - The weight of the top seven capitalizations in the US accounted for about a third of the major indices at the end of 2024, the largest concentration since at least 1900, according to a recent Bridgewater report. Crucially, while the share of sales and profits of these seven largest tech companies has doubled in the in the last decade, their total contribution to the risk of the MSCI USA index has been multiplied by 7. Today, they represent almost half of the total risk.

A few weeks before the tariff escalation, I was listening to an interview with Howard Marks, co-founder of Oaktree Capital Management. Marks, unanimously recognized in the United States as one of the greatest investors of the past forty years, shared his thoughts with two journalists. Although his reputation is primarily based on credit and distressed asset markets, he attempted to compare the current environment to major exuberance phases he experienced, such as the early 70s, late 90s, and 2006-2007. To the classic question "Are we in the midst of a new bubble?", Marks replied that quantifiable indicators were largely present, though he was more nuanced about psychological and cultural markers.

Despite this impression of uncertainty, Marks wished to highlight two immutable principles that he believes are essential to an investor. First, the importance of analyzing the present. Due to our inability to predict the future, Marks argued that our best weapon as investors is the continual assessment we must make of the current state.

Second, he emphasized our role as investors. This question, rarely central to the debate, is nevertheless crucial in the modern market ecosystem. Marks paraphrased Buffett: ‘The role of an investor is to remain cautious when others are not.’ Essentially, he stressed the need to reposition active management back at the heart of our profession.

This perspective is the greatest contrast that can be given to the increasingly notable distortions within markets today. The choice to construct one's allocation largely passively overlooks this central role each investor must bear and contributes to reinforcing an increasingly fragile balance.

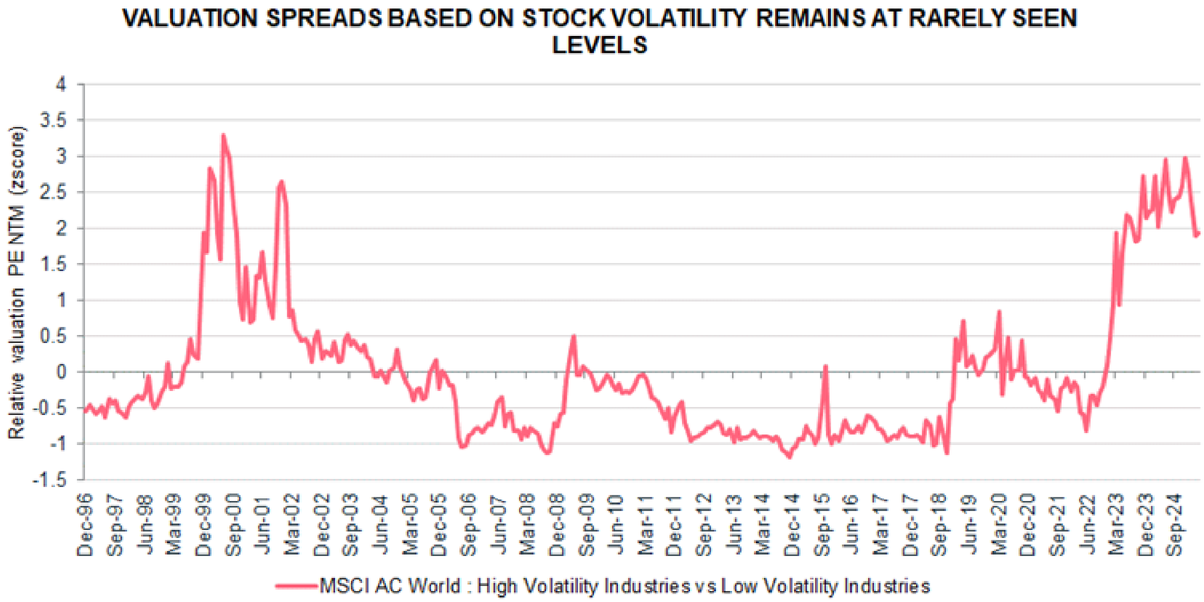
Beyond delegating one's view to that of consensus, the nature of global indices today makes passive allocation a bet on continued risk concentration beyond already record levels.

The importance of risk-based choices

If I were to emphasize one message, it would be: diversification deserves active consideration. It is unwise to anticipate the peak in market concentration, but a slowdown in passive allocations[3] or a relaxation of index constraints by major investors could lead to abrupt and prolonged rotations, impacting the vast majority of investors. As in any collective system, balance depends on individual choices.

The question that arises is not that of a binary active/passive arbitrage, but that of the importance for each investor to assert their own views to ensure global resilience. In this regard, we have been highlighting for just over a year that the opportunities in the current environment are no longer directional but relative[4]. We stress that despite high *absolute* valuations, several *relative* valuations between different equity market segments are historically attractive.

We have always favored a risk-based approach to markets. It is an approach that allows us to be more reactive and circumvent most biases inherent in estimating future performance. We are convinced that this approach is all the more relevant today in a context where the dominance of passive flows results in dislocations that urgently need to be identified.



Sources: Ostrum AM, FactSet, MSCI. April 2025

Figure 3 - Valuation spreads between more speculative and less volatile ones reached historical records in 2024. Despite the sharp rotations observed since the start of the year, low volatility stocks continue to offer significant diversification and relative risk/return potential.

By the end of April, for a year now, all of our strategies aimed at minimizing equity market volatility have outperformed their indices. This outperformance has intensified this year with uncertainty rising sharply, outflows from the United States and tariff chaos. As always during periods of stress, the adjustment dynamics initially fit the response to the new economic context. But the scale of

[3] With US pension funds and scheduled allocations accounting for a significant proportion of passive flows, changes in regulation or the shrinking labour force associated with an ageing population may be a catalyst.
[4] Diversification, the blind spot in equity markets

this response is also a function of investors' initial positioning. Understanding this positioning and the impacts of the flows that preceded it is a key factor today (the present observation Marks spoke of). Despite the recent modest correction, we notably observe that valuation gaps favoring more speculative segments remain at record levels (Fig.3), and several less risky and more decoupled sectors collectively show historically low relative levels. In this sense, the return of volatility must be integrated into a context of normalizing excesses built over recent years, and the continuation of this normalization should serve as a basis for continued outperformance.

I cannot recall where I first heard this expression, but I can't find a better way to conclude: ‘Risk does not disappear; it transforms.’ The rise of passive investing is indisputable, and the economic arguments underpinning it cannot be contested. However, an investor must not confuse the logic behind choosing to invest passively with a risk free or impact free alternative. On the contrary, given its size today and its construction anchored on company capitalization and past momentum, the implicit cost of passive growth today is multifaceted, disrupting market balance and elasticity far beyond what its name might suggest. Through this note, I wished to highlight this contrast, which in my view deserves ongoing discussion: how to balance the economic benefits of passivity with the responsibility of individual action? This reality invites us to reconsider the importance of active management and the continuous analysis of diversification and risk.

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