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Five Misimpressions Drive Baseless Warnings for Mutual Fund Industry

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(*As published in* InvestmentNews, *September 23, 2019*)

The mutual fund industry has supposedly reached a significant tipping point: assets in US index mutual funds and exchange-traded funds have surpassed those in US actively managed funds, according to preliminary data from Morningstar.

The Investment Company Institute's more comprehensive data—covering 98% of fund industry assets—don't support that claim. Based on fund flows, we project that domestic equity index funds won't pass their actively managed counterparts until sometime next year.

But what matters isn't the exact timing of this "milestone"—it's the fearmongering that has already begun about its supposed implications. Some commentators already have warned of increasing chances of stock market bubbles, hair-raising episodes of market volatility, and poor corporate governance.

Five misimpressions are driving these baseless warnings.

First is the idea that stock prices could become unhinged from fundamentals because index mutual funds and ETFs own so much of the US stock market. Yet ICI data show that when US index fund assets surpass those in US actively managed funds, index funds will hold only about 17 percent—$1 in every $6—of the US stock market.

The second misconception is that prices of stocks in indexes are driven primarily by dollars flowing to index funds: when more index fund dollars chase a fixed number of stocks, prices of stocks in the index rise (and vice versa). Although dollar flows can affect stock prices, the primary factor moving prices is new information.

Markets respond instantaneously to news about politics, monetary policy, inflation, GDP, employment, and more. Recent headlines —"Dow Notches Best Day in Three Weeks on Rising Trade Optimism" or "Stocks Close Flat as Fed Fails to Clearly Signal More Rate Cuts in 2019"—demonstrate this.

Third, some commentators assert that today's stock prices constitute a "bubble"—and the rise of index funds is to blame. These critics confuse correlation with causation. Yes, the substantial rise of index mutual fund and ETF assets in the past 10 years coincides with one of the longest bull markets in history.

But the bull market is supported not by fund flows but by fundamentals: the rebound in economic growth following the 2008 financial crisis, the accompanying reduction in household leverage, a stronger banking system, solid corporate profits, falling oil prices, low interest rates, plentiful liquidity, and subdued inflation. Those strengths undercut both the "bubble" idea and the notion that index investing is inflating prices.

Other commentators also incorrectly theorize that the rise in index mutual fund and ETF assets has made markets increasingly volatile. Yet even as index fund assets grew by 235%, stock market volatility remained low from 2012 to early 2018.

Volatility spiked in February 2018, receded, spiked again last December, and again fell. These spikes reflected fundamentals: heightened uncertainty about the possibility of a global trade war and the risk that tighter monetary policy could slow the economy.

The fourth misimpression assumes that index mutual fund and ETF shareholders are "passive investors." In fact, institutional investors trade ETFs actively, often intraday. Individual investors make active decisions to spread their assets across a mix of fund types and to periodically rebalance their holdings. Retail investors also actively manage their assets by diversifying across a mix of index products and actively managed mutual funds.

That diversification ensures that these doomsday predictions—if they did have any backing—would be self-correcting. In a world of mispriced securities and excessive market volatility, actively managed funds would find great opportunities to boost their returns, investors' dollars would follow, and arbitrage would help drive prices toward fundamental values.

Finally, some particularly fatalistic commentators look beyond financial markets and argue that index-based investing is bad for the whole economy because index funds' managers allegedly have too much influence over companies in their portfolios. But this claim is based on unsupported assumptions about asset management.

Critics overlook the fact that fund managers advise thousands of different clients, including index funds and many other investors. The managers are fiduciaries on behalf of these diverse clients, not asset owners.

And clients have different investment objectives, belying critics' assumption that all of a manager's clients take a single, uniform economic "view" of a stock or industry.

Mutual funds and ETFs—active and index—help 100 million US shareholders save for retirement and other goals and provide critical, stable capital for our financial markets. That's true regardless of whether the mutual fund industry has reached a "tipping point."

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