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'Without fear and without favour'

Letters

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Insights both professionals and public failed to grasp

Sir, In the anniversary week of Black Monday 1987, John Authers' review of the risks associated with the latest investing fad is as timely as it is relevant ("How passive investors morphed into the bad guys", The Long View, October 14). Aside from the sheer size of passively managed funds, his point about their being hostage to momentum is key. This is due to the degree to which this was also the case with the two bubbles and busts since that date. It is as surprising as it is disconcerting that neither the investing public nor professional fund managers have grasped this.

The model for markets driven by specious assumptions to become distorted has been out there since shortly before the 1987 stock market crash. That was the year George Soros published *The Alchemy of Finance*, clearly presenting the concept and relevant examples of market "reflexivity". In general, that is the psychological function whereby a well-founded fundamental basis for a rallying stock market extends to a bullish bias on some specious further logic that is broadly accepted.

The current extended US bull market since the major 2008-09 sell-off allows for the retail investor to feel comfortable with "cheaper" passive investment. Yet prior to each of the previous busts there were also good reasons to "love the bubble". And the subsequent bust was exacerbated by the retail investors' reversal of previous confidence. That was the case for the origination of portfolio insurance back in the 1980s. Retail investors enticed into selling "naked put" options (along with the misguided notion of "dynamic hedging") allowed portfolio managers to pay excessive levels for stocks.

It was the same for the "new economy" of the dotcom bubble, where a large portion of initial public offering proceeds were spent on advertising and shipping with not much chance of commercial returns. It was especially the case for the US housing bubble, where the successful use of subprime mortgages on a small scale morphed into an unsustainable "blended" mortgage-backed securities behemoth that failed once the mortgages went sour.

The last of them demonstrated again that there has to be a trigger for the failure of elevated equities valuations. While there are plenty of culprits out there, admittedly there is no way to pinpoint the timing of the reversal. Yet the Trump administration's actions on trading arrangements, and especially the potential for its tax reform to fail as badly as previous healthcare reform attempts, need to be watched closely.

Alan Rohrbach
President,
Rohr International,
Chicago, IL, US

Many thanks to the Financial Times' John Authers for his excellent Long View in FTWeekend October 14-15, 2017 on risks developing due to various aspects of passive investing's popularity. His column is available at http://on.ft.com/2yFbcv8. Our letter is hyperlinked to its FT.com page.

Our appreciation also to the FT Letters Editor for feeling this perspective is useful for its readers.