RIA Advice

The Active Vs. Passive Conflict: Why All Dips Are Bought

> *"At this time 85 years ago, Yale economist Irving Fisher was jubilant. 'Stock prices have reached what looks like a permanently high plateau,' he* rejoiced*in the pages of The New York Times. That dry pronunciation would go on to be one of his most frequently quoted predictions -- but only because history would record his declaration as one of the wrongest market readings of all time."?*-Time Magazine, "The Worst Stock Tip In History"

In Jim "El Capitan" Cramer's opening missive today he analytically addresses the active vs. passive conflict, which helps explain the market's steady bullish action. As Jim writes:

> *"Theanswer is that there are two kinds of sellers in this market: hedge fund sellers, who react off of research, and portfolio shufflers, who buy and sell ETFs and index funds. The former jump on anything, right or wrong, as long as it is actionable. Sure, if*

*PepsiCo (PEP) has an organic growth shortfall, as we said could happen in our Action Alerts PLUS bulletins last week about PEP, it could get hammered. That's a change in the margin of a bad group. But most of the? 'valuation' calls analysts make, shy of catalysts, only produce hedge fund jumps.The latter, the index funds and ETF traders, rarely jump although they may press down harder on a bedraggled ETF, like one that includes the consumer products group.**But there are two kinds of buyers. The opportunistic buyers and the index buyers. The opportunists think that the downgrades are noise and give them a chance to buy high quality stocks with the money that comes in over the transom.The index and ETF buyers? Well, they just buy.**The dichotomy explains a lot of the bullish action, and isn't talked about enough. You see the sellers off those research calls? They were either shorts, or people who hadn't done their homework, because nothing really happened to justify their actions. But the buyers?They lurk and wait and pounce."*

I am in basic agreement with Jim but would differ a bit in my interpretation of why dips are bought and how sustainable that buying is. **ETFs and index funds, when faced with a constant and large inflow of funds, are always rebalancing and buying, which is why all dips are purchased.** But sizable net inflows may not be seen over time as a constant state, because at some point there will be outflows and that steady dip buying and demand for stocks could disappear almost immediately. To be sure, attempts to give reasons why investor sentiment, now buoyant *(see the latest?CNN Fear & Greed Index),* may erode have fallen on deaf ears this year. But ebbs and flows are a more natural condition of the markets, and as sure as night follows day, the outflows at some point will return. **And if ETFs sell, who will be left to buy?Second, another source of dip buying, as mentioned below *(and not covered by Jimmy)*, are the quant funds that are influenced by a conditioning in the algorithms to buy weakness.** That buying has nothing to do with fundamentals, as machines are agnostic to the value -- or lack of value -- inherent in the income statement, balance sheets and replacement values of the constituent stocks. And, of course, traders who worship at the altar of price momentum are now following the dip buying of quant funds. **Third, money is coming out of active managers in favor of passive investing** *(i.e., ETFs and quants).* Many high-profile and successful managers have closed. Hedge funds -- the catalyst for fundamental-based selling that Jim describes -- no longer hold the sort of influence that they have in the past.

The Virtuous Circle

The dominance and impact of these three constituents -- **inflows into ETFs, an expansion in quants' influence and the contraction taking place in hedge funds -- explain a lot about the dip buying that has existed over the last year and the current virtuous circle of demand versus supply.** I recently added up some other reasons for the dip buying. From my perch, stocks continue to be buoyed by some of the following conditions:

** Massive injections of liquidity from the world's central bankers* Passive investing (quants and ETFs) are now dominating markets (at nearly 40%) at the margin* Machines and algorithms, as well as many individual investors, are behaving differently as they are now programmed and conditioned to buy the dips* 17% of the listed shares outstanding have been retired in corporate stock repurchases since the Generational Low in March, 2009.* More than half of the listed companies on the exchanges have disappeared over the last eight years* **We have a Bull Market in Complacency**--Kass Diary, "A Bull Market in Complacency"*