**Market Structure Map - False Passive**

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Karen and I are in Boston seeing friends at the NIRI chapter ?(we sponsor) and our trip today like last week coincides with snow in Denver. Next winter if the slopes turn bare, we?ll schedule a couple flights to bring in the blizzards.

Last week trooping through Chicago where you had to lean to stay upright in the wind, an investor-relations officer told me, ?Passive money can?t be setting prices because it?s, well, passive. It can only follow active money.?

Sometimes I?m so close to the trees of market structure that I forget about the forest everyone else is seeing. Statisticians warn about false positives, false correlations, false precision. The descriptor ?passive? for investment behavior following models inaccurately portrays what the money is doing. We call it ?Asset Allocation? behavior.

To understand this money let?s first review how the stock market works:

-*It?s a data network* comprised of visible nodes called exchanges and invisible ones called formally alternative trading systems and colloquially ?dark pools,? stores for stocks where you must be a member to buy. Exchanges are required to serve all customers, who must either be a broker or use one.

-*All markets share customers and prices*. You cannot continue to serve a customer in one market including a dark pool at a price worse than what?s available elsewhere. Thus, trades must match between the network-wide best price called the NBBO ? national best bid/offer (best price to buy or sell).

-*Orders wanting to price the market* must be automated so they can rapidly move from one node to the next, or the data network can?t function.

-Because of this structure, *exchanges offer trading incentives* called ?rebates? to more frequently have the best price on the network. They pay high-speed traders about $0.29/100 shares to bring orders to their markets and set prices.

-The NYSE, the Nasdaq and BATS Global Markets *operate multiple exchanges*, rather than one that would aggregate buying and selling, so as to increase the amount of time each group has the best price, which means fast traders create many prices. By our measures, fast traders are eight times as likely to set prices, but with just 100 shares.

-*Exchanges want to set prices* because any broker or market center handling customer orders must give customers the best prices so all are required to buy expensive pricing data, which is how exchanges make money.

Now you understand the stock market. Onto this network come seas of money from Blackrock and Vanguard and a raft of exchange-traded funds. For two decades investors have been choosing passive investment in accelerating fashion. It?s how Blackrock and Vanguard are the world?s biggest investors ($8 trillion of assets) and ETFs host $3 trillion while turning holdings at 2,500% (making buy-and-hold a parody).

Passive money is governed by the model it tracks, the prospectus describing the fund, and inflows and outflows. Tack on the explosive popularity in recent years of ?smart beta? money tracking mathematical measures to capitalize on trends or market inefficiencies and you have a recipe for perpetual motion.

To that end, indexed money by rule must peg its benchmark ? the measure metering its performance. Indexes use options and futures to mirror the benchmark so counterparties for options and futures are in and out of the market. That sets prices.

The majority of trading in ETFs is a form of arbitrage. ETFs don?t buy or sell stocks. ETF sponsors privately transact with authorized participants in large blocks. In the market, people are trading ETF shares that simply represent assets held by sponsors. Market-makers are shorting or going long components to capture inefficiencies, and fast traders are repricing components, indexes, options and futures for spreads.

All of this is setting your price. If money flows into SPY?, the world?s most actively traded stock with $25 billion of volume daily, arbitragers, market-makers and authorized participants must respond. This trade splashing through your peer group may move members disparately at times because of liquidity, options, futures, shorting.

A paradoxical cycle forms. Indices fluctuate because of arbitrage in ETFs predicated on them, which prompts indexed money to adjust, which must happen because rules for indexes demand it.

The sheer size of this money has pervasive market impact, often blotting out effort by active investors to buy or sell growth and value opportunities (uniform rules and uniform trade-executions overwhelm outlier orders, key to why stock pickers rarely beat indexes).

There?s little that?s passive about passive investment. Call it Asset Allocation. But it lacks emotion, reason and common sense. That?s why markets are unresponsive to terror attacks or flagging economies but wedded to monetary policy. It?s about the model.

Have a good week,

Tim Quast

President

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