From: Lee Wenzel [mailto:Lee@WenzelAnalytics.com]
Sent: Monday, September 16, 2013 9:57 PM
To: Tor Dahl
Subject: Is capitalism threatened by indexed markets?

Tor,

Do index funds impede the ability of markets to allocate capital in the effective and efficient way that is the hallmark of capitalism?

While it is hard to get an accurate picture, I assume that about a third of equity markets are comprised of transactions from indexed products, and perhaps another third are from money managers benchmarked to indexes so tightly that they affect the markets similarly. What might be prudent for the specific investor may be having deleterious consequences in the aggregate. Money going in to an indexed product buys every stock in that index, irrespective of its merits – however conceived. What happens to an auction if two-thirds of the bidders have to buy or sell regardless of price?

Correlations are up, subject to short-term fluctuations that correspond to volatility. (I have attached some data and analysis.) Not only are the waves in sync, but fewer stocks exceed the amplitude. So it is harder for an active money manager to exceed the market. The correlations are often assumed to be some kind of crowd behavior, like a wave through the stands of a baseball game. I suspect that the actual mechanism is more tied to the indexing and cross-investing rather than that everyone's moods somehow being in sync.

So the reason I'm writing to you is to ask your take about the possible impact of index products and benchmarked managers on the efficacy of markets in allocating capital.

A related question has to do with the impact of GDP growth being driven more by financial maneuvering rather than productivity in the past thirty years. My question is prompted by the attached rather provocative paper. Are we running on stimulants?

If you have a minute, I would welcome your response. Thanks.

From: Tor Dahl [mailto:Tor@Tordahl.com]
Sent: Tuesday, September 17, 2013 12:28 AM
To: Lee Wenzel
Subject: RE: Is capitalism threatened by indexed markets?

You raise a very good question, Lee! If you have the answer, and it is proven to be correct, you have may well earn a Nobel Prize in economics. Most Nobel Prizes are won for very simple answers, like those in physics, and on the presumption that nature is always simple, always elegant, and ever present.

I don't see a simple answer to your question. Although I know that the link between stock value and productivity is now more tenuous, likely lagged, and slower in self-correcting force. But that, in turn, should offer a competitive advantage to those who see this, and invest accordingly.

I have personally used an investment strategy that is both simple and elegant, and the returns have been high. I have ascribed these unusual returns to investors not applying or knowing about my particular criteria for investing, and my trading is so marginal that the patterns are not detected.

I always enjoy reading about your own careful study of markets, indices, applied statistics, and now the illusion of finance. The Norwegian Sovereign Fund is currently at $760B, and is estimated to pass $1T in 2020. Its yield averages 3.7%. That is still too much money for the full employment economy of Norway, with no inflation and low interest rates, so the fund just grows, and represents about 2.5% of every "good stock" in Europe. A sort of moral index fund, if you will. Very Lutheran, I think. They Management of the fund have written their own requirements for an eligible stock purchase that is somewhat reminiscent of Leviticus.

Thank you for sharing this! I very much enjoyed reading it!

Warm regards,

Tor