

Discussion of “Complementarity of Passive and Active Investment on Stock Price Efficiency” by Youngmin Choi

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What this paper does

- Use Russell reconstitutions to instrument for variations in passive investing
 - Stocks are allocated each year based on their market capitalization to the Russell 1000 and 2000 indexes
- Examine how these variations affect price efficiency
- Condition on the degree of active investing

Main results

- Increase in passive investing leads to an increase in price efficiency
 - Lower pricing error (Hasbrouck (1993)), lower absolute intraday return autocorrelation, lower price delay (Hou and Moskowitz (2005))
 - Decrease in post-earnings announcement drift
- Concentrated among stocks in the top quartile of active mutual funds ownership

⇒ Complementarity of active and passive investing

Comment #1: What are the theoretical predictions?

Why do we expect an increase in passive ownership to improve price efficiency?

- 1 Who is the counterparty?
- 2 How can passive ownership affect price efficiency?
- 3 Complementarity with active investing

Who is the counterparty?

An increase in passive ownership can come from

- A decrease in active institutional ownership (mutual funds or hedge funds)
- A decrease in retail ownership
- Or a mix of both

Example: Decrease in retail ownership (noise trading) \Rightarrow increase in price efficiency in a Grossman-Miller (1988) framework

- But Chang et al. (2015) and Schmidt and Fahlenbrach (2017) find no discontinuity in total institutional ownership
- At the same time, this paper finds no discontinuity in active (mutual funds) ownership?

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How can passive ownership affect price efficiency?

- In a [Grossman-Stiglitz \(1980\)](#) framework price informativeness is unaffected by the intensity of noise trading
- Reasons why the value/cost of (acquiring) information has changed?
 - Increased benchmarking predicts a *lower* price efficiency ([Breugem and Buss \(2018\)](#))
- Look at other factors such as shares lending
 - Large passive institutional investors derive substantial revenues from lending fees
 - More willing to lend their shares \Rightarrow improved price efficiency

Complementarity with active investing

Improved efficiency only for stocks that have high active mutual fund ownership

- Why increased analyst following and lower forecast dispersion for these stocks?
- “...*enough shares held by actively managed funds:*”
 - Would help to specify the magnitudes (in Table 6): difference in %active between stocks in the bottom and top quartiles?

Comment #2: Specification

- **Stock fixed effects:** since index assignment is persistent this puts the focus on the index switchers, which are likely subject to large price changes
- Maybe try an alternative specification ([Schmidt and Fahlenbrach\(2017\)](#)) with more liquidity controls
- Show a **covariate balance test:** Regress ex-ante measures on the Russell indicator
 - It would be reassuring to see that there is no difference

Other comments

- **Table 2:** market cap difference between Russell 1000 and 2000?
- **Table 3:** Why does Amihud's measure have a positive effect on passive ownership?
- **Figure 2:** not so informative because it is based on the June weights, which are biased by the Russell float adjustments
- Maybe focus on passive funds that track the Russell 1000 and 2000 indexes for a cleaner experiment