How Benchmarking Can Make Markets More Opaque

By Adrian Buss , INSEAD

The growth of assets under management by institutional investors influences the informational efficiency of financial markets, asset prices and investors' portfolio returns.

The majority of US equity is now held by institutional investors – endowment funds, commercial banks, mutual funds, hedge funds, pension funds or insurance companies. In 1950, they only controlled 7 percent of US stocks but that number rocketed to an astonishing **80 percent** by 2017. With this amount of control over equity, institutional investors have a substantial impact on asset prices – and not always in a positive way. That is, as institutional investing has soared, the informational efficiency of the markets might have deteriorated.

Benchmarking is the practice of measuring the performance of a fund manager relative to an index. It can be a powerful tool for investors because it aligns the rewards for both fund managers and investors: Institutional investors are paid more when they deliver a return higher than that of the benchmark. One example is Japan's Government Pension Investment Fund, the largest retirement fund worldwide, which pays the fund managers it uses based on their relative returns. Hence, these fund managers only earn a high fee if their investment return is higher than what the benchmark delivers.

Although this benchmarking practice is widely adopted, its impact is not well understood. In particular, is it beneficial for markets as a whole and, hence, social welfare? For example, the International Monetary Fund published a **report** in April 2019 that stated, "A larger share of benchmark-driven investments in total portfolio flows could increase the risk of excessive inflows or outflows unrelated to countries' economic fundamentals and could, in some cases, have destabilising effects" on emerging markets.

Matthijs Breugem (Collegio Carlo Alberto) and I use a theoretical framework to study how benchmarking, in broad terms, affects the efficiency of financial markets, asset prices and investors' portfolio returns. For the first time, we found that as the number of benchmarked investors increases, the acquisition of private information by managers ebbs. Our paper, **" Institutional Investors and Information Acquisition: Implications for Asset Prices and Informational Efficiency"**, was recently published in *The Review of Financial Studies*.

Repressive exchange

By slowing down the acquisition of private information, benchmarking stultifies information because it leads to prices that are less reflective of company fundamentals.

Two basic forces limit the flow of information:

1. Due to benchmarking concerns, institutional investors align their portfolio closer to the benchmark and, as a result, wind up acquiring less private information (i.e. less information availability). What is the reward in finding out more when it is not used? In particular, it is costly for a fund manager to learn – they must review financial statements or interview a firm's customers. Without potential rewards to apply this information, the fund manager is unlikely to follow up and ensure that the company's price reflects this data.

2. Benchmarked funds less aggressively use the private information that they do have. For example, even if they have data that indicates something positive about a given company, benchmarked fund managers are unlikely to

trade aggressively (such as by buying many shares). As a result, that firm's price isn't very much affected and less of the positive information shows up in the price (i.e. less information incorporated).

Overall, this can turn into a spiral effect where information isn't as aggressively collected, analysed and put to use for clients. Therefore the stock price is no longer based on the core information about a company. The price informativeness for stocks inside and outside the benchmark declines. The power of institutional investors, especially in relation to benchmarking, translates into less information about the stocks in the index. As a result, any additional news about a company results in a stronger reaction in its stock price, so that stock prices become more volatile.

Too many eggs in one basket

Passive investing is another method of investing that doesn't necessarily connect prices to fundamentals. The Fed is **concerned** about it contributing to financial instability through volatility and also, like benchmarking, passive investing may put too many eggs in one basket: Vanguard, BlackRock, State Street, Fidelity and Charles Schwab have a combined market share of 44 percent in the sector. Like benchmarking, passive investing doesn't encourage the cultivation of more information. And, like benchmarking, it makes the market more opaque and noisy, as cited in the ***Financial Times*** last year.

Another outgrowth of the combination of institutional investors' huge share of the market combined with benchmarking means that less-benchmarked funds that use private information may be better placed to make correct investment decisions, thus outperforming the benchmarked funds. More information means a better performance for investors, over time.

There are clear advantages to benchmarking, but there are more negative side effects than previously thought. It shouldn't be regulated but all investors, including retail investors, should be aware of the possible sluggishness of information and the substantial outperformance of better-informed, non-benchmarked investors. Benchmarking is an important tool, but as the number of benchmarked funds increases, this monolithic aspect means more risk, not less.

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