

# “Fundamentally Broken”.....We Agree, But We See Opportunity to Capitalize

Curt R. Stauffer

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I have previously written about the impact of both quantitative (programmatic trading) and passive (index) investing on capital markets and price discovery. I made these comments based on my cumulative 25+ years of equity analysis and portfolio management experience. However, this subject is rarely ever discussed by the mainstream financial media. This changed over the last week.

On February 10<sup>th</sup>, Greenlight Capital’s David Einhorn made a statement that grabbed significant media attention. This statement came from a lengthy podcast interview with Barry Ritholtz. During this interview with David Einhorn, who started his hedge fund, Greenlight Capital, in the late 1990s, he stated, “I view the markets as fundamentally broken.”

Using the phrase fundamentally broken on its face, it seems like a scary and very negative assessment. Still, he stated why the equity markets are “fundamentally broken,” how long it took to conclude that the market is broken, and how he has chosen to adapt as a money manager.

My sentiment after listening to the Barry Ritholtz podcast interview with David Einhorn was that...finally, someone in my profession who is respected and followed by the media is pulling back the curtain on the structural problems with our markets. These structural problems have been evident to us for many years, and we have chosen to make small incremental changes to our investment process to counter the trends we began seeing over ten years ago.

Einhorn pointed his finger at quantitative investing and passive investing as the culprits. Here is what he said about quantitative investing: "There's all the machine money and algorithmic money, which doesn't have an opinion about value. It has an opinion about price." Then he turned to passive index investing, saying, "Passive investors have no opinion about value. They're gonna assume everybody else's done the work, right?"

Over six years ago in 2017, Marko Kolanovic, JP Morgan's Global Head of Quantitative and Derivative Research, was quoted in a CNBC article from June 16, 2017, titled Just 10% of Trading is Regular Stock Picking, JP Morgan Estimates, saying "While fundamental narratives explaining the price action abound, the majority of equity investors today don't buy or sell stocks based on stock specific fundamentals." "Kolanovic estimates fundamental discretionary traders account for only about 10 percent of trading volume in stocks. Passive and quantitative investing accounts for about 60 percent, more than double the share a decade ago." Since this statement was made, passive index products and quantitative trading strategies have only grown their share of market trading.

The most recent research on the topic of the impact of quantitative trading (HFT – High Frequency Trading) on stock prices comes from a 2023 paper written by Michael J. Jung of Lerner College of Business & Economics, University of Delaware, Kyung Yoon Kwon, University of Strathclyde, Glasgow, and Hyungshin Park, Coles College of Business, Kennesaw State University titled Does High-Frequency Trading Cause Stock Prices to Deviate from Fundamental Values?

In this paper, Jung, Kwon, and Park wrote, "We find that greater HFT leads to a greater deviation of stock prices from accounting-based valuation estimates...." Our findings contribute to the understanding of the implications of HFT on incorporating of fundamental news into stock prices. Our results raise questions for the role of financial reporting in the HFT-dominated world today. To the extent that HFT does not rely on firm fundamental information, financial reporting has its limits in converging stock price towards firm intrinsic value. "

I have observed first-hand how markets have changed over the last three decades. To understand why markets behave as they do and why security prices react to certain data and events but not others, one must first understand who the primary buyers and sellers are on any given day. I am writing this month about the significant growth in passive investing and quantitative trading that has come to dominate our equity markets. The impact of passive investing is fairly straightforward. Still, without understanding what strategies are executed by quantitative trading firms, it is challenging to understand why our markets are seemingly much more reactive than they once were. On August 5, 2020, the U.S. Securities and Exchange Commission published a study on High Frequency/Algorithmic Trading titled Staff Report on Algorithmic Trading in U.S. Capital Markets. In this report, the three primary strategies used by algorithmic trading programs are:

#### Arbitrage:

*Arbitrage strategies generally seek to capture pricing discrepancies between related products or markets, such as between an ETF and its underlying basket of stocks, or between futures contracts on the S&P 500 index and ETFs on that index. Arbitrage strategies are likely to demand liquidity and involve substantial hedging of positions across products and markets. These strategies do not depend on directional price moves in a single product, but on the divergence and convergence of prices between products.*

#### Structural:

*Structural strategies attempt to exploit structural vulnerabilities in the market or in certain market participants. For example, traders with the lowest-latency market data and processing tools may be able to profit by trading with market participants who receive and process data more slowly and, as a result, have not yet updated their prices to reflect the most recent events.*

Directional:

*Directional strategies generally involve establishing a short-term long or short position in anticipation of a price move up or down. These strategies generally require demanding liquidity to build such a position. Some directional strategies may focus on predicting price movements faster than other market participants, which requires sophisticated analytics and rapid processing abilities. For example, order anticipation strategies may attempt to predict or infer the existence of a large buyer or seller in the market, in order to buy or sell ahead of the large order. Trading on such predictions may often contribute to the process of price discovery in a stock.*

The three quantitative trading strategies above have little to nothing to do with traditional fundamental security analysis. I have written and discussed with clients, more times than I can recall, how day-to-day, week-to-week and even month-to-month market price movement is much more driven by price-agnostic market participants today. When I say price agnostic, I mean trading strategies that are not driven by fundamental valuation factors. Instead, they are strategies driven by market price dynamics and structural factors, such as arbitrage, structural, and directional trading.

As an experienced analyst and portfolio manager, I view the market impact of quantitative programmatic traders as mostly noise to be ignored. However, to ignore the noise, one must understand why it occurs. A lot has changed in the structure of our capital markets since I began my professional investing career in the late 1990s. Twenty-five years ago, human investors with informed and uninformed opinions on the correct security price dominated the markets, and passive investing and programmatic (quantitative) investing came along for the ride. Today, passive and programmatic investing dominate daily trading volume and have become “the market.” Human investors who buy and sell using informed and uninformed opinions regarding the value/price relationship are no longer in control of the market. To succeed as a human investor with an opinion of value in today’s markets, one must first understand that markets are not controlled by someone on the other side of the trade with a different opinion about value. Passive and programmatic trading has no opinion about value.

We believe that to succeed in today’s markets as a human value-oriented investor, one must accept this reality and understand that the market is no longer, on a security-by-security basis, a meaningful signal about value. I view this evolution in markets as unhealthy in terms of fundamental price discovery through short-term time horizons. Still, we also understand that such a disconnect between price discovery and value can give a value-oriented investor a significant opportunity.

Jeffries Equities published a White Paper in 2019 titled When the Markets Move the Markets. The following illustration came from this paper:

When	Long Ago (The 1990s and early 2000s)	A While Ago (Early 2000s – late 2000s)	Now
Who determined buy/sell	Human	Human	Algorithm
How they executed	Human	Human or Algorithm	Algorithm

*Note: Algorithmic or rules-based trading has existed for decades but did not reach broader audiences until the mid-2000s. Even now, there is still human execution, but it has decreased substantially.*

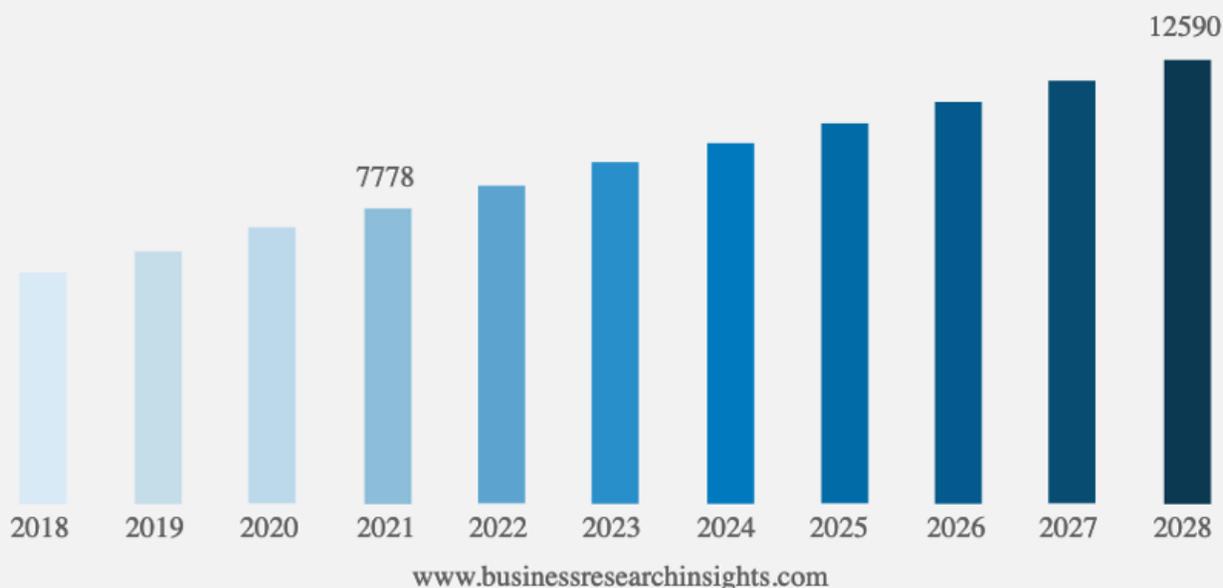
The Jeffries paper made the following statements:

"As a percentage – active management has transitioned from *being* the market to being just *one-third* of the market. Even more striking: some estimate that only 10% of daily trading is initiated by fundamental discretionary investors – those who ground buys or sells on fundamental analysis and are sometimes what comes to mind when we say “active management. Buyers and sellers on either side of a trade used to share mirror image motivations for entering the trade. The buyer anticipated the value/price would increase and had the capital to express that view. The seller either *needed* the capital underpinning that trade or felt the value/price of the asset would decline. So we’ve moved from human investors executing with human traders to (for the most part) rules-based algorithms executing via... rules-based algorithms. At the same time, the scope of *what exactly* they are trading has changed – with the number of single stock securities declining (but on average being worth more), as the number of indexed or bucketized securities has grown."

Notably, this Jeffries White Paper was written in 2019 using data from the years prior. The following graphs, from Ben Carlson’s Wealth of Commonsense blog of December 2, 2022, and Business Research Insights from February 5, 2024, respectively, illustrate just how rapidly passive and quantitative strategies have continued to attract a disproportionate amount of available market fund flows since the time the Jeffries White Paper was published:



## Global High-Frequency Trading Market Size, 2028 (USD Million)



In summary, we remain committed to seeking value opportunities in equities and attractive “real” total return opportunities in fixed income. We understand how substantially markets have changed over the last 25 years, and what we know does not deter our passion for working day in and day out to identify opportunities that these high-frequency and price-agnostic markets give us. I wrote this month’s commentary to shed some light on why investors feel that markets do not make sense and are too dangerous because of how unpredictable they have become. Since we are not short-term traders or margin investors, we do not see today’s markets as hazardous; they are just different and extremely reactive at times to the most arcane data points.

Disclosure:

**Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.**

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**Exchange-traded funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus provides a balanced analysis of the investment risks and benefits. Read it carefully before you invest.**

- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's

performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.

- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depository receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.
- The Dow Jones Industrial Average (DJIA), also known as the Dow 30, is a stock market index that tracks 30 large, publicly-owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.
- The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, with a weighted average market capitalization of approximately \$4.3 billion, median capitalization of \$1.2 billion and market capitalization of the largest company of \$18.7 billion.