The Damped Spring Report

"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

11/29/2020 Today we look at two huge portfolio rebalances one occurring tomorrow and the other sometime in late December.

The largest move in equities in a single month since 1987 and the inclusion of Tesla into the S&P 500 index provide excellent examples to describe our framework for understanding rebalancing flows. Headline:

- The November rally in equities may generarate a Month end flow but is much more likely to be a headwind partially offsetting bullish tailwinds than an alpha capture opportunity
- Tesla is a clear opportunity for alpha for those trading Tesla stock and the SPX futures

In both cases the reason that Alpha may be available is simple.

- When an investor has a tight benchmark and matching that benchmark is a requirement to hold on to one's job
- AND the benchmark is rebalanced at a the price of a specific time and date
- AND enough assets are held by benchmark tracking funds
- AND that amount exceeds normal liquidity available at the time and date of the benchmark rebalance
- AND arbitrage money is inadequate to spread out the impact and provide excess liquidity at the time and date of rebalance

The important part of all this framework is that it depends on a benchmark tracking investor transacting at a specific time and price and that the investor is price insensitive for this transaction. The alpha is paid to those who provide liquidity to the benchmark tracker and is paid by the benchmark trackers investors who purchase assets at an inflated price and sell assets at a depressed price in the process of rebalancing.

Why are these two situations interesting?

- The Global equity market has appreciated by 12-20% percent. In the US, the equity market monthly appreciation is the largest in the last 33 years.
- Tesla will be added to the S&P 500 Index and it will enter as the 7th largest member of the index. Hard index tracking funds will purchase 45BN of Tesla stock and sell 45BN of the rest of the index to fund the purchase.

Headwind

The rally in global equities is certainly meaningful regarding the current level of risk and imbalance in worldwide portfolios. But one of the important requirements for a month end closing rebalance alpha capture opportunity is by and large absent. We predict that the rebalance toward lower equity exposure by those who manage multi asset portfolios is an ongoing process and little money has a hard multi asset benchmark particularly at a month end.

When monetary conditions are tight, and portfolios are experiencing losses month ends do occasionally have significant flow related moves. Given generally easy monetary conditions and strong 2020 portfolio returns for virtually all assets we expect that the flows selling equities tomorrow at the close of each global market will be meaningful. For that reason and that we are already max bullish equities we recommend no position tweaking. For those who are not yet max long we recommend adding to a long on the close tomorrow offsetting whatever minimal selling shows up.

The numbers look like this:

In the US

- SPX is up 12% MTD
- Total returns for Bonds are also positive by 1%

A standard 60/40 portfolio would have generated a 7.6% return and the new portfolio would be 62.5% equities and 37.5% bonds. The rebalance requires a 2.5% sell of equities into bonds which given the huge equity move will likely be less than most would assume. The tailwinds that already existed during the last few weeks remain strong and we expect that tailwind will continue until the Fed Meeting later in December. But most importantly little money is hard indexed into multi asset portfolios and there are no iconic multi asset benchmarks, futures or ETF's that would generate hard rebalance flows on the closes of markets

Also stepping way back to the macro level all assets are owned by existing savings. All assets are now out of balance. For an investor to rebalance back to a desired benchmark another investor must overweight or lever up. In each case it would require the rebalancer to pay the liquidity provider. Why pay anyone to do what they do not want to do when you do not have a hard benchmark to hit.

Tesla added to the SPX in late December will be a historic index rebalancing flow.

The high-level points are that:

- 8% of the total market cap of S&P 500 stocks is held by index funds.
- Index funds investors tolerate NO tracking error between their index investment returns and returns of the actual index

- Failing to purchase 8% of Tesla by index funds will result in mass firings of index fund managers
- 8% of Tesla's market cap is $40BN and Tesla will be the 7th largest company in the index after inclusion is complete. The size of the index inclusion in Tesla is simply too large for traditional arbitrage players to offset and spread the flows.
- The way Standard & Poors has calculated the index inclusion price has not changed for decades. The Tesla case will test S&P's creativity and if they adjust policies the inclusion impact may be different.
- Lastly, Tesla is highly sophisticated and in August announced a shelf filing right ahead of the index inclusion announcement (which was to delay inclusion) We expect them to participate in some way in this inclusion liquidity event

The next few paragraphs will be controversial and reflect our deep understanding of the activities of all players during index rebalances. When you read about this you may feel that some players engage in price manipulation. Its for regulators and lawyers to address the legality of the activity but we expect that the behavior by major participants will be carefully examined creating additional complexities.

What is flow related alpha. Simple. Know that a large market moving flow is coming. For example, a buy. Buy before the flow and sell into the flow. If you also know when the flow will end short into the last of the flow and buy back later.

Essentially but without the controversial term and its legal consequences "front run" the flow.

The alpha opportunity is clear.

- Some short time prior to the closing print of Tesla on the index inclusion date one should be long and sell that long MOC to the various index funds who must be long at a price no greater than the close.
- Some short time prior to the close of all other SPX components be short a basket of those stocks, futures, or ETFs and buy MOC that basket of stocks from the various index funds selling that basket to raise cash to purchase the Tsla shares they need

Now let's address the meta issues around pursuing this strategy. Index funds know that front running their flow will happen. Here is the second controversial statement. Index funds front run their own flow during index rebalances. They have created multiple narratives around why their own activity is legit. They also have arranged various execution agreements with counterparties which simply transfer any manipulative behavior (third controversial statement) to agents.

The most important narrative that to us seems non-controversial is that self-front running allows them to purchase shares their investors demand at a price that is almost certainly going to be better than the actual closing print.

Fourth and most controversial statement. To guarantee index fund manager outperformance vs their hard benchmark. Index funds have a quite simple strategy. Buy some ahead of the print but buy enough MOC to push the shares to a price higher than their pre close purchases. This is standard operating procedure for index funds. They do it directly or often they arrange transactions with broker dealers in which the broker offers to guarantee a purchase price of share acquired on behalf of the index fund manager at a discount to the index inclusion price. To deliver such a discount and profit broker dealers engage in the same self-front running. Buying some ahead of the print and ramping the print MOC.

Three players dominate hard SPX replication. State Street which manages the SPY ETF, Blackstone which has massive institutional index funds, and Vanguard which has dominated the index mutual fund and led the shift from active to passive mutual fund investment. They all have in the past pursued strategies directly or been paid by broker dealers for their index rebalance order flow.

TSLA is simply too large. If nothing changes in the next few weeks the stock is going to make a local high on the index inclusion price. We recommend a few things to lessen the impact and the alpha paid to front runners at the expense of the index fund investor

- For large inclusions feather the impact over the average of many days for index inclusion calculation
- Encourage the companies/employees and other private or registered holders of the shares involved to issue/sell shares on the MOC print to offset demand by index funds

We will pay attention to the news of the next few weeks from TSLA and S&P and send notes regarding further developments.

But the high level for our macro clients is TSLA is going to rip higher on the inclusion print (which may or may not be higher than today) and the SPX as a whole will be a short ahead of that print and a buy on the print.