The Daily Dish

The Evolution of Equity Investments

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Eakinomics: The Evolution of Equity Investments

Capital markets serve some very important economic functions. By issuing stock to raise necessary investment and operating capital, firms can tap sources outside of the founders. The separation of ownership and management permits specialization in the latter. Let's face it, I can invest in a restaurant but I certainly should not run one. It also connects those who need funds to those households who have savings they wish to invest. This role — intermediation — again makes sure that I am able to invest in those opportunities that have the highest expected return and, vice versa, that economically deserving enterprises can get access to funds.

That's all fine and good, but it also exposes households to the risks of equity investment. There are two approaches to managing those risks. One is to diversify those risks by buying a large portfolio of stocks, while the second is to get investment advice. The original way to avoid individual consumers having to pick individual stocks was the mutual fund. As described by AAF's Thomas Wade, buying shares in a mutual fund permitted one to own a tiny slice of many stocks — an economy of scale that might not be possible for most on their own — and to diversify risk. At the same time, buying a mutual fund is also buying the investment advice of the fund manager who allocates the invested funds.

The next step was index funds. As Wade notes, "Index funds are a subset of mutual funds, but two large differences set index funds apart from mutual funds. First, an index fund does not have a professional investment advisor who actively selects what securities and assets to invest in. Instead, and second, the fund tracks a specific stock market index, e.g. the S&P 500. An index fund's underlying securities are exclusively invested in the stock of the companies their index tracks. Such an investment approach is known as 'passive management,' as opposed to 'active management,' of mutual funds." Put differently, if you diversify to the point that you own a slice of the entire market, why pay for investment advice?

The final step in the evolution he describes is Exchange Traded Funds (ETFs). "ETFs are traded on a major stock exchange (for example, the New York Stock Exchange or the London Stock Exchange). As a result, shares in an ETF can be bought and sold as if they were any other type of security…. ETFs therefore have much of the flexibility of a stock (including a low price point for a single share), but the cost efficiency and risk diversification of a mutual fund."

There is a lot more to be detailed in the joint evolution of vehicles and advice. But the important, open question is whether a market increasingly dominated by large, passive investors is the most efficient means of allocating capital. Fortunately there will always be active investors who will find and take advantage of opportunities when the less nimble index investors aren't watching.