
THE RISK OF PASSIVE FUNDS

Yesterday **Mike Green** released a video that was more blunt and direct than usual on the potential **final outcome** (“**END GAME**”) of the equity market:

<https://youtube.com/watch?v=dkL4oz8iEg4>

For years, Green—together with leading academics—has studied the **passive share of equity market flows**, arguing that it represents a **theoretical point of no return**. When **two-thirds or three-quarters of market flows become passive**, the market no longer has enough active participants to provide the “**elasticity**” (**liquidity**) required to absorb transactions.

This leads to what he calls “**impossible volatility**”, where even a small sell order could trigger a catastrophic collapse in prices, potentially forcing exchanges to halt or even shut down.

The Flow Multiplier

Traditional market theory suggests that **one dollar invested** should increase market capitalization by only **a few cents**.

However, **Xavier Gabaix and Ralph Koijen** have shown that the true **multiplier is closer to 5x**—meaning **\$1 of inflows can generate roughly \$5 in market capitalization**.

Green notes that subsequent research suggests this multiplier is **rising further** as active managers—who provide elasticity—**continue to disappear from the market**.

The Mega-Cap Distortion

Green uses this research to explain why stocks such as **Apple** and **Nvidia** remain persistently elevated.

Research by **Jiang** shows that passive flows **inflate the prices of the largest index constituents disproportionately**, regardless of fundamentals. This happens because these companies carry the **largest index weights**, yet **do not have proportionally greater liquidity** to absorb the volume of flows directed toward them.

The Critical Passive Threshold

Andrew Lo (MIT) has concluded that markets effectively **stop functioning properly** once the passive share reaches **between 75% and 80%**.

Green estimates that the market is currently **about 54% passive**, having increased by roughly **4% in the past year alone**. At this pace, the “**endgame**” could be reached **within five years**.

Key Academic Research

- “In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis” (2021)
Xavier Gabaix (Harvard), Ralph Koijen (Chicago Booth)

The **70% figure** that Green frequently references in his videos likely comes from the work of **Valentin Haddad**, whom Green often cites as the most critical academic bridge supporting his thesis:

- “How Competitive Is the Stock Market?” (2022)
Valentin Haddad (UCLA), Paul Huebner, Tyler Muir

The Failure of Active Manager Response

This study examines the “**strategic response**” of **active managers**.

Haddad finds that although some active managers attempt to offset passive flows, **they fail to do so**.

Once certain thresholds of passive ownership are exceeded, with **70% serving as a key empirical milestone** in Haddad’s sensitivity analysis, **aggregate market elasticity collapses**, leading to **substantial inelasticity**.

The Generational Factor

It may still take two or three years, but **each year the share of passive equity flows increases**. For forty years, these flows have been **consistently positive**.

However, the generation that holds the bulk of financial wealth is now **entering retirement**. As investors age:

- risk tolerance declines,
- capital is withdrawn,
- **at 80, you do not invest the same way you do at 50.**

Even **purely due to demographic effects**, not to mention a major recession, net flows could turn **negative**.

The Inelastic Market Problem

Today, the market has become **highly inelastic**:

- small inflows drive prices sharply higher,
- **but small outflows can drive them sharply lower as well.**

In an inelastic market:

- **\$1 billion of inflows** can increase market capitalization by **\$30 billion**,
- but **\$100 billion of net outflows** could destroy **30 times that amount or more** in market value.

The Bottom Line

The last time equity markets experienced **net outflows** was in **2009**, when markets fell **-46%**. Since then, flows have been persistently positive.

But today, **inelasticity is at record levels**.

The impact of a few hundred billion dollars of outflows could amount to **\$20–30 trillion in lost market capitalization**.
