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Trader Insights

Actionable Ideas for the Power to Trade Smarter

Seeing Both Sides of Index Rebalances

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Ms. Hong: Passive ownership has grown significantly in the last decade, making it hard to ignore. On the days when providers like MSCI or FTSE revise their list of index components, there are large volume spikes in markets. This is unsurprising when you consider that 15% of total S&P 500 float is now owned by passively managed funds.

Index rebalances increase liquidity demand from index managers on or around rebalance day. This drives up the price of securities selected for inclusion, and drives down the value of those being dropped. Although prices tend to recover soon afterward, there is a wider impact. In the 10 weeks leading up to an MSCI index rebalance over the period February 2009 to November 2017, stocks in companies that were added to an index generated returns of 12.6%, on average, while stocks that were deleted generated minus 3.9%.

Index rebalances are not just relevant to passive investors. As a global institution, serving both passive and active clients gives us a clear view of both sides. Among active investors, pre-positioning to provide liquidity is key. For hedge funds, the risks associated with index rebalances can be profitable, making it effective to base a strategy on projected additions and deletions. However, it’s important to understand a range of factors, including ongoing changes to benchmark indices and revision methodologies.

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