

# Why Two Credit Guys Think the Stock Market Turned into a Bond Market

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## The short version

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The stock market used to be a place where people argued about what a business was worth. Sometimes, it still is. But increasingly, it's a place where huge, mechanical, agnostic flows of money show up on a schedule and move prices regardless of what anything is worth. Index funds buying on payday. Leveraged ETFs rebalancing at 3:50pm. Dealers hedging options exposure. None of that is anyone's opinion about value, yet all of it moves price.

This is not a new observation about markets in general – it's the exact description of how corporate credit has worked for the last fifteen years. We spent our careers there. We didn't have to learn a new way of thinking to see this happening in equities; we already had the toolkit. This paper is our case for why the equity market has quietly turned into a market credit people already know how to trade, and how we are trading it.

## I. Prices don't bounce back the way they used to

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The textbook version of markets says a stock is basically interchangeable with a portfolio of other stocks, so if someone buys or sells for a reason that has nothing to do with value, smart money steps in and the price barely moves. That story has been dying for years, and the data finally killed it.

You'd expect that, as passive investing grew, the shrinking pool of active managers would get more aggressive and soak up the mispricing – more opportunity per manager, more incentive to hunt it down. Research on exactly this question finds the opposite: competition among active managers doesn't come close to making up for the lost elasticity. Every dollar that moves from active to passive makes the next dollar of flow hit harder, not softer. This is a structural shift, not a phase we're passing through.

The obvious objection is that this is really a Big Tech story: managers who deviated from the index underperformed because deviating meant being underweight the handful of companies that turned out to be extraordinary. That explanation fits the same performance data, so it has to be ruled out rather than argued with. The way to rule it out is timing. Retirement contributions and other mechanical allocations arrive on a calendar, clustered at the start of the month. Corporate fundamentals do not. Recent academic work finds that the performance gap between managers who hug the benchmark and those who deviate most widens precisely on those days – and widens further when flows are unusually strong. Earnings don't know what day of the month it is. Flows do.

The cleanest single piece of evidence: for decades, "active share" – how far a fund manager's holdings deviate from the index – predicted outperformance. Allocators built entire manager-selection processes around it. That relationship has flipped. Active share now predicts underperformance. Stock pickers didn't

get worse at picking stocks. The payoff to being different from the index changed sign, because the buyer setting the price at the margin changed. That's not a skill story. That's a technical.

This is what we mean by recursive pricing: information sets a destination, but flow increasingly sets – and resets – the path. A flow that moves price creates the conditions for the next flow. Price feeds position, and position feeds price, in a loop that runs independent of what anything is actually worth. That feedback loop, not any single flow event, is what we're actually trading. It's also where our firm's name comes from.

## II. The stock stopped being the unit. The basket is.

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Nobody really trades single stocks as the primary unit of the market anymore. It's baskets – index futures, sector ETFs, thematic ETFs, custom equity baskets, portfolio trades – executed as one transaction. And that has a mechanical side effect: stocks move together more than their businesses justify, simply because of how capital gets allocated to them.

If your edge was picking individual winners, this is bad news. The very thing you're selecting (a stock's own idiosyncratic performance) is getting compressed by the plumbing of the market itself. If your edge is picking the right basket, this is good news. Rising correlation inside a basket makes that basket a cleaner, more powerful way to express a view.

Layer on top of that the last few years of retail trading, leveraged and inverse ETFs (which are mechanically required to buy more as the market rises and sell more as it falls – a built-in momentum machine, disclosed daily, that much of the industry treats as a curiosity rather than a signal), and options dealers hedging their own exposure. None of these participants are trying to estimate what anything is worth. All of them move price, on a schedule, in a direction you can often predict in advance.

That's what a technicals driven credit market looks like. It's what credit markets driven predominantly by mechanical supply and demand have always looked like.

## III. Credit got here first

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This isn't just equities drifting toward something credit invented out of theory – credit went through its own forced market structure transformation, on a totally different timeline, for totally different reasons, and arrived at the same place.

After the financial crisis, new capital rules made dealers stop warehousing bond inventory. Liquidity in credit stopped being something a dealer just provided and became something you had to negotiate for – pay for immediacy, or get paid for patience. Every credit PM and trader of the last decade learned the economics of liquidity provision simply by showing up to work.

At the same time, credit ETFs stopped being just an access vehicle and started being the actual place where prices got discovered – trading more, and more efficiently, than the bonds underneath them. March 2020 made this undeniable: credit ETFs traded at big discounts to their stated net asset value, and the eventual consensus was that the ETF was right, and the bond prices were stale. Anyone who lived through that week learned, under real financial pressure, that a wrapper can be a better price than the sum of its parts.

Add portfolio trading (executing hundreds of bonds as one trade, priced against the ETF you can hedge it with) and the shift of the whole market onto electronic platforms (all-to-all trading), and credit ended up looking a lot like the equity market it's supposedly so different from. Both markets are converging on the same thing – mechanical flow determining price more than fundamentals do. Credit just got there under duress, about half a decade earlier.

## IV. Why the usual playbooks keep losing

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The industry has tried two responses to underperformance, and both misread the problem.

Long-only stock picking underwrites a company's earnings three to five years out – but the market is pricing a flow of money arriving on the first of next month. Even a manager who correctly predicts the earnings can still get run over while holding the position, because the thing pushing against them doesn't revert on any schedule they can survive. The path is dependent on Benjamin Graham's voting machine even if the weighing machine eventually proved they were correct. As Terry Smith put it in a recent shareholder letter, "In a market in which share price moves of 33% per day for even large stocks are not uncommon a buy and hold strategy can only work if you are not subject to flows, and we are."

Conversely, the multi-manager platform model – hundreds of "autonomous" market "neutral" pods, tight risk limits, quick stop-outs – was supposed to fix this. Instead, it created a huge pool of capital, all running similar, risk-constrained strategies with similar triggers. When something goes wrong, everyone de-risks at once, mechanically, regardless of price. That correlated, forced selling is now one of the most reliable sources of market dislocation there is – and it's produced by the very risk systems meant to prevent it. On top of that, fee structures on these platforms have eaten much of whatever edge survives the crowding dynamics.

We're not trying to compete with either of these. We're trying to be the counterparty to them. The forced, mechanical selling this system generates is, in our view, the richest source of opportunity in the equity market today – and capturing it just requires that we not be subject to the same triggers ourselves.

## V. Why us, specifically

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The obvious question: why would two credit portfolio managers be qualified to trade equities? Here's the deeper answer, before the practical one.

Credit sits structurally beneath every other risk market. Credit spreads are the market's real-time read on two things every other asset class discounts against, whether or not its own participants realize it – the cost of capital and the probability of loss. The equity risk premium is compensation for holding a claim junior to debt; when spreads widen, equity discount rates move whether or not a single earnings estimate changes. A credit PM also spends a career comparing one issuer's bonds against its loans, its CDS, its equity, and its peers' debt – pricing the same risk across different instruments and different layers of a single balance sheet. That is tactical asset allocation, practiced for years inside one company before it's ever applied across a portfolio. The practical answer follows from the structural one:

- **We already think in technicals.** Saying "fundamentals are mediocre, technicals are excellent, we're long" is a completely normal sentence in a credit meeting. In an equity meeting, it's almost taboo. We don't have to unlearn anything to trade a flow-driven market – we already have the right instincts.
- **We think in "spread to par," and in this market, the index weight is par.** Every position is a deviation from that anchor, and the passive bid enforces the pull back toward it. A credit relative value PM doesn't think in absolute price – we think in basis points away from a reference point. That's exactly the right framework for a market where deviating from the benchmark is now a real cost.
- **We know liquidity provision is a paid job, not a favor.** The post-2008 credit market taught us that supplying immediacy to people who need to trade urgently is a repeatable source of return – separate from having a view on direction.
- **We speak ETF plumbing fluently.** Creation and redemption, primary versus secondary volume, premium and discount to NAV – we learned this under real financial stress in March 2020. Most

equity managers treat ETFs as just a way to get exposure. We treat them as instruments with mechanics worth watching.

- **We already know how to price and trade baskets.** Portfolio trading in credit is the same operation as expressing a view through a sector ETF – pricing and executing a basket against something you can hedge it with.
- **We're wired for asymmetric downside.** Credit's return profile is limited upside, real downside, no recovery once something's actually broken. That produces habits – size to the worst case, watch positioning and leverage, be mindful of options activity, treat liquidity as something that changes – that translate directly to trading crowded, fragile positions.
- **We're used to flipping between momentum and mean-reversion.** Often this happens in the same book, same day, depending on what the technical is telling us – rather than committing to one style as an identity.
- **We're not part of the multi-manager herd.** We don't run leveraged exposure against tight drawdown triggers, which means we're not part of the group that gets forced to sell all at once – a precondition for being the one who buys from them instead.

## VI. How we actually trade it

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**We only use exchange-traded vehicles, across all asset classes.** This is deliberate, not a limitation. If the market prices baskets, we think you should trade baskets. Trying to pick individual winners is like trying to harvest something the market's own plumbing is actively compressing. Yes, this means we give up some precision, but we get speed of execution in size, diversification, and the ability to move fast across asset classes in exchange. That's the right trade for a strategy built around identifying a regime shift early, not for one built around a long-term tilt.

**We don't throw out fundamental research** – we just point it at a different question. Instead of “what should this be worth,” we ask how long this crowd of buyers can keep showing up before it runs out (a theme backed by real revenue growth can stay crowded for quarters; one running on narrative alone unwinds fast on the first bad headline). This does not produce a price target. All of it tells us how long to hold and how big to size it.

**We focus on “crowding”** and view it as five separate readings, not one number: 1) How much positioning has piled up? 2) Is it still accelerating or running out of steam? 3) How much leverage has been deployed? 4) How much of the expected payoff has already happened? 5) What would it cost us to get out? A crowded trade that's still accelerating is one of the best long opportunities available. George Soros said, “When I see a bubble forming, I rush in to buy, adding fuel to the fire”. There are little bubbles forming all the time in different corners of the market that can be exploited regularly. This is the loop in miniature: the flow creates the setup that attracts the next flow, until the trade runs out of new participants to pull in. Reading where a crowd sits in that loop is the whole job. A crowded trade that's decelerating while everything else about it looks the same is exactly how flow-based traders lose money – by confusing the two. That fifth reading is what keeps a crowded position from quietly becoming an untradeable one. Screen liquidity typically looks fine right up until the moment you need it. So, we watch how correlated a basket has become internally and whether it is holding a persistent premium or discount to what it holds.

**Not all capital flow behaves the same way.** Money that shows up because of a mandate – payroll contributions, target date funds, pension rebalancing, benchmark requirements – doesn't care about price and doesn't reverse. Money that shows up because someone made a choice – chasing a theme, multi-manager platforms de-risking, retail piling into a trend – reverses quickly when that bet stops working. So, our view is lean into the mandated money and treat money that was a choice as a warning sign to reduce exposure or stay away, not a trend to chase. Confusing the two – pulling back from a flow that's actually mandatory rather than optional – is costly.

Stanley Druckenmiller said, “By far the best economic predictor I’ve ever met is the inside of the stock market. I don’t mean the stock market. I mean the inside of the stock market.” That’s only true if prices reflect real information. **Our contention is that prices increasingly reflect positioning, which means the market’s internals are telling you about the crowd, not the economy.** Our fix: fundamental research is what separates the two. We make no claims to have divergent and superior views on fundamentals, just a healthy appreciation for what is already “priced in” at any given moment and when the crowding begins bordering on irrational herding. When price moves beyond our definition of reasonable fundamental support, that’s our clearest signal to get out of the way – cut the position or stay out of it entirely. When price and fundamentals move together, that’s something with real staying power, worth holding through the noisy middle.

The last distinction that matters a lot in practice: **sector trades have a real anchor (their benchmark weight)**, so they behave like a credit relative-value trade against a known reference. Thematic trades, e.g. “biotech drug discovery benefiting from AI,” – have no such anchor, no gravitational pull back to anything. Keeping those trades on a short leash is paramount.

The standard objection to any strategy like this is that active management is zero-sum before costs and a loser’s game after them. That holds only if the market portfolio itself never trades – but it does, because passive funds have to buy and sell to keep up with their own inflows and outflows. **Once the biggest player in the market is itself a mechanical trader, the zero-sum math breaks down, and providing liquidity to forced sellers (and forced buyers) becomes a genuinely compensated activity rather than a bet against another smart investor.** The one thing that has to be true for us to actually collect that compensation: we can never be the ones forced to sell (or buy). Everything about our capital structure, leverage, and redemption terms exists to protect that one condition.

## VII. How we'd know we're wrong

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A thesis you can't disprove isn't a thesis. Here's what would tell us we're wrong, and what we're actively watching for:

- If managers with high active share start reliably outperforming again during a period of strong flows, the technical isn't really binding the way we think.
- If passive ownership plateaus and the market's sensitivity to demand actually recovers, the effect is self-correcting after all.
- If the previously observed calendar-based flow patterns get arbitrated away now that they're public – which we should expect and are actively measuring.

We also watch for specific ways this could quietly break even if the big thesis holds: our own trading becoming big enough to show up as flow itself; ETF trading volume looking healthy right up until it isn't (we only own and trade ~\$1bn+ AUM & >1mm shares/day volume ETFs); and – the most serious one – the fact that credit instincts are built to take profits and trade a range, which is exactly the wrong instinct in equities, where almost all the long-term return comes from a small number of stocks that just keep running. Our fix for that last one is structural, not willpower: we will maintain at all times a core total market cap-weighted equity exposure. This ensures we capture the winners over time a la Hendrik Bessembinder. The part of the market that produces the real long-term gains is always a core holding and we are never tempted to sell early.

## The bottom line

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The active management industry spent fifteen years explaining away its underperformance and about five years finally gathering the evidence to explain it correctly: demand curves slope down, the marginal buyer

doesn't care about price, and being different from the index now costs you money instead of making you money.

The two standard responses – traditional concentrated stock-picking, and the multi-manager platform model – have both failed on their own terms. One is still pricing a horizon the market doesn't care about anymore. The other has built a machine that generates the very dislocations it's trying to trade and charges a lot for the privilege.

There's a third option, and to us, it is not clever, is just accepting the market as it is:

1. **Treat positioning as the main risk**, and fundamentals as the tool for judging how long a crowd can hold together.
2. **Trade baskets**, because that's what the market actually prices.
3. **Flip between momentum and mean-reversion** based on what's really happening, rather than committing to one style as an identity.
4. **Stay structurally unforced**, so that providing liquidity to everyone else who is forced to transact becomes a repeatable source of return.

That's just a description of how corporate credit relative-value investing has always worked. It's what we've done for our entire careers. The equity market didn't ask our permission before turning into a market that looks like credit – but it did, and we already speak the language.

If we had to defend one statement against any challenge, it's this one:

**The equity market did not stop caring about what things are worth. It stopped letting that set the price. Positioning and technicals do that now; the equity market now runs on the same RECURSIVE logic our name describes.**

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**A note on sources.** The empirical claims in this letter – the finding that competition among active managers does not restore elasticity, the reversal in what active share predicts, and the month-start calendar effect described in Section I – come from published academic work over the last six years. We have kept the citations out of the body for readability, and will provide the full reference list, on request.

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