Who trades indices, and why most of it is not speculation

> **INDEX FLOW**
>
> The order flow moving index products. Most of it comes from participants under an obligation rather than a view: tracker funds replicating a benchmark, pension schemes rebalancing to a mandate, and desks hedging exposure they did not choose. Speculation is the visible part and the smaller one.

Ask why an index moved and the answers you find will be about news. A useful correction is to ask who was obliged to trade that day, because a great deal of index volume is not an opinion about anything.

Trackers have no discretion

A fund whose mandate is to track an index must hold what the index holds, in the proportions the index specifies. When money flows into the fund it buys. When the index changes its constituents the fund follows, whatever it thinks of the price.

That is a large and permanent source of demand with no view attached to it. It also means index membership itself has consequences for a company, because inclusion creates buyers who are required to buy.

Rebalancing is a calendar, not a decision

A pension scheme running a fixed split between equities and bonds has to correct that split as markets move. If equities have had a strong quarter, the scheme is overweight equities by arithmetic, and it sells to get back to target.

The direction is mechanical and the timing is known. Rebalancing flow concentrates at month-end and quarter-end, and it points the way it points because of what markets already did, not because of what anyone expects next.

Hedging is exposure someone did not want

A desk holding a portfolio of individual shares can neutralise its market exposure by taking an offsetting index position. It keeps the company-specific bets it wanted and sheds the market risk it did not.

The index trade there is not a view on the index. It is the by-product of a view on something else.

And then there is speculation

Directional traders, retail and professional, are real participants and index products are convenient for them - one contract expresses a view on a whole market without picking a company.

But they are a minority of the flow, and treating index moves as the aggregate opinion of people with views gets the market wrong. A significant share of what you are watching is somebody discharging an obligation.

Why this matters before you look at a chart

It explains why moves cluster at particular times of day and particular days of the month, which is lesson 9. It explains why an index can move sharply with no news you can find. And it is a defence against the most common error in market commentary: reading every move as a message.

Check your understanding

1. Why is tracker-fund buying described as having no view attached?

a. Trackers only buy when an index is rising
b. The mandate requires holding what the index holds, whatever the price
c. Trackers are not permitted to trade derivatives

Answer: b. Replication is an obligation. Inflows and constituent changes force trades regardless of what the manager thinks about valuation.

2. Why does rebalancing flow concentrate at month-end and quarter-end?

a. Because exchanges reduce fees then
b. Because mandates are checked on a calendar, and drift is corrected on those dates
c. Because index constituents change on those dates

Answer: b. A fixed allocation drifts as markets move, and the correction happens when the calendar says so. The direction follows from what already happened, not from a forecast.

3. A desk hedges a portfolio of shares by shorting an index. What does that index trade express?

a. A bearish view on the market
b. No view on the index - it removes market exposure from a company-specific position
c. A view that the index will outperform the portfolio

Answer: b. The desk wanted the company-specific bets and not the market risk that came with them. The index leg is a by-product of a view on something else entirely.