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Active fund managers and the rise of passive investing: Epistemic opportunism in financial markets

Yuval Millo, Crawford Spence and James J. Valentine

Abstract

Financial markets have witnessed a dramatic shift in financial flows in recent years from Active fund management where professional investors attempt to beat the market (generate ‘alpha’) to Passive investment where portfolios are assembled that follow existing market indicators (track ‘beta’). This transition has important implications for both corporate governance and wider society,

Yuval Millo, University of Warwick, Coventry, United Kingdom. E-mail: yuval.millo@wbs.ac.uk

Crawford Spence (corresponding author), King’s College London, London, United Kingdom. E-mail: crawford.spence@kcl.ac.uk

James J. Valentine, Marquette University, Milwaukee, WI, United States. E-mail: james.valentine@marquette.edu

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with potentially significant distributive effects. Passive investing is predicated upon different bodies of knowledge and is suggestive of an epistemic shift of sorts in financial markets. In such circumstances, field theory suggests that incumbent groups like Active players will try to adapt to the new rules of the investment game. However, drawing from an empirical study which explores the views of the Active investment community in both the United Kingdom and the United States, we document significant defensiveness *vis-à-vis* the rise of Passive investing. Whereas behavioural approaches might explain this defensiveness in terms of irrationality, the conceptual approach advanced here instead emphasizes the epistemic opportunism (convoluted and self-serving attempts to demonstrate superior knowledge) that communities strategically engage in to justify their position. As such, we conclude that financial markets should be understood as constituted by slowly evolving communities of practice whose habits, routines and ways of knowing can be difficult to shift, even when faced with overwhelming evidence that what they are doing doesn't work most of the time.

Keywords: fund management; passive investing; index investing; active investing; epistemic opportunism.

1. Introduction

Financial markets in recent years have witnessed a seismic shift in investment flows from Active funds, which seek to beat the market, towards Passive funds, which seek to broadly mirror market performance, or segments thereof. By some measures, the volume of assets managed by Passive funds now eclipse those managed by Active fund managers (Gittelsohn, 2019; Whyte, 2021), a trend which shows no signs of abating. The gravitation towards Passive funds can be attributed primarily to the high fees charged by Active funds and the relatively poor returns they tend to earn for clients. For example, it has been shown that index equity funds cost an average of about 10 cents a year per \$100 of assets, compared with 70 cents for Active funds (Gittelsohn, 2019). This illustrates the challenge facing Active fund managers who are not merely under pressure to 'beat the market' but to do so after fees have been considered. Indeed, the rise of Passive investing has also led to downward pressure on Active management fees. For example, the average expense ratio paid by investors in mutual funds roughly halved between 2000 and 2020 and appears to still be on a downward trajectory (Johnson & DiBenedetto, 2021).

Data shows that Active fund managers hardly ever 'beat the market'. Evidence supports the view that the Active fund management industry consistently underperforms its relevant benchmarks and that index investing offers a better solution for investors. For example, based on data from 1970 to 2001, Malkiel (2003) shows that the median US mutual fund produced returns more than 175 basis points lower than returns from the S&P index after expenses. More recently, Morningstar's comprehensive analysis of the

performance of Active versus Passive funds in the US equity market shows that only 23 per cent of Active funds outperformed their Passive counterparts over the period of 2010–2020 (Johnson, 2021). The performance of Active versus Passive funds is also regarded as a cause for the consistent capital flows from Active fund management to Passive over the past two decades. Chronic under-performance, combined with relatively high fees, lead commentators to describe financial intermediation (of which Active fund management is a major component) as either grossly inefficient (Philippon, 2015) at best, or as an unjustifiable tax on society at worst (Arjaliès et al., 2017).

While there are benefits to investors from switching to Passive strategies (e.g. index investing, exchange traded funds/ETFs), such strategies may also have troubling consequences in terms of wealth distribution and corporate governance. Index investing has given birth to new monopolies, with the ‘big three’ indexers of Vanguard, State Street and BlackRock now owning about 20 per cent of the S&P 500 (Wigglesworth, 2021). This increased concentration in institutional investment heralds a new chapter in ‘asset manager capitalism’ (Braun, 2021), in which power shifts ever more towards financial intermediaries and further away from individual savers and pension contributors. This shift privileges index-related events that in themselves contain no new information to market actors. For example, inclusion in an index alone generates automatic price changes for the stock in question. The move towards index investing also means that corporate governance is increasingly shaped by a small number of economic agents with no real skin in the economic game and who arguably have even less interest in engaging with management than their Active counterparts (Braun, 2021).

Our intention here is not to lament the demise of Active fund management – indeed, one could be forgiven for experiencing *schadenfreude* for a field that can be lambasted for its own deleterious distributive effects (Arjaliès et al., 2017) – but to understand the shift from one dominant investment mode to another. The shift from Active to Passive investment is reflective of deeper changes in financial markets, implying a new nexus of social structures, new practices, and different bodies of knowledge. This shifting field structure should be evident from the discourse of the actors who populate the field (Fligstein & McAdam, 2012). As such, probing the discursive strategies that these actors advance affords an opportunity to both highlight what is at stake with the shift from Active to Passive investing and to observe how this change reflects societal processes related to the distribution of power and the nature of knowledge in the new cybernetic capitalist order (Ström, 2022).

We explore this shift empirically by documenting how Active fund management actors explain the relative strengths and weaknesses of Active investment strategies in the face of the increasing dominance of Passive approaches. We focus on this category of actors because, unlike index investors, their viewpoints *vis-à-vis* their own utility and impact upon society have been well documented by prior research (Ellis, 1975; Millar, 2021; Taffler et al., 2017), thereby establishing a baseline against which to compare recent developments. Our findings

present a puzzle. As the economic landscape surrounding Active fund managers changes, one might anticipate a reciprocal change in the worldviews held by the Active investment community. Instead, we find a recognition of the merits of Passive investing coupled with a simultaneous defensive attachment to existing epistemic parameters, tantamount to a discourse that supports inaction. Informed by the findings, we develop the concept of *epistemic opportunism* as an explanandum for why the Active investment community reacts to its potential demise in such a way. Building on our analysis, we discuss the implications of what we see as epistemic opportunism in financial markets more widely. We suggest that financial markets should be understood as characterized by slowly evolving communities of practice whose habits, routines and ways of knowing can be difficult to shift, even when faced with overwhelming evidence that what they are doing doesn't work most of the time. This insight can serve as a basis for analysing market fads and bubbles, not as outcomes of irrational behaviour *à la* behavioural finance, but as manifestations of the social nature of the communities of practice who constitute financial markets.

2. Communities of practice in the investment field

The Active fund management world is understood here as a community of practice. Communities of practice are conventionally defined as groups of people informally bound together by shared expertise and passion for a joint enterprise, who regularly interact to learn or improve their practice (Lave & Wenger, 1991). The concept of communities of practice offers a parsimonious account of the connection between expert knowledge, social organization, their perpetuation in time, and the emergence of novelty (Nicolini, 2022). All of these are explored in this paper as we consider the knowledge base of actors, how they organize themselves, what their views are in terms of whether their position in the social space is secure, and how they respond to external stimuli. While many interpretations of communities of practice exist (Nicolini, 2022), our understanding of them as sites of struggle and conflict over power and expertise has much in common with a Bourdieusian field (Bourdieu, 1979). As in other fields, Active fund management has conditions of entry, particular logics that govern field structure (Lounsbury, 2007), different forms of capital that are more or less valued by its participants, and a relatively distinct habitus embodied by its members (Millar, 2021).

Regarding actors involved in Active investments as members of a community of practice allows us to address the social and cultural dimensions of the seemingly technical knowledge associated with Active investment. The Active investment community of practice evinces a particular worldview. This worldview is built around the possibility of 'generating alpha' (Taffler *et al.*, 2017) or in the mantra to 'beat the market' (Ellis, 1975). This elusive goal can be understood, simply, as improving returns while

not taking on additional risk. However, as our findings indicate, this belief is more far-reaching than its mere economic meaning. Those who do appear to successfully 'generate alpha' on a consistent basis can be accorded celebrity status and their investment advisors labelled 'star research analysts' via mechanisms such as annual *Institutional Investor* surveys (Traflet & McGoun, 2008).

Notwithstanding these practices that undergird alpha generation discourse, self-belief in the Active investment community has been shown to be fragile (Chong & Tuckett, 2015). Fund managers tend to both believe and not believe that they can 'beat the market' (Taffler *et al.*, 2017), and, relatedly, both believe and not believe in market efficiency (Roscoe & Willman, 2021). This is suggestive of a certain cognitive dissonance (Festinger, 1957) held by members of the Active investment community. The rise of Passive investing introduces an interesting dynamic to this epistemic tension. On one hand, the growing success of Passive strategies like index investing carries with it the premise that it is not possible to beat the market. As such, the conflict in the Active community between circumstance and belief intensifies, much in the way that it does when members of religious groups are faced with failed prophecies (Hood, 2011). However, in such circumstances, members of religious or other groups often tend to increase their commitment to their beliefs and even start to proselytize more vigorously. In sociological terms, such responses constitute attempts to avoid the 'hysteresis' that ensues when objective possibilities are out of sync with subjective aspirations (Bourdieu, 2000). This characteristic of the Active community – its core belief in the possibility of beating the market – invites re-examination in light of the rise of Passive investment.

A further characteristic of the Active community is its multivocality. Communities of practice, as is the case in other fields, have many sub-spaces within and surrounding them (Fligstein & McAdam, 2012). For example, Godechot (2016) has looked at the boundary work undertaken by those working in a trading room who are keen to distinguish themselves from others pursuing different investment strategies such as mathematical arbitrage, economic analysis and chartist analysis. Beunza and Garud (2007) show how different analysts covering the same stock often apply quite different intellectual frames when adjudicating over valuation and prices. Similarly, Preda (2007) outlines two very distinct traditions within the world of financial analysis: chartism – the epistemic attachment to stock price and volume changes over time; and, fundamental analysis – the epistemic attachment to a range of valuation procedures drawing on a broad range of accounting, company and industry information.

While these works highlight various distinctions internal to the world of Active fund management, the literature also implies that the differences *within* the Active community are distinct from the differences *between* the Active and Passive communities. Critically, while different Active strategies disagree on the right way to understand the market and intervene, the Passive approach argues that any such intervention is unlikely to bear fruit in

any case. As a corollary, this challenges the professional standing of Active managers.

The literature on communities of practice suggests several reactions from incumbents when such fundamental challenges to legitimacy are raised (Nicolini, 2022). One reaction entails asserting a strong identity, which can rally previously disparate members of a community together and offer a renewed sense of purpose. Another defensive manoeuvre is to delegitimize non-members' knowledge and establish boundaries between 'us' and 'them'. Finally, communities can also defend their existing field position by framing a practice as inaccessible to others, perhaps by inscribing their worldviews into particular artefacts or practices.

These defensive strategies above constitute different forms of symbolic boundary drawing (Lamont, 1992) or, as we prefer to label them here, *boundary work*. Identifying whether members of the Active fund management community engage in such boundary work *vis-à-vis* another community that appears to evince a quite different epistemic regime (Seabrooke & Tsingou, 2014; Seyfert, 2016) would give clear evidence of a community that was facing an existential threat, as well as offering some indication of the extent to which they are adapting to that threat or not. As Nicolini (2022) points out, many of these defensive tactics can actively thwart learning and frustrate innovation, which potentially point towards failures to adapt.

Our reading of these various literatures thus motivates us to explore how the Active investment community reacts to the rise of Passive investment. This exploration should offer insights into, not just the extent to which the Active investment community is adapting to a seemingly existential threat, but into the ways in which groups of actors in financial markets more broadly manage to persist despite clinging to an epistemic regime that is seemingly at odds with the changing intellectual landscape.

3. Methods and sample

3.1. *Data collection*

In total, we interviewed 70 investment professionals between April 2019 and May 2021. Our interview sites were London, Chicago and New York, and were relatively balanced between those working in mutual or investment funds (buy-side) as either analysts or portfolio managers and their equity analyst advisors working for investment banks (sell-side).¹ These two broad links in the investment chain (Arjaliès *et al.*, 2017) constitute a core section of the Active fund management industry and are taken as representative of this community.

On the fund management side, our participants were involved with managing assets between \$120 million and \$135 billion, with average assets under management of \$14 billion. Their experience and seniority ranged from one

year out of college through to 30 years in the fund management industry. On the sell-side, our participants were drawn from a range of analyst firms, including specialist research providers, boutique investment houses and bulge-bracket investment banks. Again, their experience varied considerably, from two years out of college up to 20 years in the field. Our sample as a whole covered various sectors including technology, financial services, real estate, industrials and transportation. While all the sell-side analysts and most of the buy-side analysts were assigned to specific industries, a portion of the buy-side population were generalists in that their 'investment universe' covered any industry of interest.

Our sample was more heavily weighted towards those that Godechot (2016) classifies as pursuing 'economic analysis', privileging those engaged in more fundamental approaches and portfolios of less than 50 stocks. A small number of our interviewees pursued statistical arbitrage strategies so we have some insight into this group, but our main insights come from those of a more hypothesis-driven, fundamental analysis disposition. Our interviews lasted generally 60–75 min and explored the different investment/advice strategies of these actors and covered in detail the rise of Passive investing and how this was impacting upon their work, both in a practical day-to-day sense as well as in terms of how this altered their views on the role and prospects of Active fund management.

3.2. *Data analysis*

The transition from data to conceptual narrative of our findings was facilitated by the pursuit of an approach inspired by the Gioia method (Clark *et al.*, 2010; Gioia *et al.*, 2013) which is interpretive in nature and calls for giving appropriate space and voice to the actors under study. This provided a road map by which we identified first order (descriptive, participant driven) themes followed by second order (conceptual, theory driven) themes. During the data analysis phase, the writing team iterated between data, emerging themes, cognate literature and wider social theory in order to develop a deeper understanding of the Active community.

Our first order analysis was undertaken using the NVivo software package. A limited number of transcripts were read by all members of the writing team and then discussed. This process served to identify broad areas of thematic interest. Following this, a largely inductive coding process was conducted by a single knowledgeable coder (Campbell *et al.*, 2013) who produced over 50 first order themes. Each theme and its content were then read and discussed by the three members of the authorial team in detail. These discussions identified several overlaps and higher-level categories that many of the sub-themes might have been collapsed into. The outcome of these discussions was to identify a smaller number, still primarily descriptive codes, before proceeding to a more conceptually driven second-order data analysis.

Our second-order data analysis proceeded by rebounding iteratively from data to literature on fund management/Active and Passive investing to wider theoretical studies and back again, all the while discussing in detail the emerging findings and the best way to interpret them (Gioia *et al.*, 2013). We looked at overlapping themes and re-labelled certain first order categories accordingly. A limited number of interview quotes were coded more than once as they resonated with more than one identified theme. While we avoided going as far as producing inter-coder reliability percentages as we felt this to be inconsistent with the interpretive approach adopted (Clark *et al.*, 2010), we nevertheless sought to instil rigour into the data analysis process through multiple encounters and readings of the first order codes by members of the ‘interpretive community’ (Syed & Nelson, 2015, p. 10). As such, the move from first to second to eventually third order codes did not proceed until all members of the authorial team were happy with interpretations at each transition stage. In the narrative below, we rely on the language of the actors themselves, recognizing that the subjective interpretations of research subjects, even when self-serving (Whittle & Mueller, 2012) are rich resources for theory building (Ahrens & Chapman, 2006).

4. ‘Active’ community of practice discourse

4.1. *Recognizing the threat*

Before considering in detail the defensive strategies we identified among the Active community, we will first document, if and to what extent Passive investing is regarded as a threat to the Active community and how the growth of Passive investing impacts upon the Active community on a day-to-day basis.

4.1.1. *A shrinking eco-system* There was widespread recognition that more and more funds were being ‘lost to Passive’. This trend was explained by superior fund performance and lower fee levels. Indeed, the shift towards Passive was regarded as logical by many fund managers, who conceded that most investors would lose money after Active fees were considered. This shift is further compounded by what was seen as a lack of effort or skill on the part of the Active community members, as the following example around the understanding of property, plant and equipment (PP&E), a basic label in balance sheets, was advanced to illustrate:

There’s an analyst who called me from another one of the very big asset aggregators, and we had written a report and that analyst was covering it. And I’m speaking to the person, and the question I get asked is, ‘You are raising a question about PP&E. What is PP&E?’ ... The amount of ignorance on the buy-side is mind blowing, and that’s one of the big reasons why I think there is no alpha generation happening, why the industry is moving towards Passive ... Steve Cohen is right

when he says, 'the industry has a massive lack of talent'. It's just made up of very average people who just don't know what they are doing. (BS40)²

Implicit in this characterization of the 'buy-side' is a boundary drawn between those who are average and those who are not. Presumably, this portfolio manager, who knows what PP&E is, puts himself in the non-average category, thereby creating a boundary internal to his community.

One hedge fund manager observed a shift in recent years from '20 per cent Passive to almost 40 per cent Passive now, especially in trading volume anyway' (BS3). Some saw a grim future for the Active community, with fees, headcounts and the overall size of the sector all gradually diminishing (BS35, SS1, BS41). This was seen by some as an irreversible or secular trend, irrespective of whether the bull market would turn bearish at some point:

I don't see any reason why this trend towards Passive management won't continue even if the market hits the skids, which it eventually will. I still think it's going to take something dramatic for Active management to come back. (SS21)

Many interviewees were so persuaded by the growth of Passive investing that they themselves almost sounded like advocates for it:

You can see the attraction of Passive because you're saying, well most fund managers don't beat the index. So, why am I paying all these high fees when on Passive products the fees will be lower. [And] in terms of the performance [it] is the same or actually slightly superior. (BS59)

All my own money is in index funds. (SS27)

This latter respondent was then asked what motivated him to go to work every day if he believed that Active asset management was a largely futile activity:

I get out of bed each morning thinking I have an incredibly interesting job. Because I can learn about China one day and Mexico the next and micro fluidics the next day and aircraft engines the next day and it is a very interesting job. And then debate things with smart people about, I almost liken it to being a sports commentator, like we are up in the field commentating on the companies that are battling each other out in the marketplace, on the field and we are commentating on who is going to win and lose by how much. (SS27)

This statement, as the one presented earlier about how a particular Active fund manager differs from the many who 'lack talent', supports the multi-vocal nature of Active community and highlights a typical instance of the boundary work we encountered frequently among the interviewees. Active fund managers frequently draw boundaries within the Active community between the

general herd on the buy-side and an elite few who know more, have a superior understanding of markets and, in general, regard themselves as intellectuals.

In summary, interviewees confirmed that Passive investing is a growing phenomenon in financial markets, even to the extent that many recommended Passive investment vehicles rather than their own, actively managed funds. This acknowledgement, in several cases, was coupled with exhibition of internal distinctions within the Active community, between elite analysts and fund managers and ‘the rest’, with those making such distinctions generally placing themselves in the elite grouping.

4.1.2. *Passive price distortions cause problems for Active managers* Beyond the obvious threat posed by the growth of Passive funds, Active managers also highlighted problems that Passive trading causes by changing the causality in financial markets, thus making Active analysis less relevant. In the following example, a hedge fund manager refers to momentum trading, a trading strategy that builds on existing trends and gambles on their continuation for a particular time period:

The price momentum in the market is a real thing, obviously. And I think it gets more prevalent as the years go by, really, with more machines making investment decisions. (BS3)

This actor’s concern about the increasing prevalence of ‘price momentum’ is rooted in the fact that such price movements do not represent opinions about the fundamental value of the assets being traded, but instead aim to gain from others’ opinions and, crucially, in doing so, amplify these price movements, causing the market to ‘deviate’ from what the prices ought to be according to a fundamental value analysis. This view was echoed by another hedge fund manager, who stated that algorithmically traded stocks (a process that index investing relies heavily upon) caused unexplainable price movements:

This stock for example, *for no reason at all*, suddenly started spiking 5, 10 per cent each day for just two weeks, that’s it, two weeks, the stock doubled, went from 10 to 20. And then came back promptly within two weeks to 10 back again, and then went to seven. So we would have made 30 per cent net if we had nothing else wrong. But the point is the way it works is, somebody writes a positive note on the stock, one of the robots pick it up, so some algorithms buy some more. It becomes a self-fulfilling prophecy, and that kind of pulls the stock up, up and up. (BS40)

The unexplained price movements described in the quote above reveal the depth of the epistemic gap between the world assumed by Active traders and the emerging reality of replicative trading strategies in the market. In a market populated only by human Active traders, one might be able to identify and understand events in the world that would lead to a stock doubling in price.

However, in a market dominated by algorithmic trading strategies, opinions are amplified rapidly leading to dramatic price changes. Such a process can create an economically punishing environment for the Active community.³

Such gaps in the ability to generate a coherent picture of the market are also perceived as impacting securities analysts who work within an Active worldview. The analysts struggle to explain price spikes or drops to their fund manager clients:

Algorithmic and fast money is another huge topic because it's changing the dynamics of the stocks that we cover ... it's creating these more drastic changes in stock prices ... If a client calls, they're like 'Why is this stock down 10 per cent?'. They miss margins or something, modestly, and it's like 'Ah, I don't know'. Or maybe it's like the algorithms or whatever, it's a very common thing. (SS22)

A more aggregate outcome of the replicative and amplifying nature of these trading strategies is the concentration of trading positions:

So, what I see is that everybody's following the same, everybody's chasing the same stocks, everybody's chasing the same investment ideas and not only this year, the year before and the year before. *So maybe the whole economic and financial environment is prompting active investors to follow the same idea and there is little outperformance.* (BS33, emphasis added)

The momentum created by Passive funds and robotized ETFs means that larger and larger sections of the market end up chasing the same opportunities, making it harder for Active funds, whose *raison d'être* is to outperform the market, to fulfil their mission. To stress, the market concentration ('everybody's chasing the same stocks') is expressed not only in asset prices, but, even more dramatically, in traded asset volumes. The impact of Passive strategies is so strong that little trading volume is directed to other assets, making the latter more susceptible to price changes and thus riskier.

Actors in the Active community are aware of their epistemic inability to explain price movements in a market dominated by Passive strategies. One fund manager, for example, pointed out that his fund had a policy of not investing in stocks that were tied to 'robot ETFs' because it was, in his view, impossible to make sense of the price changes that these cause:

It's basically just from the informational perspective and understanding risks, versus we wouldn't invest in something that is tied to a robot ETF, even though they don't have any robotics, so that it might move wonky, different than what you would expect. (BS19)

This interviewee then went on to explain how 'over time, it all corrects' – evincing an underlying belief in efficient markets – but that robot ETFs cause

short-term price distortions that make it hard for Active funds to make sense of, a view clearly shared by many others in the Active community.

In summary, Passive funds are perceived as creating practical problems for Active fund managers by causing price distortions that are difficult to trade against. Coupled with the more generalized existential threat that a growing market share of Passive funds constitutes, this creates a double whammy for the Active community. However, notwithstanding these practical problems and the broader existential threat posed by Passive investing, Active fund managers and their advisors often remained sanguine about the prospects for the Active fund management industry, thereby resolving any cognitive dissonance that they may be experiencing (Festinger, 1957; Hood, 2011). The following section and series of sub-sections speak to the boundary work that they undertake in highlighting how Active fund management is, in their view, still ultimately superior to Passive investing.

4.2. *Boundary work*

4.2.1. *Asserting a strong identity* Before exploring the views of Active fund managers *vis-à-vis* the growth of Passive investing, it is worth spending some time to understand the epistemic and expertise base of those operating in the Active community, as any adaptation in the face of community-level threats is likely to entail a concomitant shift in the dispositions of the actors who populate the community. Despite societal trends towards data analytics, big data and increasingly automated ways of processing information, members of the Active community were relatively unimpressed by these:

I think there probably are some [*sic*] boutique-y places that would be hiring specific computer people to look at the information flows and how computer programs can be set up to kind of exploit that, but that would be a specialist area. As a general sell-side analyst, I think you're still looking for people who would have financial expertise so whether it's accountants or MBAs, I think you still need to understand how accounts and finances and financial modelling works. I don't think that's changed at all. (SS50)

Highlighting the importance of a traditional knowledge base and forms of expertise is a key means of a community asserting its identity (Nicolini, 2022). This, as the quote above shows, is done through asserting that the normal knowledge applicable to understanding and acting in the market is that of the Active community, whilst Passive-related knowledge and experts (information flows, computer people) are presented as marginal and appropriate only in specific situations. In this respect, not only were big data and data analytics seen as the preserve of others, technological change *per se* was in some ways passing the Active community by, in ways that did vex some of its members:

But at [this firm], there are still people who just need to print out the research on their table and tell them to read it. Don't know how to use the computer. It's amazing. One of the top fund managers. We need to read from paper. He has a printer and his PA printed it out for him. He still has a paper diary, which is frustrating. Has a little eraser. (BS43)

The individual described here may be something of an aberration, but the interviewee's description of him is suggestive of a community that may be stuck in its ways and struggling to learn or innovate.

Buy-side individuals that we interviewed generally held a long-term time horizon (six months minimum) and held a portfolio of less than 100 stocks. As such, they were stock pickers who evinced a strong attachment to fundamental methods of analysis which emphasize micro-level analysis, speaking to individuals and judgemental interpretation of specific events or news items.

Related to the marginalization of Passive-related knowledge was another strand of this type of boundary work, which focused on the inherent superiority of Active over Passive. In many cases, this was expressed by highlighting the advantages of human over machine-driven analysis. The following sell-side analyst described why going out and speaking to people remained very relevant in his view:

I'm focusing more on the unique things that I can do because anybody can go out and buy access to a database. If I can go out and kind of take people to go meet people that they would otherwise never [have] known, or if I can go out and talk to people that they would have no access to, that's a way for me to compete against supercomputers. (SS1)

Collecting information and generating interpretations through face-to-face interactions are presented as highly valuable and irreplaceable, both due to differences in the availability of information ('access'), but also due to information discovery ('meet people they would have otherwise never known'). This latter part alludes to limitations of the algorithmic nature of Passive investment: in most Passive strategies sources of information to be investigated need to be scripted in advance into the algorithm. This eliminates, in effect, the potential of serendipitous findings that may be beneficial for investors. These views were in the majority, although we also witnessed important nuance. For example, the following fund manager was keen to embrace more big data and AI, already incorporating some elements of this into his investment process by using predictive modelling and machine learning, but felt frustrated that his small firm's financial constraints and general scepticism prevented him from doing more in this regard:

I think in today's world, I think you need a bit of everything. Old-fashioned fundamental analysis is not going to make things work. I think big data is ultimately

where I want to see myself, incorporating a larger and larger part in my business. (BS46)

This more agnostic approach to market worldviews, which can be seen here as methodological syncretism ('you need a bit of everything'), however, was in a strict minority. By and large, Active community members had much faith in their own processes and were keen to highlight the importance of their training and the experience they had picked up over (in some cases) long periods of time in the investment world. In this respect, they continued to assert their identity as hypothesis-driven, relying on small data and bottom-up forms of analysis.

4.2.2. *Delegitimize others I: Active needed for price discovery* The marginalization of Passive is also related to a strong theme that attaches Active to the natural order of the markets and, relatedly, presents Passive as introducing biases or distortions. In contrast to the lamentations around price distortions reproduced above in section 4.1.2, some respondents saw the distortive effects of Passive funds as potential sources of value for the Active community, and for society more broadly. In this respect, one community seeks to *delegitimize* the competing community (Nicolini, 2022). For example, the following fund manager explained the importance of identifying firms that were about to be picked up by passive ETFs: 'when you've got a company that is looking to, that is on the cusp of entering an index, you gotta pay attention to that' (BS17). Once a firm enters an index, the interest in it increases significantly because of the demand created for its stock by ETFs. Active managers can also take advantage of the price surges that tend to follow, as the following fund manager describes:

Actually, the growth of Passive represents perhaps an opportunity for us, which I hadn't really appreciated before. There's some really good research out there, I think actually it came out of Goldman Sachs, which was related to the clearing of these, these sort of instruments and how that leads to some weird market dynamics which [we] can actually be profitable from. (BS48)

The notion that price distortions create opportunities for savvy, Active players alludes to a 'price discovery' function that the Active community perceives itself as performing for the market more broadly. The Active worldview proclaims that markets reveal the fundamental value of assets through their operation. This, however, may happen only if actors who follow fundamental value principles dominate trading. When such actors do not play a dominant role, prices deviate from their intrinsic value. Such deviations, though, can serve as opportunities. For example, one equity analyst illustrated at length the ways in which an Active analyst such as himself could, through diligent research, identify 'inflection points' in stocks that a Passive investment vehicle would miss. The example he gave was of a company running a gene therapy trial that aims to slow degenerative blindness. Predicting whether or

not the therapy would be approved by the regulator was something that, we were told, required in-depth industry knowledge that ‘no electronic trader could pick up’ (SS39). This highlights the perceived importance of undertaking proprietary research in order to gain an in-depth view of the likelihood of a particular stock taking off or not. Passive strategies, this analyst pointed out, cannot incorporate this sort of background channel checking because they simply jump into a stock once it has already surged enough to get into the index. As a result, many respondents see the Active investment community as both being able to benefit from such strategies and serving a wider price discovery function for the rest of the market. Similar views were echoed by those on the buy-side too:

If everyone goes Passive, who’s doing price discovery? And does it then actually swing back and become easier for Active managers? Now, I’ve seen no evidence that that’s true, but I understand the idea that if the world goes Passive, you want to be the one Active manager out there because there’s suddenly gonna be opportunities for you. (BS57)

In sum, despite the growth of Passive investing and the overall case against Active investment strategies, these specific examples presented as price deviations being uncovered by Active researchers were cited as evidence of the continued relevance of the Active community. In general, the Active community is there to protect and preserve the ‘natural’ order of the market. In contrast, the Passive community was presented as unable to perform this role and, despite occasionally providing benefits, is the cause of many price distortions in the first place.

4.2.3. Hopeful fantasizing: Bring on the bear market! A different strategy of delegitimization was also evident from our data analysis. Specifically, the Passive community was seen as only able to operate in certain market conditions and thereby of limited ultimate utility. For example, one hedge fund manager didn’t see Passive funds as a threat at all to his investment strategy. Rather, speaking in spring 2019, he was looking forward to the next economic downturn, which he said Passive funds would be unable to hedge. Indeed, he welcomed the growth of Passive funds, as this presented him with ‘more lambs to the slaughter’ (BS20).

In slightly less combative language, another portfolio manager welcomed the growth of Passive funds as these, in his view, led to less value being ‘priced in’ which, particularly in a bear market, meant that there would be opportunities for savvy, Active investors like himself:

I don’t know what the tipping point is. People are saying that as more flows into Passive, the hope is that we can eventually go back to an era ... It may not be what it was 20 years ago, maybe like 10 years ago. We can go back to an era

where it would be a lot more easy to make money. Less people playing, and the return, the alpha, could be bigger in the space. (BS28)

Others also expressed a hope that Active funds would be proven more valuable when economic downturns came around again:

And I'm not quite sure just personally whether momentum trading will work in the downturn because we had an upturn and it's all about chasing the up cycle. But whether the old rhythm will figure out when things start collapsing, liquidity will dry up, so I don't know whether in a bear market that would be as popular as now. (BS43)

The boundary drawn here between bull and bear markets serves to position the Passive community as helpful for investors in one, but not the other. As we interviewed Active actors during the pandemic, the widely expressed thesis about the superiority of Active during bear markets became more nuanced. For example, the following equity analyst who was interviewed about 15 months into the COVID pandemic stated:

And I think it'll be very interesting if we're going through a period now that who knows quite how long it'll last but it does clearly offer the buy-side, much alpha generation opportunities. I think the argument that might have been valid 12–24 months ago, that it's very hard to generate alpha against Passives, is just not, you know, as clearly the case right now. (SS37)

The argument that Active fund management provides superior performance to Passive strategies in volatile or downward trending markets is not supported in recent findings that show that in the first six months of 2020, when the COVID-19 collapse of global financial markets occurred, almost half of actively managed UK equity funds underperformed a common benchmark.⁴ Nevertheless, Passive investment strategies are presented as risky approaches when prices are generally in decline because they have no ability to: (a) predict when this might happen; and, (b) hedge against such eventualities due to their being generally 'long-only' in orientation.

4.2.4. *Framing a practice as inaccessible to others: ESG to the rescue!* One final identified dimension, particularly by British rather than American interviewees, as a key advantage that the Active community held over the Passive community was the ability to incorporate meaningful Environmental, Social and Governance (ESG) factors into investment strategies. ESG was framed as a practice area that was inaccessible to the Passive community, thus constituting another form of defensive boundary work consistent with a community that is feeling threatened. As the following interviewee indicates, one of the key phenomena driving the growth of his fund's Assets Under Management

(AUM) – which he admitted was underperforming relative to benchmarks – was his firm’s willingness to deal with ESG issues:

When we started about two years ago, it was just a small proportion of investors that wanted ESG. Nowadays, most people actually want it. And the main reason nowadays why we have been able to grow our assets was because of ESG. It wasn’t because of the systematic return prediction or alpha process, it was because of ESG. (BS63)

The above interviewee was a ‘systematic’ investor, corresponding more closely to Godechot’s (2016) sub-community of mathematical arbitrageurs. His views on ESG as an opportunity for the Active community, however, were echoed in some form by those of a more fundamental approach. For example, the following interviewee describes how ESG and engagement (engaging corporate boards through mechanisms such as voting at AGMs or proposing shareholder resolutions) are his fund’s ‘secret sauce’:

Yeah, I think [ESG and engagement] are fundamental to what makes us a good Active manager. And actually, I would go as far as to say that engagement is our secret sauce ... And I would, arguably, I would say that is the edge. And it’s the one thing that cannot be commoditized by the Passives and can’t be modelled. (BS58)

This head of investment effectively oversees a group of fund managers in his firm. He goes on to explain the various ways in which engagement works for them:

It’s about going and talking to the C-Suite, it’s about talking to the board, about setting objectives and having measurable steppingstones, to get to those objectives. We’ll only ever have two or three things that we’re talking to a company about. There might be one sort of overall, I call it a guardrail activity, which might be around governance. So it might be board composition or exec pay. And then it pisses off, you know, we vote against their executive pay, even if that’s not the issue. The issue is you’re emitting too much carbon, but you won’t take it seriously and you won’t listen to us, then we’re gonna vote against your executive pay. (BS58)

The detailed explanation around engagement here is designed to hammer home the point that Passive investment vehicles, even if incorporating some ESG screening criteria, are not designed to undertake this form of stockholder engaged stewardship. If investors want to be ethical, we were told that they would have to enlist the help of the Active community. Similar views, which have more than a hint of the self-serving hero narrative to them (Whittle & Mueller, 2012), were expressed by other fund managers too:

People talk about decarbonizing their portfolio and the need to address climate change, either to help solve climate change or to take advantage of it, it isn't easy to get to a truly Passive solution. (BS57)

The notion that Active fund management had an advantage over Passive investment vehicles in the ESG space was keenly contested by an advisor to pension trustees whom we spoke to on this issue:

I find that incredibly rich of the active fund industry, which have largely for decades, cared nothing about stewardship that, all of a sudden, they're under this massive existential threat from Passive, they're saying, 'Oh. You've got to be an active investor to ensure that companies are being held to account on issues like the environment and society and so on'. (SS62)

Beyond pointing out what he saw as the hypocrisy of the Active investment community on this issue, this respondent went to claim that Passive actors, due to their commitment, in many cases, to owning a set of assets, are less effective in their ability to persuade corporations to change undesired policies:

if you're an Active manager, and you don't like what the board is doing, you can just take the toys away if you like. But if you're a Passive manager and your mandate requires you to carry on investing in those funds, you have no choice but to carry on engaging. (SS62)

The implication here is that 'taking the toys away' (divesting) is a strong tool in the Active funds' toolbox, but one that does not bring about change, as others in the market will buy the assets in question in any case. In contrast, the argument goes that Passive funds, which are tied into certain companies due to index tracking principles and lack the option to divest, are forced in effect to engage with companies and are more likely to bring about change in corporate behaviour. Such criticisms notwithstanding, ESG appears to have emerged as a key justification for the continued allocation of capital to the Active fund management industry.

5. Discussion and conclusion

The seismic rise of index investing in recent years presents an intellectual challenge to the epistemic regime (Seyfert, 2016) of the Active investment community, which one might anticipate would be taking steps to adapt to these changing field conditions. However, while research has shown that the Passive community is very active in ensuring that its investors behave passively (Hayes, 2020, 2021), we show here how the Active community is rather inactive about its own decline relative to index investing. Our findings indicate that the Active community is falling back on the well-established dispositions and

practices of its actors, effectively fighting this threat with what prompted the rise of Passive in the first place. Rather than proactively outlining adaptation strategies, we found that interviewees engage in discursive boundary work that aims at justifying their doing the same things that they have always done. Among the 70 subjects interviewed, fewer than five mentioned any efforts by their firm or individually to adapt to this change through training or adopting new investment techniques. In addition to the three defensive strategies outlined by Nicolini (2022) – asserting a strong identity, deligitimizing others and framing a practice as inaccessible – the Active community also engages in a fourth: hopeful fantasizing. Critically, each of the defensive distinctions we identified is contestable. For example, many Passive firms have large ESG engagement teams; there is bountiful evidence suggesting that Active strategies fare even worse in bear than bull markets (Johnson, 2021; Pástor & Vorsatz, 2020).

However, the plausibility of the Active community's defensive boundary work is of less interest here than charting what it is tantamount to. We suggest that the boundary work serves to resolve community-wide cognitive dissonance that the Active community is facing and, ultimately, supports a logic of inaction. We coin the term *epistemic opportunism* here to capture these dynamics, denoting as it does the convoluted attempts to justify an existing epistemic regime (Seyfert, 2016) in the context of existential challenges to it.

We suggest that the Active investment community engages in discursive epistemic opportunism rather than (say) more comprehensively adapting their material investment practices for a number of reasons. First, epistemic opportunism can provide meaning and purpose. Just as other groups of financial actors need to tell themselves that what they get out of bed in the morning to go and do has meaning and utility and that they are not the bad guys (Whittle & Mueller, 2012), our findings show that the Active community is struggling to explain to itself what its purpose and utility are given the rise of Passive investing. Indeed, at least one interviewee explicitly pointed this out ('I have to have that view [i.e. Active investing adds value] because of the living that I have', BS24). In such circumstances, falling back onto an extant epistemic base is a parsimonious means of re-establishing meaning and purpose for the Active investment community and resolves in some way any cognitive dissonance that Active players are experiencing.

Additionally, there are a number of institutional factors which support reproduction of the *status quo* rather than adaptation. For example, despite the loss of market share to Passive strategies, overall flows to Active strategies are still managing to marginally increase year on year in terms of AUM (Maddock-Jones, 2021), thereby sending a signal to the Active community (and, by extension, their pension fund clients) that what they are doing is still valuable and worthy of pursuit. A further institutional factor relates to the path dependency of investment mandates. Large institutional funds tend to triage their portfolio into portions, with some going to a Passive strategy and others allocated to various Active strategies with various criteria baked

into investment mandates, such as growth, bottom up, factor based, long-short, etc. In such settings, Active fund managers must stick to their mandate and doing so possibly further focuses their intellectual viewpoints. There are also technical/regulatory obstacles to a more rapid pivot to Passive investing, with US employees often unable to direct their 401(k) contributions to common index vehicles such as Exchange Traded Funds due to the legacy systems of retirement accounts (Enete *et al.*, 2019). As long as such obstacles exist, the Active fund management community still has something of a captive market and will be under less pressure to adapt. Future research could explore further the institutional conditions that support the persistence of an Active community that consistently fails to outperform its Passive counterpart.

By highlighting the various ways in which a category of actors resorts to discursive practices with the aim of defending their threatened position in the field, we conceptualize financial markets as a field where different bodies of belief compete for relevance and influence. To stress, the conflict between the Active and Passive communities, at least as it is seen from the Active's side, is not about which set of actions yield better results. Many Active actors, our data shows, acknowledge that Passive yields superior results. Instead, the struggle is about which is the right set of beliefs about the market. Epistemic opportunism is both the outcome of purposeful, defensive ideational social action and itself provides relevant knowledge for processes of reproduction in the institutional investment field. In turn, this leads to a view of financial markets less as inexorable, mystical entities whose salient characteristics are innovation, dynamism and efficiency and more as variegated sites of contestation, populated by different groups vying for epistemic supremacy.

How the battle between Active and Passive communities will play out is difficult to predict but, on the basis of what we find here, might hinge more on the purposeful social action of groups and institutional factors than on the economic outcomes that they generate. As Braun (2021) implies, both Active and Passive communities combine to govern a new mode of 'asset manager capitalism'. The key trend within this mode of governance is concentration in the asset management space in which the battle is for total assets under management rather than investment performance. While the big three index firms (Vanguard, BlackRock and State Street) are currently at the forefront of this trend, more Active players could continue to grow and establish themselves a permanent seat at that table. The winners in this mode of governance are those with sufficient scale – might is right – rather than those with the stronger arguments necessarily. In this respect, *epistemic opportunism* might not be a distress signal for a particular community so much as a routine feature of how markets operate.

Future research could extend the communities of practice perspective and look at charting the contours of a Passive community whilst also probing how members of a Passive community see their relevance *vis-à-vis* more established Active players in the investment space. Indeed, the communities of practice perspective advanced here can be applied to other groups of actors in the

‘investment chain’ (Arjaliès *et al.*, 2017), exploring the extent to which epistemic opportunism – and the concomitant inertia that goes hand in glove with such opportunism – are key characteristics of other communities in financial markets. Equally, we recognize that our coverage of the Active community was not exhaustive. We spoke only sparingly to quantitative fund managers, some of whom described themselves as pursuing ‘Passive plus’ or ‘enhanced index’ strategies. These individuals potentially constitute a distinct sub-community in their own right, occupying a liminal space between the Active and Passive spheres. Exploring how they manage such tensions could offer further indications of the future trajectory of capital flows in financial markets.

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Notes

1 In the world of institutional investment, ‘buy side’ generally refers to asset managers who buy and sell securities such as mutual funds and hedge funds, whereas ‘sell-side’ refers to firms who provide services to the ‘buy side’ such as execution, brokerage and research. In the narrative below, quotes are attributed to interviewees using unique alphanumeric identifiers, for sell-side actors (e.g. SS1) and buy-side actors (e.g. BS2).

2 Steve Cohen is an American billionaire hedge fund manager.

3 Algorithmic trading does not always follow a Passive strategy. The crucial point is that dynamics involving algorithmic trading frequently replicate trading positions, thereby amplifying market movements, similar to Passive trading strategies.

4 <https://www.ft.com/content/71029acc-21c2-4453-bcb5-6527d8003534?shareType=nongift>.

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Yuval Millo is a leading contributor to the field of Social Studies of Finance (SSF). Yuval's research approach is inherently interdisciplinary, combining theoretical and methodological elements from accounting, finance and sociology.

Crawford Spence is a Professor at King's College London and studies various groups of financial intermediaries from a sociological perspective including accountants, tax advisors, equity analysts and fund managers.

James J. Valentine is the Director of the Applied Investment Management Program at Marquette University. Prior to joining academia, he was a sell-side equity research analyst for 14 years which informed him in authoring the book *Best practices for equity research analysts* and founding the analyst training company AnalystSolutions.