

Thirty-Thousand Feet

The Invisible Hand Has Competition: The Structural Forces Reshaping Price Discovery

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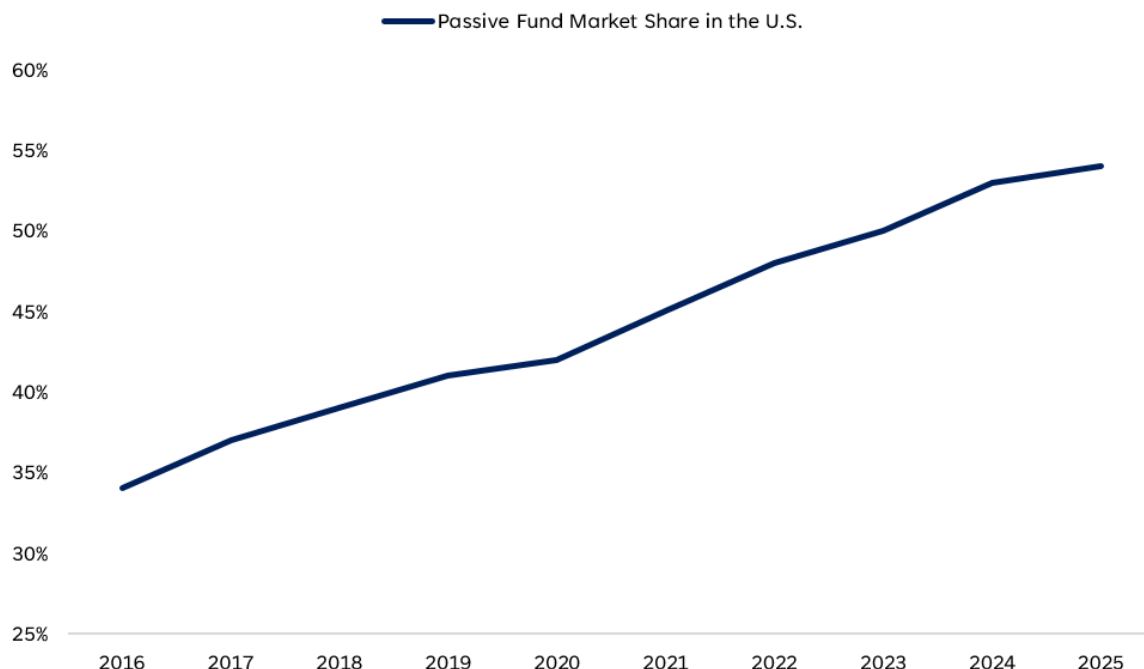
For decades, investors were taught to view markets almost exclusively through the lens of fundamental analysis. The archetype was the Graham-and-Dodd schooled analyst buried in financial statements, building discounted cash flow models, debating earnings assumptions, and estimating the intrinsic value of a business. In this framework, stock prices were the product of millions of valuation decisions, with markets serving as an efficient mechanism for ultimately translating fundamentals into price.

Now don't get me wrong, fundamentals still matter. Over the long-run, earnings, cash flows, and economic growth are the real anchors of investment returns. But the way markets function today is meaningfully different than it was just a few years ago. Structural flows, investor positioning, derivatives activity, and systematic trading strategies have become larger and larger drivers of market behavior. As a result, price discovery is no longer determined by just active investors making incremental judgments about value. Large pools of capital now move according to rules and mandates that are largely indifferent to traditional valuation metrics. The implication is that understanding modern markets requires more than analyzing balance sheets, earnings forecasts, and economic data. Investors must also understand the forces shaping liquidity, positioning, and investment flows. In many respects, market structure has become just as important as market fundamentals. Those who can combine traditional fundamental analysis with an appreciation for how money moves through today's system will be better equipped to understand both where markets may ultimately go and the path they are likely to take along the way.

The New Mechanics of Price Discovery

One of the most important developments over the past decade has been the rise of passive investing. As assets continue to flow into index funds, target-date portfolios, and other rule-based strategies, capital is increasingly allocated according to pre-established formulas rather than on judgments of intrinsic value. Whether stocks appear expensive or cheap matters far less when investment mandates require buying whenever new money arrives. The result has been a steady and often underappreciated source of demand that has helped underpin the major equity indexes.

The Rise of Passive Investing

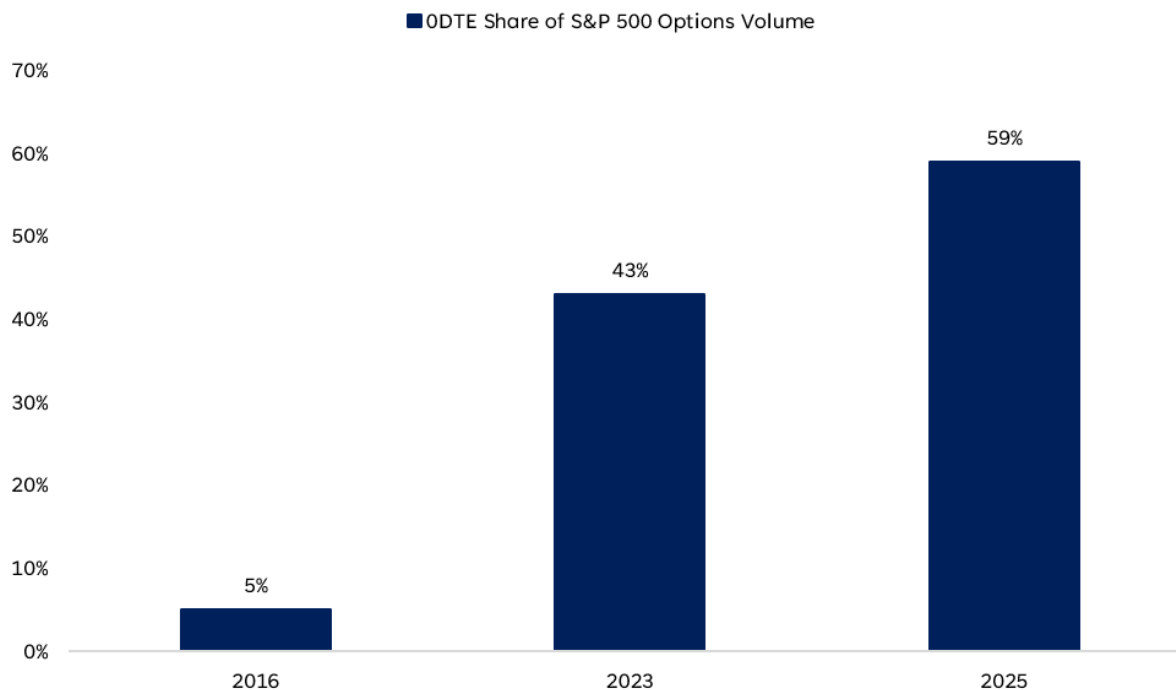


Source: LPL Research, ICI 09/22/26

At the same time, corporations themselves have become some of the largest and most reliable buyers of equities through share repurchase programs, with U.S. annual buybacks now exceeding \$1 trillion. Much like passive investment vehicles, buybacks are often driven by long-term capital allocation plans rather than valuation considerations. As companies retire shares, they reduce the amount of publicly traded equity available to investors, creating a structural overall tightening of supply that provides ongoing support for stock prices. The growth of private equity has further amplified this dynamic. With unprecedented access to private capital, companies can remain private for longer, reducing the number of firms that ultimately enter public markets. The result is a public equity universe that is significantly smaller than it once was, both in terms of the number of listed companies and the supply of shares available for investors to own. Taken together, these forces have fundamentally altered the supply-demand balance in equity markets as passive investment vehicles create a persistent source of demand; corporate buybacks steadily shrink the investable share base, and private capital keeps more companies out of the public arena altogether. The combination is a structurally constrained supply of public equities facing increasingly rules-based sources of demand.

Options markets and levered exchange-traded funds (ETFs) have become another critical force that shape market behavior. The explosive growth of options trading, particularly short-dated and zero-days-to-expiry contracts (ODTE), has fundamentally altered market microstructure. Dealers who stand on the other side of this trading activity must continuously adjust their hedges, and those hedging flows, which can total tens of billions of dollars per day in S&P 500-linked options alone, now represent a major influence on near-term market direction. The impact of these flows depends heavily on dealer positioning.

From 5% to Nearly 60% of S&P 500 Options Volume in Less than a Decade



Source: LPL Research, CBOE 09/22/26.

Past performance is no guarantee of future results. Indexes are unmanaged and may not be invested in directly.

When dealers are positioned “long gamma” (gamma measures how much a hedge needs to change when the market moves), they tend to buy weakness and sell strength, dampening volatility and creating a stabilizing force within markets. However, when they are “short gamma,” the opposite occurs. Dealers are forced to sell into declines and buy into rallies, reinforcing trends and amplifying volatility. In these environments, market moves can become self-reinforcing, with price action driven as much by hedging activity as by any change in the fundamental outlook. Leveraged ETFs, which saw assets in them more than triple over the last year, can create a similar feedback loop. Because these products must rebalance their exposures, strong market moves can force them to buy more of what is rising and sell more of what is falling. In periods of elevated volatility, these mechanical flows can amplify market moves and contribute to larger swings, further increasing the influence of market structure on price behavior.

The growing influence of systematic investment strategies adds another powerful dimension to today's market structure. Volatility-targeting funds, trend-following commodity trading advisors (CTAs), risk-control strategies, and other quantitative investors now collectively oversee over \$1.5 trillion in assets. Unlike traditional discretionary investors, these strategies allocate capital based primarily on market signals such as volatility and momentum rather than assessments of fundamental value. Their models are specifically designed to respond mechanically to changing market conditions. As momentum strengthens, they increase exposure. As volatility declines, they take on additional risk. And when key technical thresholds are crossed, significant amounts of capital can be deployed automatically. These rules-based responses create powerful feedback loops that can reinforce existing market trends and push asset prices higher, often independent of any improvement in the underlying fundamental backdrop. The reverse is equally important. When volatility begins to rise, trends deteriorate, or technical signals break down, these same strategies can quickly shift from buyers to sellers. What was previously a source of market

support can rapidly become a source of selling pressure. As a result, systematic strategies have become an increasingly important force in determining market outcomes, helping to explain why advances can extend further than many investors expect and why reversals can oftentimes unfold with surprising speed and intensity.

Modern Markets Require a Broader Lens

Understanding earnings, valuations, and economic conditions will always be essential. They help determine where markets are likely to gravitate over the long run. But understanding positioning, market structure, and systematic flows helps explain how prices actually get there. In many ways, today's market operates on multiple levels simultaneously. Fundamentals establish the destination, while flows, positioning, and market mechanics shape the journey. Investors who focus exclusively on one while ignoring the other risk overlooking some of the most important forces driving asset prices.

For portfolio construction, this structural shift has profound implications. It means that periods of apparent overvaluation can persist far longer than traditional models would suggest. It means market leadership can become increasingly concentrated as passive and systematic flows further reinforce existing trends. It means there will be more sporadic bouts of volatility. And it means that understanding liquidity and positioning dynamics has become just as important as understanding balance sheets and income statements.

The Case for a More Dynamic Approach

As Benjamin Graham famously observed, the stock market is ultimately a weighing machine over the long run. But in the intermediate-term, it increasingly resembles a complex engineered system, one driven by powerful internal feedback loops, mechanical flows, and positioning dynamics that can frequently overshadow traditional fundamentals for long periods of time. Recognizing the distinction between long-term value and shorter-term market mechanics may be one of the most important insights for investors navigating today's changing investment landscape. From our perspective, this evolution in market structure strengthens the case for incorporating tactical asset allocation into the portfolio construction process. In a world where passive inflows, systematic strategies, dealer hedging activity, and shifting volatility regimes can generate what once would have been annual returns over the span of just a few weeks, static portfolios can benefit from a more adaptive framework. Markets increasingly move through distinct regimes where trends become self-reinforcing, liquidity conditions change rapidly, and positioning can matter just as much as valuation. As such, tactical asset allocation provides a disciplined approach for navigating these shifts. Rather than attempting to predict every market move, it seeks to identify when structural forces are creating opportunities or risks that may not yet be reflected in traditional fundamental analysis. By adjusting exposures as risk-reward dynamics evolve, investors can better align portfolios with the realities of an increasingly flow-driven market environment.

In many respects, tactical asset allocation serves as a bridge between long-term strategic convictions and the shorter-term realities of modern market behavior. Strategic asset allocation determines where investors believe capital markets will go, while tactical asset allocation helps navigate the path. As investment horizons compress and market movements become increasingly influenced by mechanical flows, the ability to adapt becomes more valuable. Investors who can combine fundamental discipline with an understanding of market structure, liquidity, and investor behavior will likely be better positioned to capitalize on opportunities and manage risks in a world where how markets move can be just as important as where they ultimately end up.

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