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Commonwealth Bank's record run exposes how ETFs are reshaping share prices

By JAMES KIRBY

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What happens if the sharemarket is driven by dumb money?

In our local sharemarket, the biggest puzzle of the year is Commonwealth Bank. The biggest bank in Australia is also the biggest stock in the ASX 200.

CBA have risen by 40 per cent over the past year.

It's astonishing, and some might say downright dumb, because the bank only increased profit by 2 per cent in its half-year result and its dividend yield is now a modest 3 per cent.

So what is the explanation?

Many in the market are coming to the conclusion that CBA's crazy share price, along with a range of related trends, is explained by passive investing. This is typified by exchange-traded funds.

Using ETFs, investors place their faith in computer algorithms that perfectly reproduce the action in the market. To mirror the market index, the ETF must buy the underlying stock.

For example, the more the ETFs buy CBA, the higher it goes. The higher it goes, the more they have to buy.

At its worst, so-called index investing can ignite an endless circle of stock purchasing that has nothing to do with the underlying fundamentals.

According to Jack Tossol, a financial adviser at the Partners Wealth Group, instead of backing businesses based on merit, index funds just throw money at companies based on their size. "(It) doesn't matter if they're shooting the lights out or languishing in the trenches, if they're big, they get your money," Tossol says.

Speaking on The Australian's The Money Puzzle podcast, Tossol says: "All this new money keeps going into passive investing so this issue is going to get worse."

He says the market is distorted.

"If you took CBA out of the mix, the return for the ASX 200 for the year would be about 6 per cent," he says. "Where is the money coming from that's pushing it up? Can anyone seriously tell me that CBA is the best bank in the world?"

Tossol's explanation is hard to dismiss.

Currently hovering at around $180, CBA is overvalued by 38 per cent according to a consensus of analyst estimates. We have never seen such a stretched valuation on such an important stock.

And while all this has been going on, passive investing is going gangbusters.

The ETF sector now represents more than 400 funds with a whopping $250bn invested. That's up by 27 per cent in 12 months.

Until now ETFs have been widely regarded as a win/win for many investors.

After all, most active fund managers don't match the index. This failing has been at the heart of the decline in the big names that once dominated active funds such as Perpetual, Platinum and Magellan.

Better still, ETFs mean that rookie investors don't get stuck with dud funds.

ETFs have their place. They are a very useful option for investors who are happy with average returns.

But CBA's stock gains have triggered hard questions that need to be asked. No investment is perfect and ETFs on close inspection have plenty of drawbacks.

For private investors, the most obvious drawback is that the market average is acceptable when the market is doing well. It's been going very well for three years in a row. But what about when there is a downturn? Getting the average loss will not feel quite as satisfying.

What's more, if the pundits have it right, then loss-making investments will be pushed lower again by ETFs.

Ethically, ETFs are oblivious to most concerns, not just the traditional problems of tobacco and weaponry, but the more mundane issue that if you buy everything on the market you knowingly buy all the rubbish as well.

Academic research shows that many of the failings that characterise bad stock investors are just as common in the world of ETFs. People who buy at the top and sell at the bottom are just as likely to do so with ETFs.

And then there is the biggest issue of all. Do index funds actually disturb how markets work?

If huge amounts of money are blindly chasing mispriced stocks, then big stocks will just get bigger and the rest of the pack will remain ignored.

Applying that logic to our domestic sharemarket brings us back to the notion that CBA keeps going up because ETFs ensure it keeps going up.

Michael Burry, the investor who inspired the Big Short movie, has long held that passive investing artificially inflates valuations and fuels market bubbles.

He believes passive investing makes everything more amplified and that upswings are more outrageous, downturns are more dangerous. Ultimately, it's a risk to the market itself.

Is it too much?

Well, needless to say, the ETF industry is very keen to dispel such qualms. It says ETFs are not important enough to drive market patterns.

David Tuckwell of ETF Shares summarises the argument for the defence when he says ETFs are being used as a scapegoat.

"If ETF buying is responsible for rallies in high-weight ASX 200 names, why has the effect been isolated to CBA?" he says. "BHP, the next-largest ASX stock, has an 8 per cent index weight yet it's down 9 per cent this year."

Tuckwell also says the trading data inside the ASX does not suggest that ETFs spend enough money to drive prices in the manner Tossol and others suggest.

"Could ETFs one day become so large that they do set the CBA price? Theoretically, yes, but we are nowhere near there yet," Tuckwell says.

We might be a lot nearer than Tuckwell would like to think.

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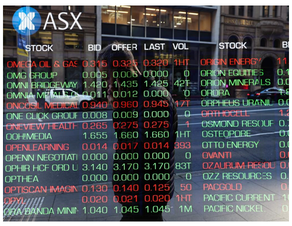

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JAMES KIRBY ASSOCIATE EDITOR - WEALTH

James Kirby, Associate Editor-Wealth, is one of Australia's most experienced financial journalists. James hosts The Australian's twice-weekly Money Puzzle podcast. He is a regular commentator on radio and television, the author of several business biographies and has served on the Walkley Awards Advisory Board He was a co-founder and managing editor at Business Spectator and Eureka Report and has previously worked at the Australian Financial Review and the South China Morning Post. Since January 2025 James is a director of Ecstra, the financial literacy foundation.

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