Market View
What to keep in mind with passive investing in highly concentrated markets

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Author Sanjay Rijhsinghani

At a glance

- The active versus passive investing debate persists, with passive investing remaining popular in the US for its cost-effectiveness.

- Passive investing faces scrutiny due to the dominance of the "Magnificent 7" stocks in the S&P 500, which are driving its returns.
- Understanding index construction is crucial, particularly in market-cap weighted indices like the S&P 500.
- Passive investing, while seemingly straightforward, has drawbacks, leading to valuation and concentration risks.

The age-old debate about active versus passive investing persists – the former involving buying and selling shares with the aim of outperforming the market and the latter, where index funds and exchange-traded funds (ETFs) track a specific index by buying and holding assets.

In the US, passive investing has proven to be a cost-effective way of getting exposure to the wider market. However, popularity aside, there are important considerations with passive investing, which has come under increased scrutiny recently given how much weight the so-called Magnificent 7 stocks account for of the S&P 500.

When following an index, it is important investors are acutely aware of how they are constructed. Last year, the Magnificent 7 stocks – Apple, Nvidia, Microsoft, Amazon, Tesla, Meta and Alphabet – drove the bulk of the S&P 500's returns, as these companies continue to benefit from optimism surrounding artificial intelligence (AI) and are perceived to be less impacted by inflation, geopolitical events and higher costs of capital. In 2023, the top ten stocks in the S&P 500 accounted for around two-thirds of the index's return.[1] Removing these stocks from the S&P 500, the "average" stock gained just 13% last year relative to 24% for the wider index.

Market-cap weighted index vs price-weighted index

The S&P 500 tracks the performance of 500 of the largest publicly traded companies listed in the US. Given its wide coverage, it has become a primary choice for ETFs and passive trackers in recent years. However, it is important investors understand the methodology used to construct the index in comparison to its peers. The S&P 500's underlying companies are weighted by market capitalisation. This means larger companies have a greater impact on the index's performance.

This differs from the Dow Jones, which is a price-weighted index, meaning that companies with higher share prices have more influence on the index's performance. In other words, Dow's index value is based on the price of stocks, NOT the market value of its underlying companies.

Drawbacks of passive investing

The Dow Jones 30, and the similarly constructed Nikkei 225, are therefore not as widely followed. The price value of a stock is subject to more manipulation and hence not the best way to create an index. However, there are also drawbacks to consider when using passives which buy into market-cap weighted indices such as the S&P 500.

One downside is you are buying more stocks that have risen, and fewer stocks that have fallen. In essence, capital is allocated according to market capitalisation rather than underlying company fundamentals. Stocks that have seen their share prices decline, may in many instances have higher return potential, along with diversification benefits. Yet these companies are receiving less capital, as investors allocate to passive instruments. In passive investing, investors are effectively buying more shares that are getting more expensive and buying fewer less expensive shares.

To put this into perspective, the percentage the Magnificent 7 companies make up of the S&P totalled just over 20% in 2022. This increased to 28.2% in 2023. In other words, for every dollar you put into the S&P 500, 28 cents goes into the Magnificent 7 companies.

It is also important to look at indices from a geographical perspective when considering broader indices such as the MSCI World. The US stock market represents some 70% of the world stock market value, while the US economy accounts for 17.8% of global GDP.[2] In 1989, the Japanese stock market accounted for 50% of the global market capitalisation and its economy made up 10% of global GDP.[3] Japanese markets experienced a correction soon after.

Even BlackRock, one of the biggest benefactors of the decade-long boom in passive investing, recently cautioned investors of overreliance on passive investing. A combination of higher interest rates, persistent inflation and heightened geopolitical risk should give active managers more opportunities to outperform passive counterparts in the foreseeable future, the asset manager said.[4]

"The trend is your friend" is applicable to passive investing. However, given concerns over concentration and valuations rising to levels not seen since the dot com bubble (see our recent article 'what we can learn from history when navigating financial markets?'), investors need to be wary that simply adopting a passive investing style means you are following the herd.

[1] Bloomberg

[2] Gavekal Daily: Indexation Will Destroy Capitalism. 08/02/2024

[3] Gavekal Daily: Indexation Will Destroy Capitalism. 08/02/2024

[4] Bloomberg: "BlackRock Says 'New Regime' Calls for More Active Management." 27/02/2024

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