Passive Aggressive: The Hidden Risks of Passive Investing Q&A

Artisan Partners U.S. Value Team

PORTFOLIO MANAGER
Viewpoints

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In 1990, less than 5% of US mutual fund assets were in passive index funds. Today, more than 50% of assets in US mutual funds and exchange-traded funds (ETFs) are passively managed. How did we get here?

Kane: The shift from pensions to defined contribution plans and the proliferation of ETFs have underpinned the rise of passive investing. The first US ETF, SPDR® S&P 500® ETF Trust (SPY), debuted in 1993. Today, there are more than 12,000 ETFs globally and even more indices. According to the Index Industry Association, there are close to three million stock market indices around the world. Amazingly, this is more than the total number of public companies, which, in a sense, is absurd.

In a nutshell, passive investing's appeal is broad market exposure, low cost and tax efficiency. Combine these benefits with the heady investment returns of US large-cap stocks over the decade-plus since the great financial crisis—the S&P 500® Index returned 16.9% annualized from its March 2009 low through the end of 2024—and the upshot is a pervasive belief that successful investing is as simple as purchasing an index fund or ETF that tracks any broad US stock market index When times are good, people tend to forget the down periods.

I think other factors are accelerating the shift to passive. If you're an investment consultant or a financial advisor, shifting client assets to passive helps you minimize performance and career risk by matching an index return. If you're responsible for a defined contribution plan, you won't get sued for having more expensive and/or potentially underperforming options in your company's fund lineup. Also, the record of active managers protecting capital on the downside is mixed. Although, there is evidence that value managers have more success at protecting in down markets.

Given these advantages, why not go 100% passive?

Kane: First, passive funds don't claim to outperform; you get the market return and no better. Zero index funds and ETFs beat their index. Second, if you have a process to find managers that can outperform a particular index over the long run after fees, you have the potential to outperform, sometimes significantly. Just because it's not easy to find talented managers doesn't mean it's not worth trying. Third, the tax advantages afforded to passive aren't written in stone. Future tax policy is hard to predict. Just as one might balance contributions between traditional and Roth 401(k)s or IRAs for tax purposes, it may make sense to hedge with an allocation to active management. Fourth, we've had a one-way market for the better part of the last decade. The Federal Reserve's monetary policies, including socializing market losses by holding interest rates at zero for several years after the 2008 financial crisis, allowed some of the riskiest companies in indices to survive. Active managers typically have a quality bias that can potentially help them avoid these riskier businesses. According to a Morningstar study of the 20-year period beginning in February 1998, nearly 60% of active funds outperformed during down markets, on average. Protecting capital in significant drawdowns can be a significant contributor to compounding longer term returns. With a passive index, you never get that opportunity to do better.

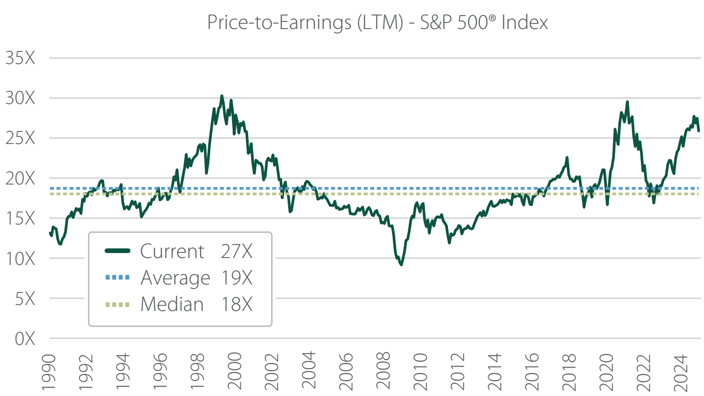
As a team of long-only value investors, we readily admit we are not an independent voice in this matter. However, we believe risks have been building based on a few unusual circumstances. Of concern is the combination of high market concentration (Exhibit 1) and valuations near all-time highs (Exhibit 2).

Exhibit 1: Market Concentration at All-Time Highs

Source: Artisan Partners/Empirical Research Partners. As of 28 Feb 2025.

Based on trailing twelve-month earnings, the S&P 500® Index was trading around 27X at the end of 2024 and early 2025, which was more expensive than all but a handful of months in 2021 and the early 2000s. Many of us remember how the 2000s played out. The US equity market suffered a decade of below-average returns and growth stocks trailed value stocks for most of that period. We believe the crowding into large-cap growth stocks (like the Magnificent Seven) is pushing market concentration to unsustainable levels. The current circumstances are also reminiscent of the late-1990s dot-com bubble and the early 1970s Nifty Fifty era.

Exhibit 2: Historically High Valuations



Source: Artisan Partners/FactSet/S&P. As of 28 Feb 2025. **Past performance does not guarantee and is not a reliable indicator of future results.**

It's important to realize that high valuations at the market level are predictive of lower expected long-run returns due to mean reversion. However, according to David Kostin, chief US equity strategist at Goldman Sachs, high market concentration is a distinct variable that also correlates with lower returns over longer horizons. Indices don't consider valuation levels or future expected returns. And the funds tracking those indices buy or sell purely on a transactional basis, with no consideration of much else.

Why is the term "passive" investing a misnomer and how has the shift toward passive impacted price discovery?

Kane: Well, we need to look at incentives before speaking about whether passive still serves its original purpose. Indexing has become a very good business. Thousands of "passive" options are available, which suggests to me that the fees to be earned are substantial. Follow the money. Index providers create and license indices as benchmarks for passive funds to track. The biggest index providers, including S&P, Dow Jones, FTSE Russell and MSCI, have become hugely successful, with more than $6.5 billion of revenue in 2023 and profit margins of 60%-70%. Index providers are not concerned about investment results, only that you use the index as a tool to invest. In fact, there are now more indices than public companies. According to the Index Industry Association, nearly three million stock market indices existed around the world as of 2018, compared to 43,000 public companies. That's a whopping 65 times more indices than stocks! Seven years later, I'm certain the number is much higher.

When viewed through a macro lens, everyone is an active asset allocator. You are actively allocating whenever you pick components of the global financial market for your portfolio. Plus, most allocation decisions are made with the intention to "beat the market." Emerging markets equities, private equity, global and alternatives are among the menu of asset classes to pick from. Whichever asset classes you find more or less attractive, you allocate more or less of your money accordingly. That makes you as an asset allocator, who might use all passive vehicles, no different than the active portfolio manager, just on a macro level rather than the security level.

Active allocating may also take the form of rebalancing, factor investing, smart beta, tilting, etc. ETFs allow you to jump in and out of investments based on your market or economic views. And boy, is there a lot of jumping. Rates are going lower, you can buy housing ETFs. The economy looks to be turning down, then you can buy a consumer staples, health care or utilities ETF. You think growth is going to do well, then you can buy the smaller companies in the Russell 2000® index. So, in this light, there is no such thing as passive.

How might passive flows result in overvaluation?

Kane: The rules for passive investing are as follows: If you have cash to invest, buy. If you need cash, sell. As David Einhorn remarked in the February 2024 Masters in Business podcast with Barry Ritholtz, "money doesn't have an opinion about value, it only has an opinion about price." Passive is not just about reduced trading activity, low fees and tax efficiency, as the name infers. Passive brings participants into the market who have a 100% marginal propensity to buy or sell, regardless of valuation. In fact, valuation isn't considered at all. S&P has no fundamental equity analysts determining the appropriate values for the 500 companies in its headline index. Index construction is based on market capitalizations. As an example, if $100 billion were invested in a fund tracking the S&P 500® Index, $30 billion, or 36%, of that would go into the top 10 largest stocks, despite those 10 names accounting for just 30% of the index's profits. As a result, flows into passive funds disproportionately impact (i.e., increase) the stock prices of the largest firms, especially large firms that we think the market tends to overvalue. Further, active portfolio managers are under pressure to own these largest companies in similar proportions in their own funds for fear of underperforming. This further drives up the prices of the largest firms. The result is a feedback loop of rising prices.

Along these same lines, every two weeks your 401(k) contribution is put to work. If you buy via a passive index, it's at current prices and with no view on market valuation. It's an active decision to buy on autopilot. Although it echoes the dollar-cost averaging approach that Ben Graham introduced as a way to reinforce scheduled savings, the follow through can be very different. In 1962, Graham, in his remarks about dollar-cost averaging, emphasized that, "such a policy will pay off ultimately regardless of when it is begun, provided it is adhered to conscientiously and courageously under all intervening conditions." Yet, this ignores human behavior. Who has the stomach to continue buying (or even to refrain from selling) when stocks are down 30%, 40% or 50%? As we saw in 2008, participants often sold their equity holdings (including index mutual funds and ETFs) only after the crash occurred.

One argument behind passive investing is that the market is efficient and liquid enough for there to always be an incremental seller for the incremental buyer. However, the structure of the 401(k) market creates a situation where the buyer shows up but given the need to "hold" stocks in a passive construct, supply is scarcer, leading to a higher price that drives up market cap. Barry Ritholtz has called this the "relentless bid". This constant buying isn't really passive at all, it's transacting in a systematic and purposeful fashion.

How do index methodologies distort their price-to-earnings ratios?

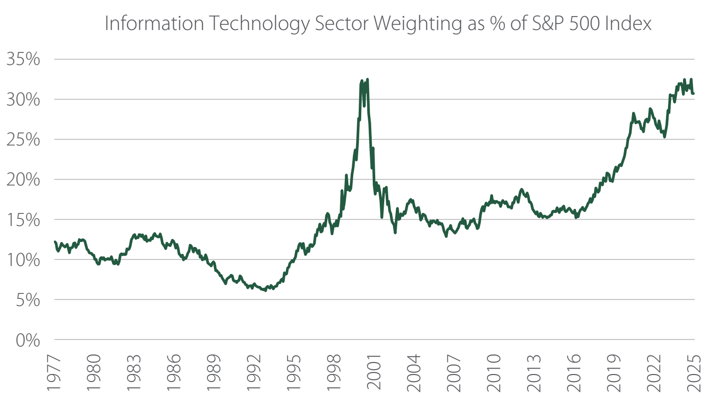
Kane: This is most applicable to the small cap indices where a significant percentage of the companies included do not have positive net income and less so for the S&P 500® Index since profitability is part of the inclusion criteria, alongside float, market cap and domicile. When calculating an index's P/E ratio, the non-earners are excluded from the median and average calculations, since a negative P/E is nonsensical. For example, the reported Russell 2000® Index's trailing twelve-month P/E of 16X excludes almost 43%, or 840, companies without earnings out of 1,953 companies. If you instead calculated the combined market cap of all constituent companies divided by combined earnings, you would get a P/E over 100X. The index providers aren't hiding the fact they do this, so it's known. But when you don't see the calculated statistic in plain sight, the numbers can be misleading. Imagine if you tried to convince a college statistics professor to drop all the scores below 70 when setting the curve for the midterm!

Are investors who choose to get broad US equity exposure through passive funds getting the diversification they need?

Kane: Concentration has increased tremendously as a function of market-cap weighted indices pushing up the biggest names, as we pointed out above in Exhibit 1, creating a dearth of companies to round out the remainder of these. The number of public companies has shrunk as either they get gobbled up by private equity (in a debt-financed, low interest-rate world) or decline to come public given more interest in getting to unicorn status. The misleadingly named FT Wilshire 5000 Index, which covers the entire US stock market, including small- and mid-caps, reached 7,000 constituents at its peak in 1998. Now, it has less than 3,500 stocks, largely due to the loss of small caps from acquisitions, bankruptcies and fewer initial public offerings. Yet the amount of money tracked by this index is $52 trillion compared to just $1.4 trillion in 1980, leading to greater dollars chasing fewer public companies.

The S&P 500® Index looks and behaves increasingly like a growth index than a core index that reflects the broad investment universe, as was its original intention. Just look at the information technology (IT) sector weighting as shown in Exhibit 3. The weighting in IT has returned to similar highs (32%) as during the dot-com bubble. These distortions are even worse in some of the growth style indices.

Exhibit 3: A Less Diversified S&P 500® Index



Source: Artisan Partners/Empirical Research Partners. As of 28 Feb 2025.

The market may simply reflect technology's increasing role in the economy and a rational assessment regarding the potential of artificial intelligence. Perhaps. However, the market capitalizations of these IT stocks are mind-boggling. NVIDIA's $3 trillion market cap is on par with that of France. Yes, the entire country. The second-, third- and fourth-largest equity markets in the world after the US are China, Japan and India. The Magnificent Seven stocks, with a total market cap of $17 trillion, are worth more than these three countries…combined. These are staggering statistics.

Final thoughts?

Kane: Rising concentration and market narrowness have been tailwinds for the large-cap indices and headwinds for active managers over the last decade. Herbert Stein, the former chairman of the Council of Economic Advisers during the Nixon and Ford administrations, once said, "if something cannot go on forever, it will stop." With risks building, investors may want to consider if the next decade will be like the previous one.