SAWGRASS
ASSET MANAGEMENT LLC

Passive-Aggressive Investing:

The Hidden Risks of Indexing

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What Risks are Involved in Index Investing?

- Benefits
- Pitfalls
- Alternative (Active)
  - Pros & Cons

What is Indexing?

- **Passive** Investment Strategy.
- Designed to track the performance of a **specific market index**.
- Used for **Broad Market Exposure**
  - SPY, IVV – S&P 500
  - QQQ – Nasdaq 100
  - AGG – U.S. Investment Grade Bonds

Indexing Benefits

- ☑ Low Cost → helps performance
- ☑ Simplicity → low effort
- ☑ Diversification → reduces risk
  - …but doesn't eliminate risk

Goal of Diversification

- "Don't put all your eggs in one basket…"
- Reduce risk of significant losses from any single investment.
- How '**Diversified**' are you?

Hidden Risks

- Due to the **composition** of indexes, other less obvious risks are present and can be ignored.
- Reality: The better the index is performing, the **riskier** it becomes.
  - Passive investing can be deceptively aggressive.

Concentration Risk

- Indexes can become increasingly concentrated over time.

10 Years Ago June 2014	S&P 500 Weight(%)
Apple	3.22
Exxon Mobil	2.48
Microsoft	1.80
Top 3 Weight	***7.50***

5 Years Ago June 2019	S&P 500 Weight(%)
Microsoft	4.19
Apple	3.61
Amazon	3.18
Top 3 Weight	***10.98***

Current June 2024	S&P 500 Weight(%)
Microsoft	7.24
Apple	6.66
NVIDIA	6.65
Top 3 Weight	***20.55***

- **Impact**: If one of these stocks moves just 2%, it can add 1.3% to the index.
  - Or subtract 1.3%!

Source: FactSet; as of 6/28/24

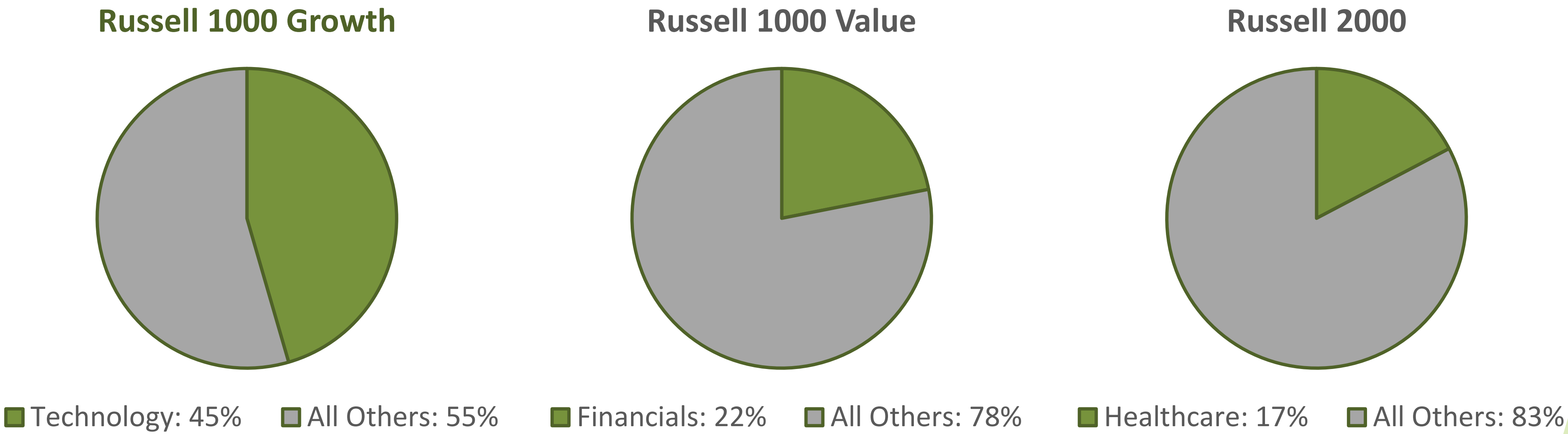
Concentration Risk

- From 12/2022 – 6/2024
  - Microsoft +89% → 12% of S&P return
  - Apple +63% → 9% of S&P return
  - NVIDIA +746% → 17% of S&P return
- Concentrated positions have abnormally large impact on market performance.
- Why should you care? **Reduces the benefit of diversification.**

Source: FactSet; as of 6/28/24

Exposure Risk

- Indices can have overexposure to certain sector/industry groups.



- Exposures can have dramatic effect on index performance.

Source: FactSet; as of 6/28/24

Downside Risk

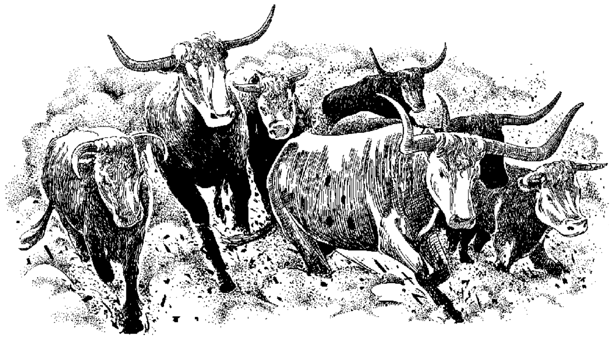
- Index funds capture **all of the downside.**
- Significant losses delay the ability to compound gains.
- Pain of losing money can lead to inefficient decisions.
  - Buying High and Selling Low

Asset Risk

- "There is **no such thing** as **<u>passive</u>** investing."
- **Active** bet on asset size, class, quality, sector, region, etc.
- True "**Passive**" Allocation based on Global Markets"*
  - Equities: **42%**, Bonds: **46%**, Alternatives: **12%**

*Source: State Street Global Advisors; *as of 6/2023*

Mispriced Risk



- Why is risk mispriced **consistently** in the index?
- Herd mentality (**concentration risk**) which…
  - results in distorted valuations (**exposure risk**)…
- Why does this matter to index investors?
  - Mispriced risk complicates decision making (**asset risk**)…
  - and leads to increased market volatility (**downside risk**).

How Active Addresses Index Risks

Type of Risk	Active Investor Capabilities
Concentration Risk	reallocate weights to maintain proper diversification.
Exposure Risk	manage exposures based on desired characteristics.
Downside Risk	structure portfolio to limit losses, buy low/sell high.
Asset Risk	tailor active bets to fit individual/plan needs.
Mispriced Risk	research/recalibrate portfolio to maintain favorable risk/reward.

But Don’t Forget…

- Active management is **higher cost**.
  - Higher costs can affect performance.
- Active management is **more complex**
  - Increases individual stock selection risk.

Summary

- Indexing has **benefits**.
- Indexing has **risks**.
- Be "**Active**" about understanding the risks of "**Passive**" investing.