



# **Passive Investing:** *The Hidden Risks of Indexing*

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# What Risks are Involved in Index Investing?

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

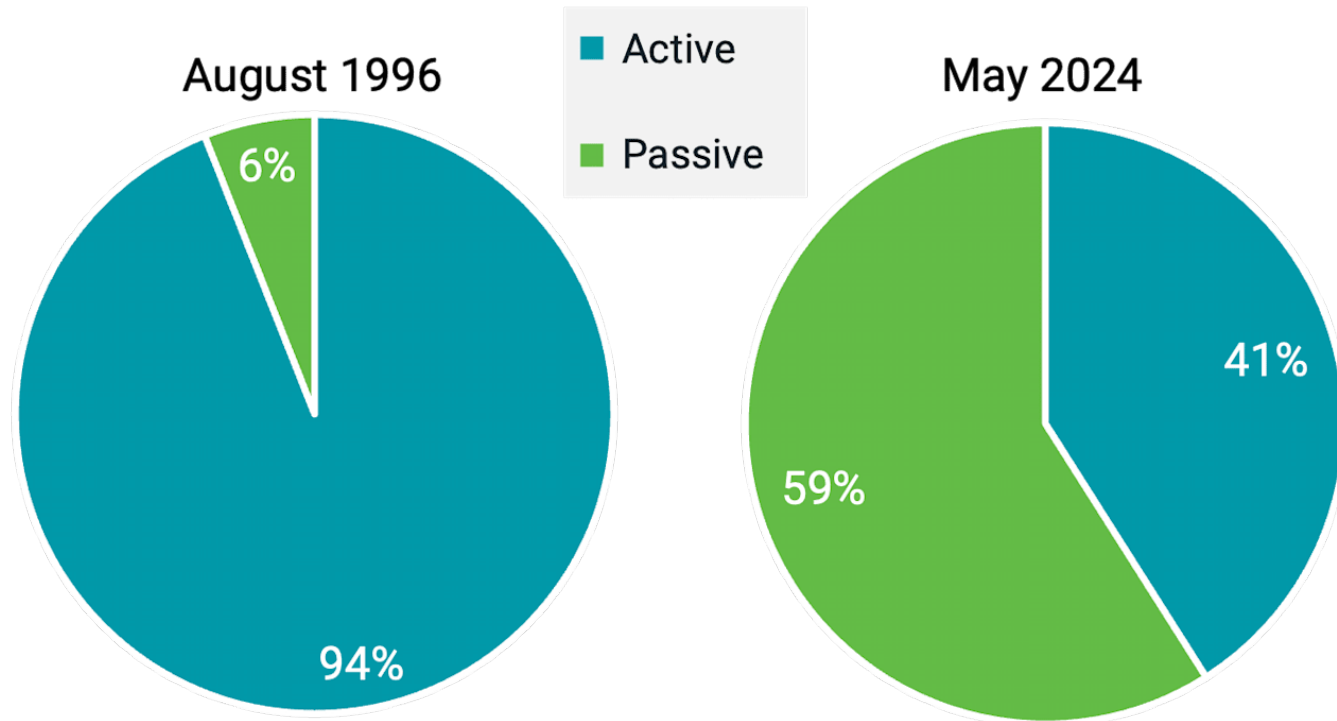


# What is Indexing?

- ▶ **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

# Passive Exponential Growth

- ▶ **Passive** fund assets have grown exponentially over the past several decades.



# 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?



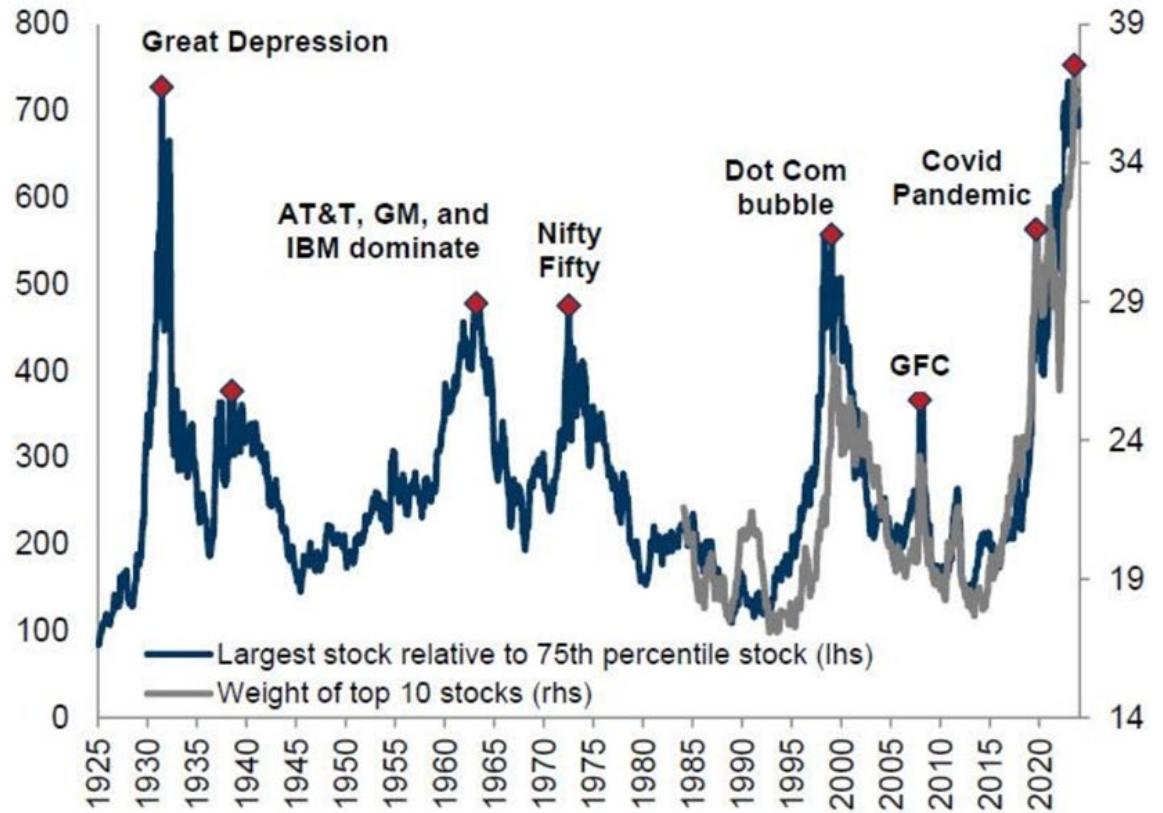
# Hidden Risks

- ▶ 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

- ▶ Market cap of the largest stock relative to 75<sup>th</sup> percentile stock (x, lhs)
- ▶ Weight of the top 10 stocks in S&P 500 (% , rhs)



Source: Goldman Sachs GIR,  
Keneth R. French; as of 12/31/24



# Concentration Risk

- ▶ Top 10 Stocks in S&P 500 Characteristics
- ▶ Passive Investing Can Be Deceptively Aggressive!

Ticker	Name	Market Cap (millions)	Percent of S&P 500 Index	P/S	P/E	Free Cash Flow Yield
AAPL	APPLE INC	3,665,587	7.3	9.5	33.1	3.1
NVDA	NVIDIA CORP	3,485,319	7.22	30.9	48.2	1.78
MSFT	MICROSOFT CORP	3,150,196	6.27	12.4	32.4	2.22
AMZN	AMAZON.COM INC	2,347,687	4.2	3.8	43.3	2.02
GOOGL	ALPHABET INC-CL A	2,407,962	4.13	7.1	24.4	3.91
META	META PLATFORMS INC-CLASS A	1,571,742	2.71	10.1	27.3	4.71
TSLA	TESLA INC	1,265,935	2.26	12.9	86.0	0.5
AVGO	BROADCOM INC	1,085,264	2.18	20.8	36.4	2.41
BRK/B	BERKSHIRE HATHAWAY INC-CL B	979,320	1.63	2.1	22.9	3.84
LLY	ELI LILLY & CO	734,073	1.34	17.1	58.0	1.58
<b>Top 10 S&amp;P 500 Companies</b>		20,693,083	39.24	13.9	39.2	2.6



Source: Bloomberg; as of  
12/31/24

# Concentration Risk

- ▶ Concentrated positions have large impact on market performance.
- ▶ Why should you care? Reduces the benefit of diversification.

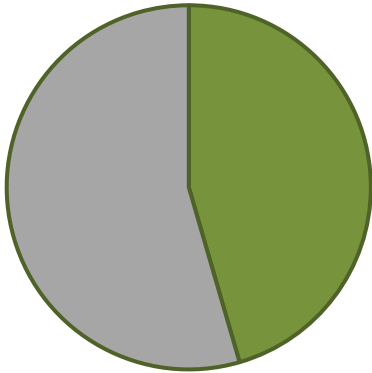
Ticker	Name	% Change 12/22-12/24	% Index Mover
NVDA	NVIDIA Corp	819.58 %	16.04 %
AAPL	Apple Inc	94.76 %	10.22 %
MSFT	Microsoft Corp	78.64 %	7.89 %
AMZN	Amazon.com Inc	161.18 %	6.92 %
GOOGL	Alphabet Inc	115.33 %	6.28 %
META	Meta Platforms Inc	388.41 %	5.88 %
AVGO	Broadcom Inc	329.79 %	4.44 %
TSLA	Tesla Inc	227.85 %	4.32 %
LLY	Eli Lilly & Co	114.49 %	1.99 %
JPM	JPMorgan Chase & Co	88.48 %	1.85 %
<b>Top 10 Stocks Contribution to Large Cap 500 Return 12/22-12/24</b>			<b>65.84 %</b>

Source: Bloomberg; as of  
12/31/24

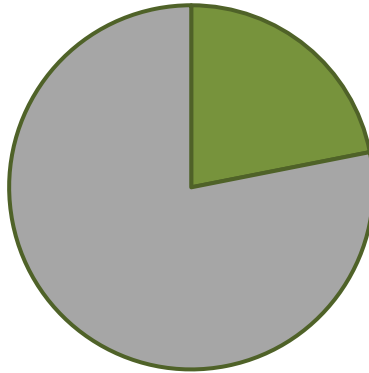
# Exposure Risk

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

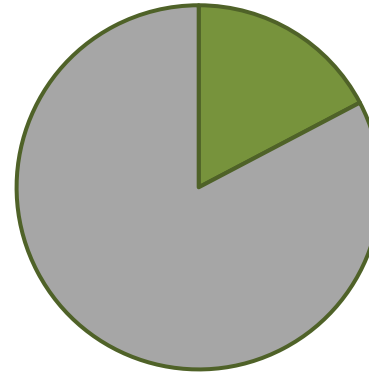
Russell 1000 Growth



Russell 1000 Value



Russell 2000



■ Technology: 45%   ■ All Others: 55%   ■ Financials: 22%   ■ All Others: 78%   ■ Healthcare: 17%   ■ All Others: 83%

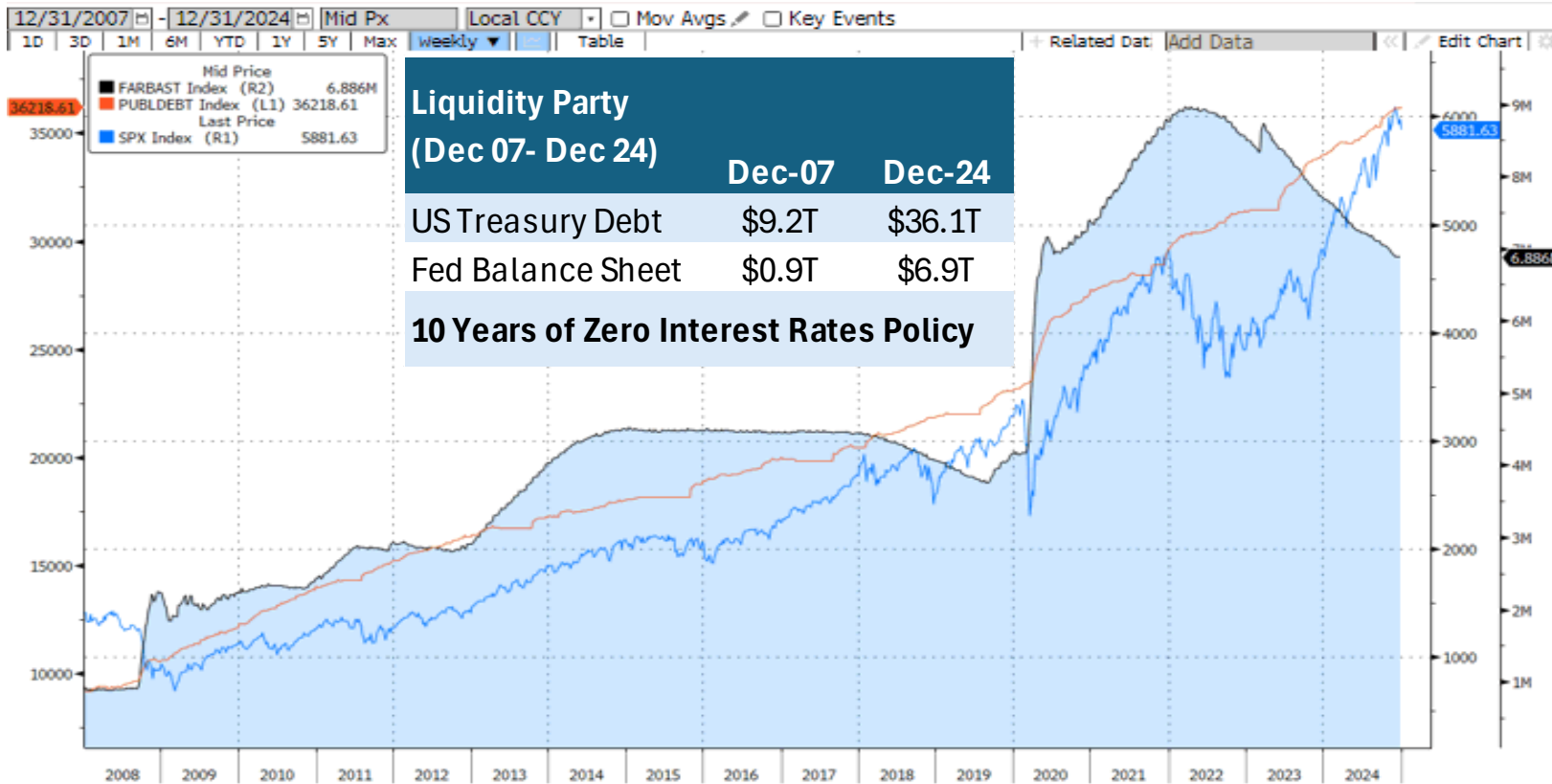
- ▶ Exposures can have dramatic effect on index performance.

# 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

# Macro Policy Stimulus

- ▶ **Passive** investing benefited from the historic fiscal and monetary driven liquidity expansion. Going forward, it will be difficult to maintain the same rate of stimulus and support for risk assets.



Source: Bloomberg; as of  
12/31/24

# Equity Risk Premium

- ▶ Downside Risk - Equity Risk Premium near Zero means investors are not getting paid to take on equity risk.



Source: Bloomberg; as of  
12/31/24

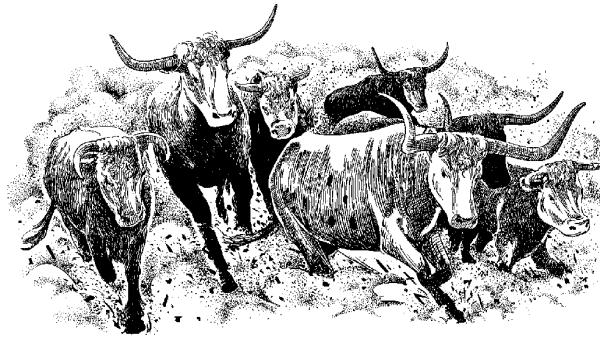
# Asset Risk

**CONTROVERSY**

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



# 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
<b>Concentration Risk</b>	reallocate weights to maintain proper diversification.
<b>Exposure Risk</b>	manage exposures based on desired characteristics.
<b>Downside Risk</b>	structure portfolio to limit losses, buy low/sell high.
<b>Asset Risk</b>	tailor active bets to fit individual/plan needs.
<b>Mispriced Risk</b>	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.