



EPISODE
382



MARKET CONCENTRATION RISKS

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Agenda:

- Too much passive investment
- Too much in top stocks

MSCI:

- MSCI 85% free float adjusted cap: Aust= 60 stocks, World: 1,300 (falling from 1,600 5 years ago)
- MSCI 99% free float adjusted cap: Aust = 225 stocks, World = 5,156

US Domestic Passive:

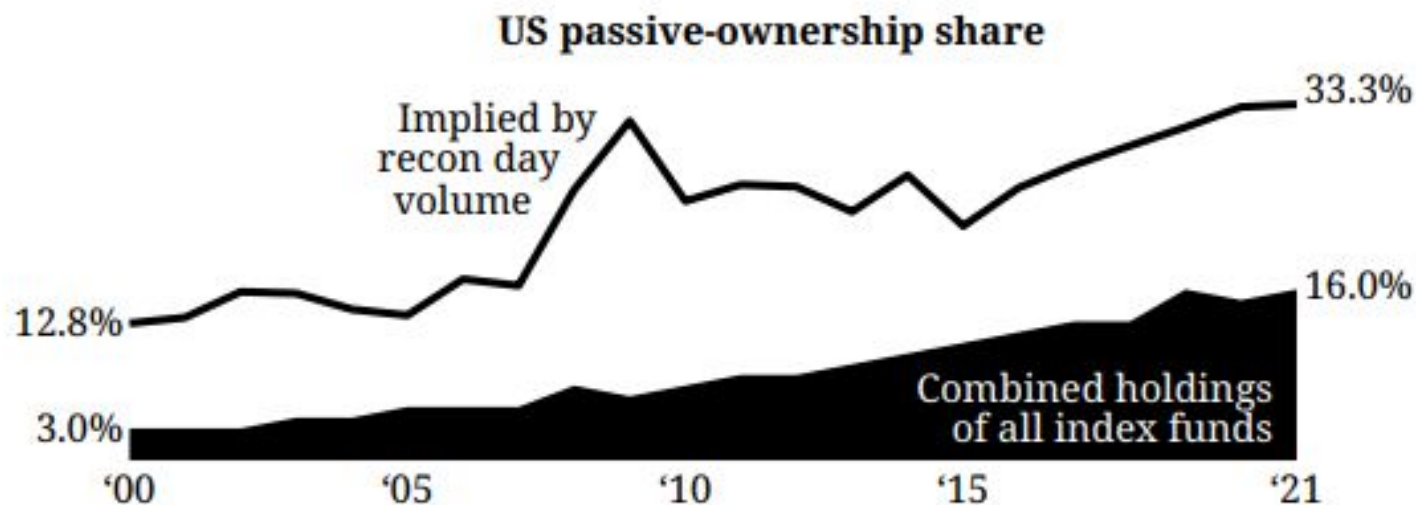
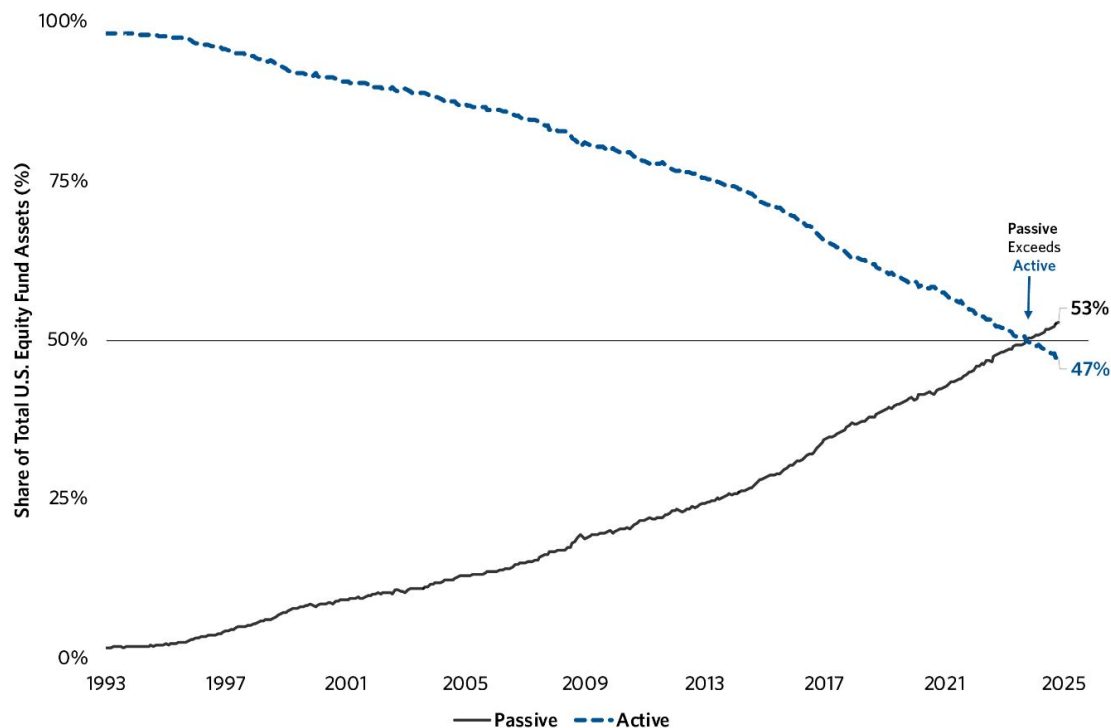


Figure 2. Black line depicts the percent of the US stock market owned by passive investors tracking the S&P 500, S&P MidCap 400, Russell 1000, Russell 2000, and Nasdaq 100. Calculation is based on total volume experienced by index additions and deletions on reconstitution day. Black ribbon shows that percent of the US stock market owned by domestic index equity mutual funds and ETFs according to the Investment Company Institute (ICI). Sample: 2000 to 2021.

US Passive total:

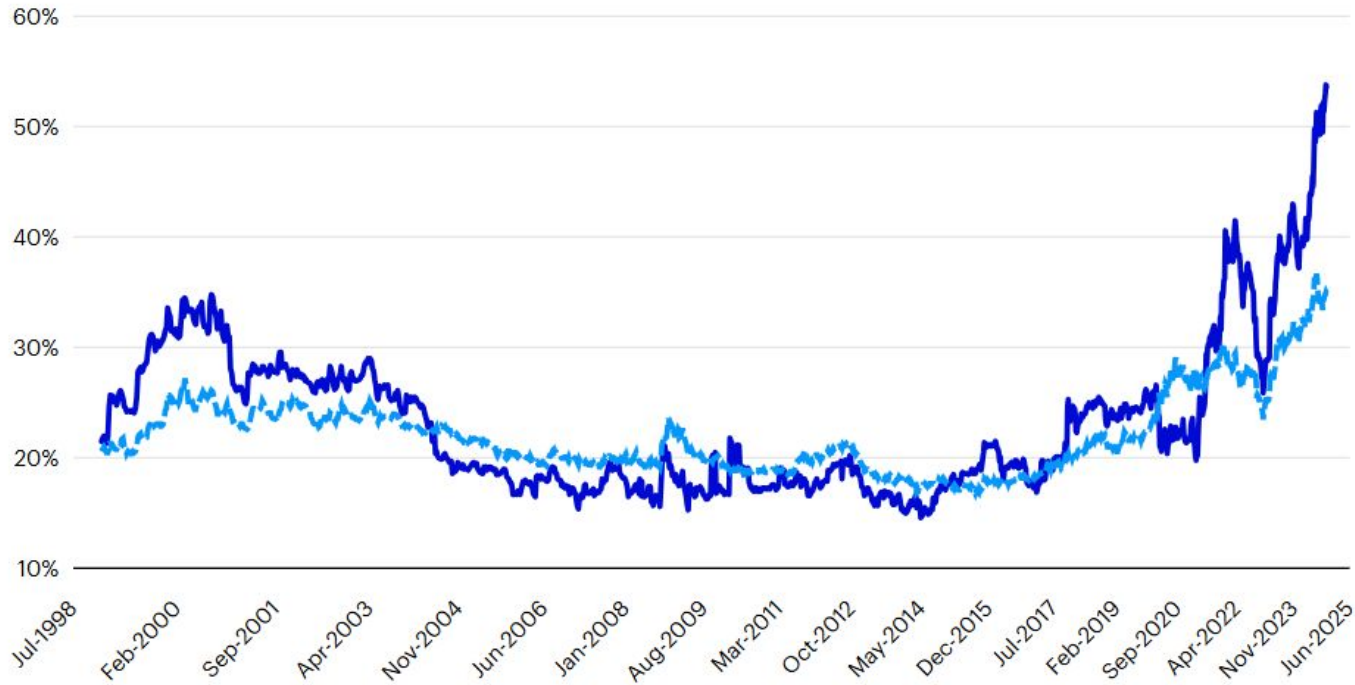
Figure 1. Passive Strategies Surpass Active Management



Source: Research Affiliates and Morningstar. Data as of December 31, 2024, and include U.S. open-ended funds and ETFs (with obsolete funds included). The lines represent the percentage of assets under management in actively and cap-weighted passively managed U.S. equity funds. In February 2024, passive assets under management (black line) surpassed active (blue dashed line).

Valuations:

Fig.1: Weight and contribution to risk of the top 10 names of the S&P 500 index



Special Cases:

Novo Nordisk / Denmark

- >50% of the index at peak
- Managers limited to 20%
- Passive outperformance, now passive underperformance

Australian Small caps

- Usually a bet on small resource companies or not.
- Most FM not

Equal Weight:

- 1958-2015 = equal-weight beat market weight by 2% p.a.
- 1989-2023 = equal-weight beat market weight by 1% p.a.
- Since 2023, market weight beats equal weight by 35%
- It is a factor bet

Passive Bubble:

- Active underweight large stocks
- Traders overweight large stocks
- Disproportionate Price Increases for Large Firms
- Wide Market Impact
- Increased Idiosyncratic Volatility
- largest stocks outperform the index in the first week of each month

Small Cap issues:

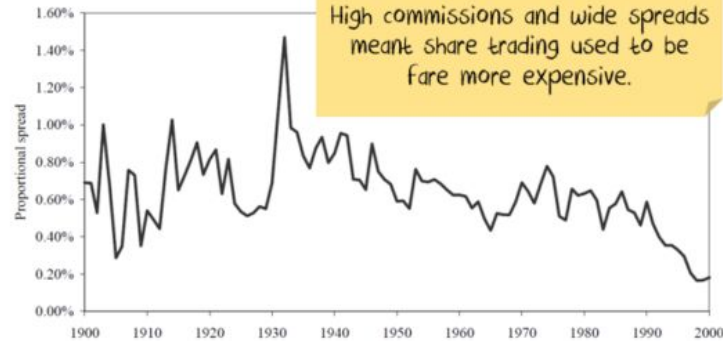
- Asset allocation
- Best and biggest are lost (+CGT)
- Worst of the biggest become the biggest in your universe
-

Equal Weight:

Figure 3. Average commissions on round-lot transactions in NYSE stocks
(based on fixed schedule pre-1968 and member commission revenue thereafter)

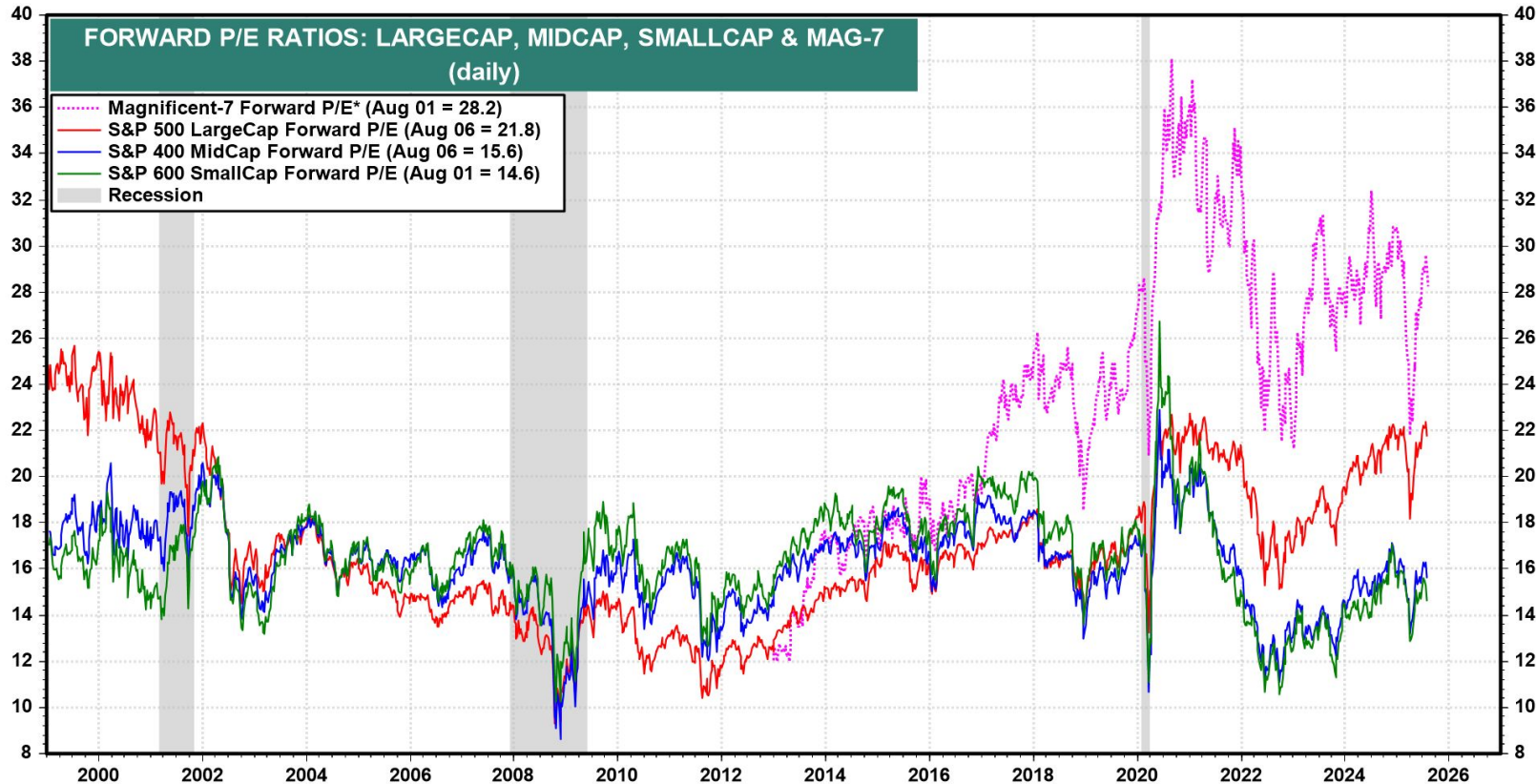


Figure 1. Bid-ask spreads on Dow Jones stocks
(all DJ stocks 1900-1928, DJIA stocks 1929-present)



Source: *A Century of Stock Market Liquidity and Trading Costs* (2002)

Valuations:



Source: LSEG Datastream and © Yardeni Research, and Standard & Poor's.

* Magnificent-7 stocks include Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, NVIDIA, and Tesla. Both classes of Alphabet are included.

Special Cases:

1. Passive Investing Doesn't Eliminate Price Discovery

Although passive investors don't actively trade on fundamentals, *active managers still exist* and continue to analyze and trade based on price signals. The price discovery mechanism still functions because:

- A significant share of the market remains actively managed.
- Active investors set prices; passive investors simply follow.

2. Market Efficiency May Improve

Passive investing can reduce *overtrading, speculation, and herd behavior* common in active management. This may actually *improve* market efficiency:

- Lower churn and trading costs.
- Active managers often underperform after fees.

3. Common Ownership ≠ Systemic Risk

The idea that passive investing creates systemic risk through common ownership is debated:

- *Empirical evidence is mixed.*
- Investors can still withdraw from passive funds, preserving market responsiveness.

Special Cases:

4. Momentum Isn't Caused Solely by Passive Flows

Momentum existed long before passive dominance:

- *Behavioral biases* and return-chasing exist in active funds too.
- Cap-weighted indexes are just one of many momentum sources.


5. Systemic Risk May Be Overstated


- Passive ownership is often *diversified* across funds and sectors.
- ETFs and index funds include liquidity mechanisms to function during volatility.


6. Alternative Indexing Mitigates Concerns


The growth of *smart beta* and *fundamental indexing* blends passive strategies with valuation sensitivity and factor exposure.


Choose themes to screen from your portfolio away from (i.e. remove stocks)


Climate Change



War



Human Rights



Health


Vices


Animal Rights


Religion


Asset Class


Thematic


Climate Change

- ☐ No Fossil Fuels (Worst Offenders) ⓘ
- ☐ No Fossil Fuels (Any) ⓘ
- ☐ No Coal Seam Gas or Fracking ⓘ
- ☐ No Nuclear Power ⓘ
- ☐ No Old Growth Forest Logging ⓘ

Personalise Your Portfolio

Screens

You can exclude the below to customise your portfolio

Climate Change	War	Human Rights	Health	Vices
Animal Rights	Religion	Asset Class	Thematic	

- No Fossil Fuels (Worst Offenders) ?
- No Fossil Fuels (Any) ?
- No Coal Seam Gas or Fracking ?
- No Nuclear Power ?
- No Old Growth Forest Logging ?



Tilts

You can add the below to customise your portfolio

Investment Style Factors	Climate Change	Technology	
Consumption	Commodities	Military	GICS Sectors

- Quality Stocks ?
- Value Stocks ?
- Growth Stocks ?
- Defensives ?

Personalise your portfolio now >



Build Your Portfolio

Need help with this page?  Video Tutorial

Account Selection

Investment Choice

Risk Profile

Build Your Portfolio

Ethical Overlay

Review

Applicants


Bank Details


Compliance


Final Review


Portfolio Tilts



Quality Stocks 


Value Stocks 

Growth Stocks 

Oil & Gas Stocks 

Gold Stocks 


Agribusiness 

Large Technology Stocks 


Cloud Computing Stocks 


Robotics/AI 

Video Gaming 


Cybersecurity 

Clean Energy 

Defensives 


Battery Supply Chain 

Nuclear Power 


Defense Contractors 

Travel 

Luxury Goods 


Logistics 


Global Communication Services 

Global Consumer Discretionary 

Global Consumer Staples 

Global Energy 

Global Financials 

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