

Why index investors may unknowingly be putting themselves at great risk

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Passive investing has made investing cheaper and more accessible. Its success can also encourage a comforting assumption that buying the market removes the need to think about what is being bought. With a handful of companies dominating the S&P 500, that assumption deserves scrutiny.

There is a strong case for passive investing: low fees, broad market exposure and a long record of many active managers underperforming their benchmarks. These are real advantages.

But a low-cost fund can still own expensive stocks, and a long list of holdings can conceal considerable concentration.

Portfolio manager Michael Green, who recently co-authored a paper examining how growing passive ownership could make markets more unstable, argues that passive investors aren't truly passive.

He calls them the world's simplest systematic traders. The algorithm is: Did you give me cash? Buy. Did you ask for cash? Sell. There's no consideration of valuation, business quality, or macro conditions. It's all about flows.

Opinion: No country for retail investors: Are your ETFs a great product – or are you the product?

When John Bogle launched Vanguard's S&P 500 index fund in 1976, he gave investors a simple way to own the market at low cost. Index funds could rely on prices established by investors evaluating individual stocks.

In that era, the very small proportion of money in index mutual funds could get a free ride on the results and clearing prices established by everyone else, without impacting those prices.

Since then, passive investing has grown quickly, helped along by industry norms that turned broad, low-cost index funds into the easy recommendation.

Today, passive funds control more than 50 per cent of U.S. domestic equity-fund assets. Market cap-weighted flows have become large enough to influence prices rather than simply follow them. New money into the market automatically chases whatever has

already gone up, reinforcing trends and supporting the market. In practice, this effectively turns passive tracking into active price setting.

The S&P 500 has become highly concentrated. Its top ten holdings, largely the biggest U.S. technology leaders, now account for nearly 40 per cent of the index. While there's nothing magical about the 40-per-cent figure, it's worth noting that it has marked market tops.

The Nifty Fifty, a group of 50 U.S. growth stocks in 1973, and Technology, Media, and Telecommunications (TMT) stocks in 2000, reached roughly the same share of the S&P 500 at their respective peaks. Also, Japanese stocks represented roughly 44 per cent of the MSCI World Index, which tracks developed markets, during its top in 1989.

At the core of today's concentration are the "Magnificent Seven," companies that carved out dominant niches, built ecosystems competitors struggled to enter, and generated substantial free cash flow.

Passive investing? That S&P 500 index fund is basically a tech fund

However, these tech giants now see dominating AI as an existential priority and are willing to spend hundreds of billions just to defend their moats. The comfortable, separate monopolies of the past decade have given way to direct competition, and the fight has turned into a bruising, winner-take-all contest.

Sure, some of these companies could emerge as huge winners from this AI arms race. But that's beside the point. What matters is that the passive index has shifted into a concentrated wager on AI succeeding and generating attractive returns on staggering amounts of capital.

As an investor in passive funds, yes, you're getting low costs, but you're no longer getting true diversification. And while these may be some of the best businesses in history today, that doesn't guarantee their stocks will make good investments going forward.

It is also important to remember that passive investing has worked exceptionally well in the U.S. but not everywhere. Over the past 10 to 15 years, if you bought passive ETFs tracking China or Europe, your returns have been underwhelming. The U.S. has benefited from consistent net inflows, a strong currency, and a dominant tech sector. But this one-way bet on America isn't immune to reversal.

As the late Charlie Munger famously advised, "Invert, always invert." In this new market environment, we must ask ourselves the inverted question: What happens when the persistent "buy" order for passive funds reverses?

If these passive flows were to ever reverse in a meaningful way, the lack of traditional, active buyers (as there are very few true active investors left in the market) could trigger a steep and dramatic market decline. This scenario represents a significant systemic

risk, highlighting the fragility beneath the surface of today's seemingly stable, passive-driven market.

Gen Z is obsessed with dividends. But at what cost?

Passive funds still have many merits, but they've become far more concentrated than most people realize. If you own a S&P 500 index fund, you're effectively tied to AI paying off in a very big way. That may happen, or it may not.

In a market shaped so heavily by flows, narratives and concentration, understanding your real exposures, and ensuring you're genuinely diversified is simply a sensible step toward building a more resilient portfolio.

Disclosure: The author and accounts he manages at White Falcon own shares in Amazon.com, one of the Magnificent Seven companies discussed in this article.

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