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Opinion Piece

The Risks of Passive Investing

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Investors should take heed of concentration risks in equities and bonds, procyclical weighting and inflated profits: the pitfalls lurking in ETFs and index funds.

A growing number of securities portfolios, namely between 25 and 30 per cent, are managed passively. This trend is primarily rooted in the fact that a majority of active investors fail to outperform a benchmark or reference index in the long term. But passive investors underestimate the occasionally exorbitant concentration risks they are accepting. According to the principles of passive investing, anyone who consistently refrains from making active decisions in their equity investments is running an indexed portfolio (MSCI World). As a result, around two-thirds of the equity portfolio will be allocated to US securities and just 2 per cent to Swiss ones.

In other words, the investor holds a similar stake in the chip manufacturer Nvidia as it does in all of the approximately 700 companies listed on the Swiss and German stock markets combined. This makes no sense from the perspective of a Swiss investor. There are, after all, good reasons why barely any Swiss investor or pension fund invests thirty times as much in US equities compared to the domestic market. As a rule, the proportion of Swiss equities is actually significantly higher than that of their American counterparts.

Following the crowd

History teaches us that this preference for the domestic market makes sense. In its heyday during the late 1980s, the Japanese stock market accounted for around 50 per cent of the global market index (compared to just 6 per cent today), before the bubble burst and the Nikkei plummeted by over 80 per cent. Anyone investing in global market portfolios will be blindly participating in this madness. There are also concentration risks within individual countries. In the US, tech stocks linked to artificial intelligence account for around 50 per cent of the S&P 500. It's reminiscent of the dot-com bubble.

Moreover, with the flotation of SpaceX, the stock market rules were abruptly amended to accommodate the company's prompt listing on the MSCI and Nasdaq indices. This had corresponding consequences for millions of passive investors: they were unaware that their portfolios had been flooded with shares carrying a stratospheric valuation, equivalent to more than a hundred times their revenue. Since then, SpaceX shares have almost halved in value. Passive investors follow these fads like lemmings.

> «There are now significantly more ETFs on the Swiss stock exchange than equities.»

The AI hype has ensured that indices such as the MSCI World and the S&P 500 are increasingly dominated in a procyclical manner by expensive equities. Here, a handful of players are just funnelling a lot of business in each other's direction to keep business moving in circles, leaving them vulnerable. The paradox in this regard is that companies such as Nvidia and Micron recognise their sales in full as revenue in their profit and loss accounts, whilst, in contrast, buyers such as Microsoft and Alphabet record the same transactions as investments.

So corporate profits are ballooning into the billions as a result. Once the high margins of overvalued companies start to feel the pinch when competition intensifies, passive investors – many of which are pension funds – will pass through a valley of tears due to the concentrated procyclical risks they have accumulated. There are also concentration risks on the Swiss equity market. The heavyweights Nestlé, Novartis and Roche alone, for example, account for nearly half of the SMI's market capitalisation. Yet the penny should have dropped long ago that not even these blue-chip companies are immune to crises.

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Passive investing in bonds is downright grotesque. Their indices follow a rather peculiar weighting system: the more debt a country or company accumulates, the greater its index weighting. This means that highly indebted nations such as Japan and the US carry the greatest weight in passive ETFs. Another issue is the maturity risks, which are inherently procyclical. For reasons of pure self-interest, governments and companies issue bonds with particularly long maturities in times of low or even negative interest rates. This significantly increases the duration and, consequently, the interest rate risk. The duration of relevant bond indices is currently around 50 per cent higher than it was twenty years ago.

And in 2022 we received a glimpse of what this would mean for investors in the event of a rise in interest rates. At the time, passive investors very quickly lost around 15 per cent on bonds that were thought to be safe. But that's not all. More bonds with lower credit ratings are included in indices during low-interest phases and, consequently, in the portfolios of passive investors, aggravating their risk exposure.

Who should consider ETFs?

A closer look reveals passive investing to be an illusion, as the most important aspects of portfolio management itself are by their very nature active. So what would be a healthy allocation to shares, real estate and bonds, as well as the currency breakdown and the proportion of alternative investments such as gold, private equity, hedge funds or cryptocurrencies? These decisions account for around 90 per cent of the return and the risk.

Anyone investing in the wrong asset classes stands to miss out on potentially far higher returns compared to a scenario in which their Swiss equities deviate from a passive index by 1 or 2 percentage points in a single year. Incorrect prioritisation of these fundamental issues is not uncommon. This applies even to professional pension funds: their average equity allocation is just over 30 per cent, which is clearly too low given an almost perpetual investment horizon.

ETFs are a sound alternative for investors who hold securities portfolios worth, for example, 100,000 Swiss francs and who, for diversification reasons, cannot implement this through individual investments. Beware, though: there are now significantly more ETFs on the Swiss stock exchange than equities. If the selection of passive ETFs ultimately triggers more active management than the selection of individual shares, something has gone wrong. By contrast, investors with around half a million or more in available assets would be well advised to put their money into top-tier individual investments. When it comes to equities, it is advisable to aim for a balanced allocation across around thirty to fifty holdings in order to ensure good diversification. Purposeful selection also keeps the portfolio free of the kind of junk that is inevitably included in indices.

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