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Registered Investment Advisor

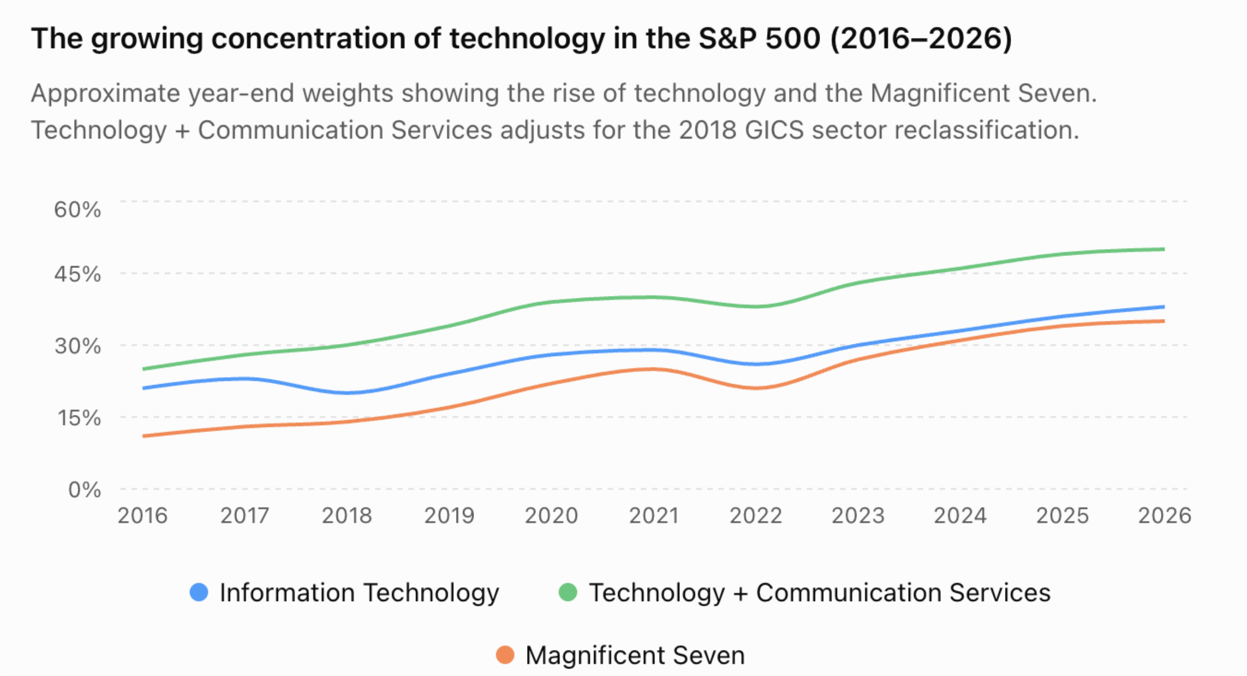
FCM Weekly Market Notes

Now is When Passive Indexing Fails You

Investors are used to spending a disproportionate amount of attention, analysis and investment dollars in the tech sector. But it is increasingly clear we are at an inflection point where, unless the AI story of massive profit growth materializes, that will result in a sub-optimal outcome.

What most of us think of passive investing has been a great development: it has dramatically reduced the costs of investing and simplified decision-making for most of the investing population. But it also rewards growth: companies that grow in market cap attract more dollars that leads to a bigger share of the investing pie, which attracts more passive dollars.

Over long periods of time, as tech has come to dominate markets, that has resulted in a spectacular rise in the percentage of major indexes that receive the bulk of passive dollars.

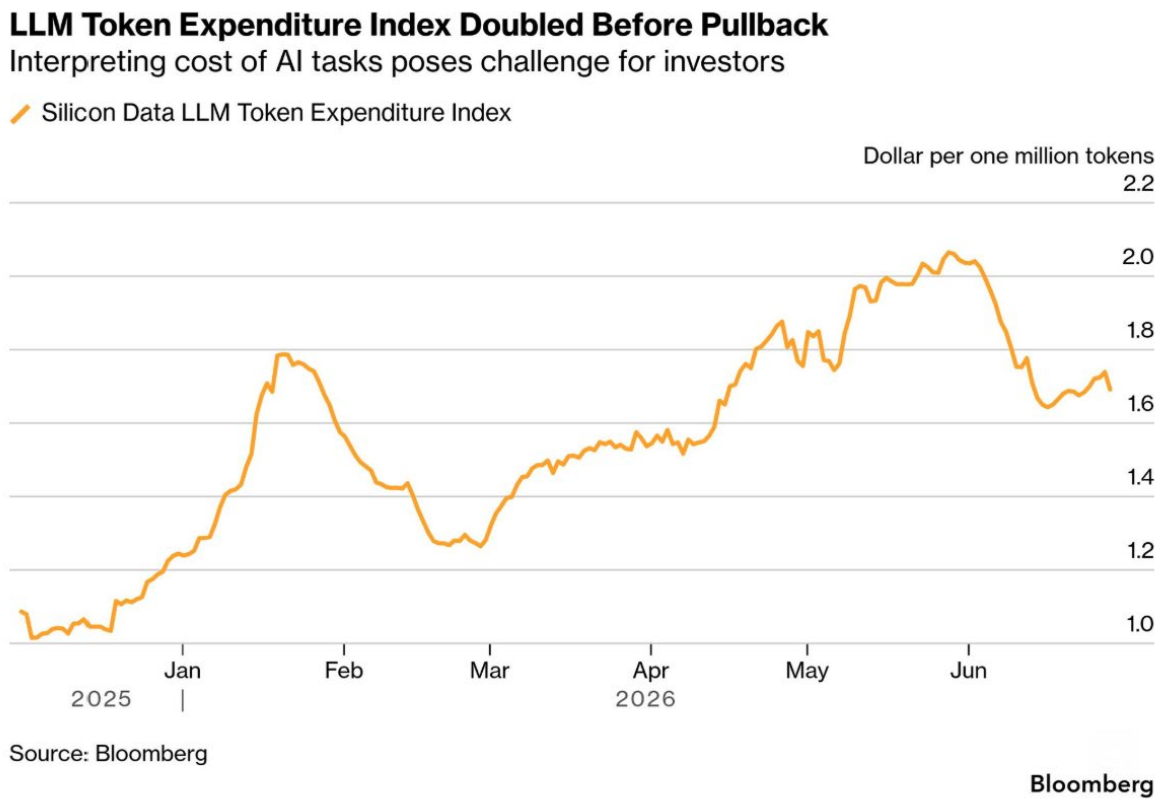


Tech and tech adjacent share of the S&P has risen from less than 30% to roughly 50% in ten years. Buying a passive S&P fund is now buying a massive stake in technology. As a reflection of the economy and the growth of earnings that makes sense. The problem arises when the inexorable growth in those factors stops or reverses.

It's not just the trillions of dollars invested passively that matter, but the billions of dollars invested in trying to out-perform the index. Those investors have career risk to think about—they can't be too far away from index weightings lest they well under-perform and get shown the door, so the psychological reference point for broad active funds is a very large percentage in tech.

Unless the AI story pays off according to its narrative of massive profits just around the corner, the vast majority of investors will discover they have an extremely uncomfortable percentage of their investable assets tied to a failed investment theme.

This week brought some more indications of cracks in that story. Meta announced it would sell excess compute capacity. Though the stock temporarily rallied on that headline, that is not the story you would expect if you were looking to justify hundreds of billions in investing in that capacity. Secondly, there are signs that companies are re-thinking extravagant AI expenditures when they are unsure what the economic payoff might look like:



The market will be extraordinarily sensitive to signs that AI returns are not moving straight up and to the right. Mega-caps are spending their free cash flow and issuing stock and debt to fund investment. That investment is in data centers with depreciating assets, funded by debt issuance that will almost surely still be there when the current generation of chips are eclipsed by the next.

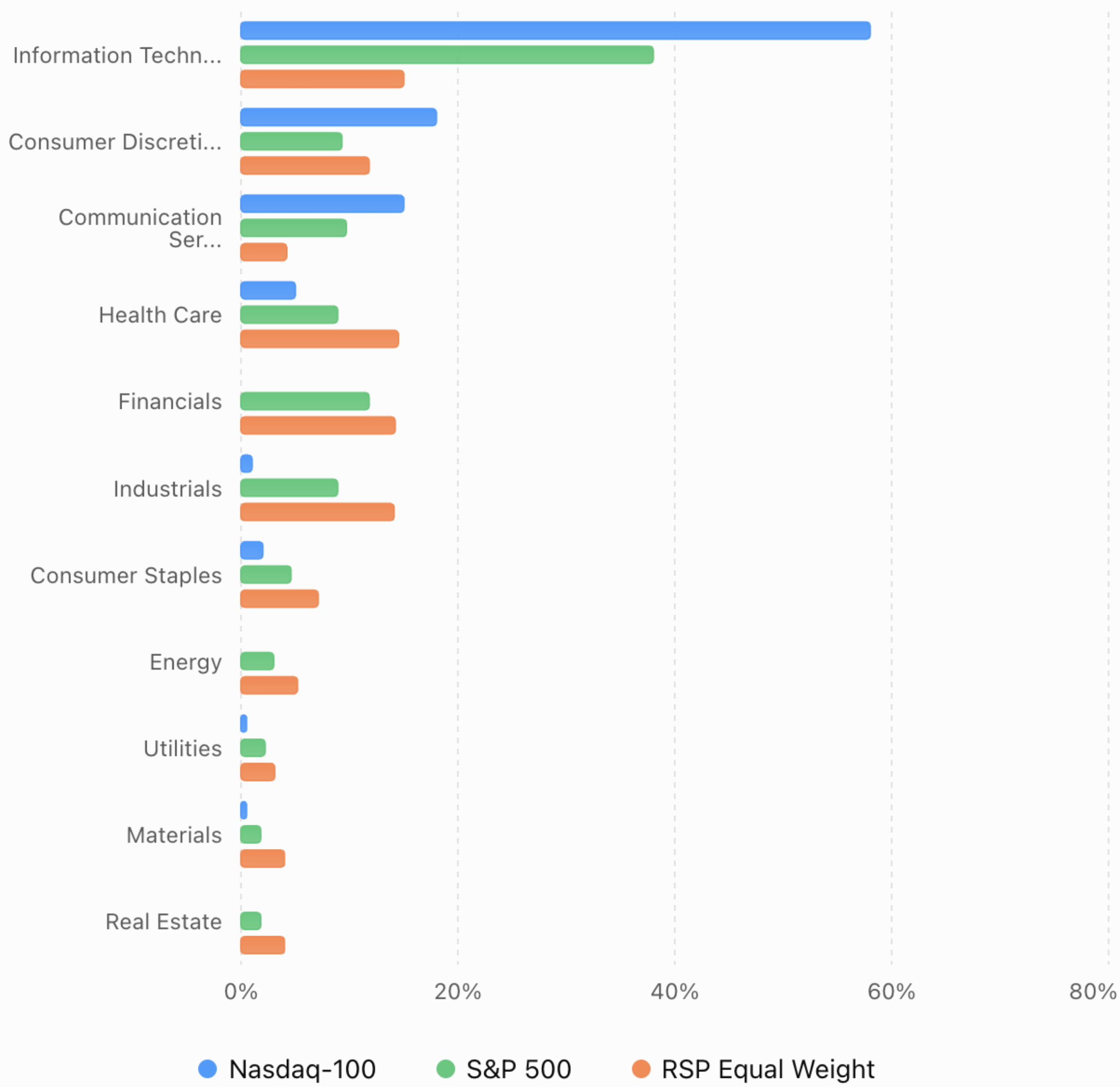
Not a lot can go wrong with the story in that scenario.

And this is occurring when the passive indexing revolution has led the investing world to accept that the proper baseline for tech exposure is nearly half of your assets.

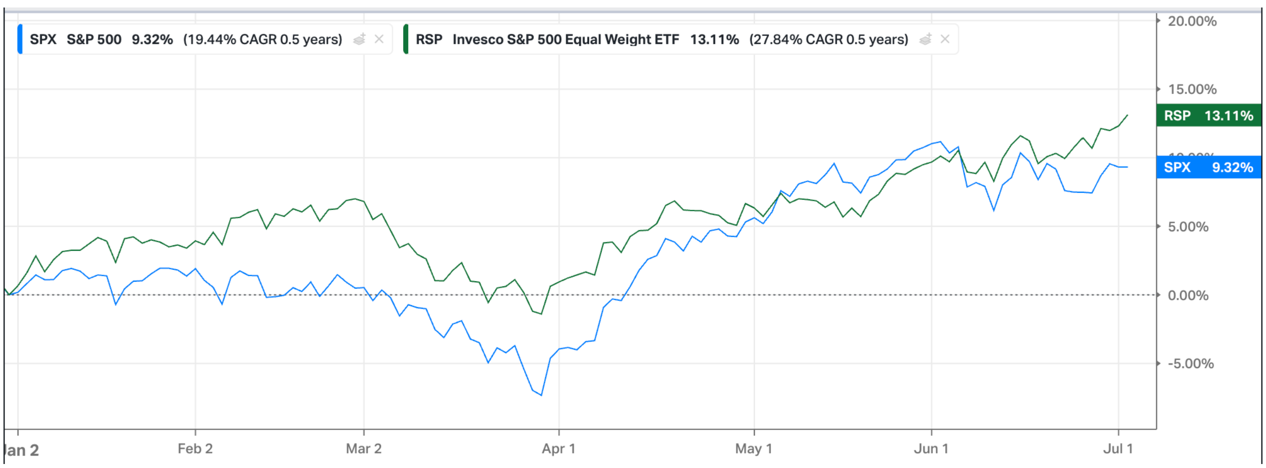
It is extraordinarily simple for investors to fix this, with a move that gets virtually no attention in an S&P-referenced world: an equal-weighted index. This is how your exposures look in the major indices, and how they would look on a simple market-weighted approach:

Sector weights: Nasdaq-100 vs. S&P 500 vs. RSP

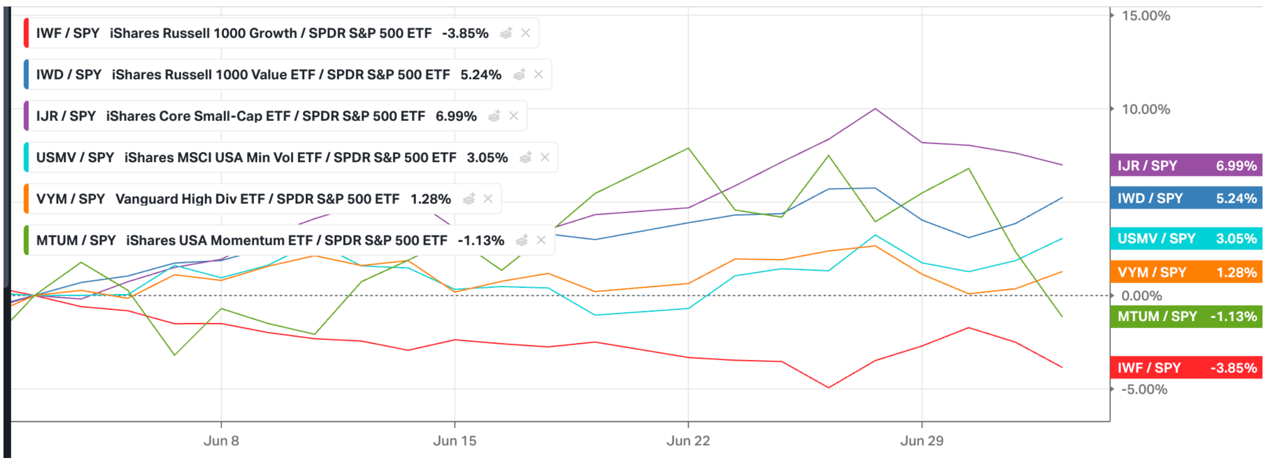
Approximate sector allocations illustrating the concentration differences between the three indexes.



What would have happened to your returns this year if you had moved from a market-cap weighting passive approach to an equal-weighted one? You would have prospered:



Of course, investing in “factors” that presumably lead the market over different cycles will be affected by any wobbling of the AI-trade as well. Momentum and growth are out; value, high dividend, small caps and low volatility are in. These are the returns for the past month relative to the S&P index return:



You can be an “AI_Avoidance Investor” (AAI, pronounced just like a startled scream of pain…) in many ways, and you can still do it passively: you need not rely on choosing an active manager who chooses stocks (with its low probability of an above average return). All you have to do is avoid the major indices that virtually the entire investing world uses as its common reference.

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