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Who Wants To Bet Their Retirement On AI?

Passive fund investors may be effectively making a highly active, one-way bet on the AI boom.

By Matt Bogdan

MANY INVESTORS ASSUME THAT passive, index-tracking funds with hundreds of holdings are inherently more diversified—and therefore less risky—than concentrated, actively managed funds. But we would argue the opposite. In fact, passive, market-capitalization-weighted index funds may be more concentrated today than many actively managed funds, particularly as these passive funds continue to coalesce around a singular investment theme: AI.

As big tech becomes an ever-larger proportion of investors' equity portfolios, we caution that passive fund investors may be effectively making a highly active, one-way bet on the AI boom. By their very nature, passive funds cannot adapt to changing market conditions, leaving them to capture nearly all the upside or downside of future market moves. If the market gets overexuberant about the potential promise of AI—as we believe it already has—passive investors could face losses comparable to those experienced during the dotcom bubble. And given the very nature of passive investing, there would be no way for the passive fund to quickly recalibrate its positioning.

The S&P 500 Is More Concentrated Than Ever Before

Holding 500 stocks in a portfolio does not necessarily reduce concentration risk, especially when the largest holdings dominate the index to the extent they do today. To illustrate this, we analyzed the S&P 500's effective number of holdings, which represents the number of equally weighted holdings needed to produce the same level of portfolio concentration.

Due to the concentration within the S&P 500's market leaders—its top 10 holdings accounted for 40% of the index's market capitalization as of September 30—the index effectively only holds 43 stocks, a historical low. This is far fewer than the 67 total holdings of a typical U.S. large-cap active fund and is approaching parity with their median effective number of holdings, which currently stands at 37.

As of the end of September, the Technology, Media and Telecommunications (TMT) sector comprised 45% of the S&P 500, exceeding dotcom-era highs. When factoring in tech-adjacent sectors like biotech or fintech, whose performance tends to be highly correlated with big tech, the index's exposure to the broader tech and AI megatrend is roughly 62%. Investors seeking diversification in the current environment may be better suited by active funds.

High Concentration Paired With Extreme Valuations

Not only is the S&P 500 highly concentrated at present, but it is also trading at valuation levels that imply unprecedented future earnings growth, in our opinion. Despite billions of dollars in capital expenditures by big tech to win the AI arms race, we have not yet seen these earnings materialize.

The average stock in the index trades at a next-12-month price-to-earnings (P/E) ratio of 23x as of September 30, compared to a historical average of 16x. For reference, the index hit a P/E of 24x at the end of 1999, right before the burst of the dotcom bubble.

Meanwhile, the S&P 500's average price-to-sales ratio (P/S), a gauge of how much investors are willing to pay for a company's revenue, is at an eye-popping 3.5x. More than one-third of the S&P 500 traded at a P/S above 10x as of September 30. In comparison, only 21% of the index reached this milestone at the height of the dotcom bubble, with an average P/S of 2.3x.

While the past does not predict the future, historically, the higher valuation multiples rise, the further they fall. We examined the average relative returns for all stocks in the S&P 500 over the past 30 years that had reached a P/S above 10x and found that stocks that crossed this threshold fell by an average of 10% over five years—a deleterious outcome for long-term investors. The decline for stocks reaching a P/S of 20x (13% of the current S&P 500 vs dotcom bubble high of 11%) averaged nearly 30% over five years, and those reaching a P/S of 30x or more suffered devastating losses of 70% over the same period.

As of September 30, AI darlings like Palantir, Crowdstrike and Nvidia were trading at P/S ratios of 126x, 28x, and 27x, respectively.

Passive Investors Face Significant Downside Risk With No Way To Pivot

Modern markets can fall fast. During the dotcom bubble, the market lost its first 20% over the course of six months; during the great financial crisis, it took 11 months to reach that milestone.

But over the last decade, we have observed multiple occasions where the market dropped 20% in less than a month. We believe the next major drawdown could be the fastest in history, and we would advise investors to actively prepare, not passively react.

Not only could the market fall extraordinarily fast, but we believe the U.S. government will have fewer tools to stabilize a faltering economy today than in previous crises. The U.S. federal government is in a much different fiscal position today than it was in 1999, and market drawdowns over the past 30 years have often been cushioned by government interventions like interest rate cuts and quantitative easing. We believe these options will be constrained this time due to the U.S. government's ballooning budget deficit and its ongoing battle with inflation.

The Case For Highly Adaptable Active Management

Passive funds tied to benchmark weightings are all-in on AI, whether their investors realize it or not. In contrast, active managers can leverage their ability to go beyond the benchmark to navigate concentrated risks, reduce exposure to potentially overvalued sectors and position portfolios to help better weather potential market volatility. For investors seeking true diversification and effective downside risk management, active management deserves reconsideration.

We think the time to prepare is now. While not a panacea for investment losses, portfolio diversification is especially crucial in times of record-high valuations.

As you examine your equity portfolio today, the question you should be asking yourself is simple: Do you want to bet your retirement on AI?

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