Evidence is Mounting; the Time is Now for Active Management

The sales pitch for passive investing is that it offers investors diversified exposure to the stock market with lower risk. As I argued in my article, The Hidden Risks of Passive Investing a couple of weeks ago, the diversification argument is not really true anymore. Looking at the S&P 500 ETF, as many as 486 stocks have a weighting of less than 1%, making it almost totally reliant on the top 14 stocks to deliver a return. Which brings us on to the 'low risk' element. How low risk is it to have so much exposure to the Magnificent 7 stocks which have all performed so well for so long? What happens when these stocks start to underperform?

The point is that the underperformance of the big names is already happening, and it's been brought about by a downturn in fundamentals. Not only are the fundamentals fading for some of these companies but there is also new leadership coming from other areas of the market which are showing explosive growth, but which are not well represented in the S&P 500 index.

When we look at the so-called Magnificent 7 stocks, we find the biggest weighting is Apple at 7.1% which has been flat to down in price terms for several quarters now. Part of the reason for this is the deceleration in growth; last quarter it managed to eke out 2% top line growth after several quarters of negative revenue growth. The stock has been underperforming the S&P 500 since the end of June 2023. Tesla has also been underperforming, peaking vs the index back in December 2021. It has suffered from new competition and has been forced to cut prices to make up for over-production. Mag 7 has therefore become Mag 5 and with recent bad news coming out of Alphabet concerning their AI platform, Mag 4 is perhaps on the horizon.

Apple and Tesla are both having problems in their core businesses and as investors look forward, they are now realising that they are not well positioned in terms of the new secular themes, most notably AI. There are simply better places to have your money and that is what the weakness in these two stocks is telling us.

Everything is cyclical, and as this new cycle turns, active managers can proactively adjust their portfolios to account for the new reality and the new opportunities that the market is offering, whereas the index trackers must stick with the winners of the old cycle. And because these former winners are so large in market cap terms, they will remain the top holdings of the trackers for many years to come.

In an environment where some of the biggest weights in the index are faltering, this is a great time for investors to consider actively managed funds such as the VT Tyndall North American Fund. Our focus is the winners of tomorrow not the biggest stocks in the index, and the current backdrop is much more conducive to this style of investing.

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