

Drummond Capital Partners

Market Insights – September 2025

Market Update | Passive Aggressive

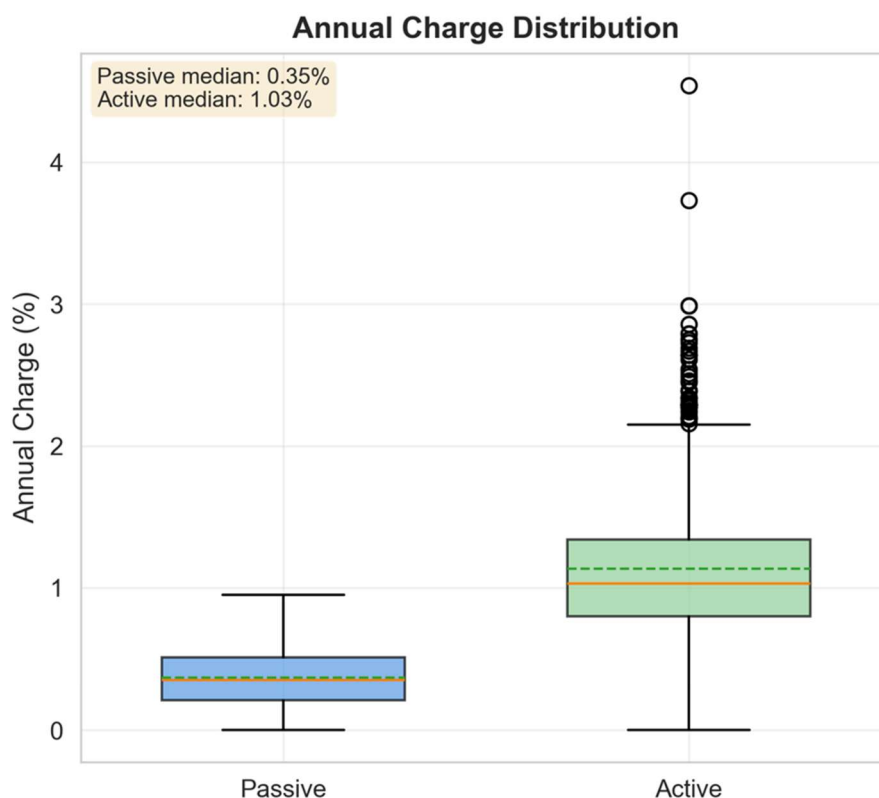
Key Points:

- Active managers underperform and charge for the privilege, few beat their benchmarks despite charging 3x the fees.
- Today's "passive" portfolios are dangerously concentrated. 10 stocks drive 30% of the portfolio risk for a global exposure, abandoning diversification entirely.
- Market cap weighting creates a momentum feedback loop. Winners get bigger regardless of fundamentals, attracting flows that push prices higher.
- Choosing passive isn't passive. It's betting the biggest stay biggest while accepting extreme concentration for lower fees.

Active equity managers overall have struggled to deliver decent performance for many years now. They, on average underperform their respective market cap weighted indexes and charge investors a reasonable premium for doing so. So why do investors still allocate capital to active managers? Over time, and almost certainly due to the industry's underperformance, the market share that is actively managed has been shrinking, however remains substantial. In this month's *Market Insight*, we review active and passive management within equity markets. Ultimately, we think there is a place for both, and each represents an important counterbalance to the other.

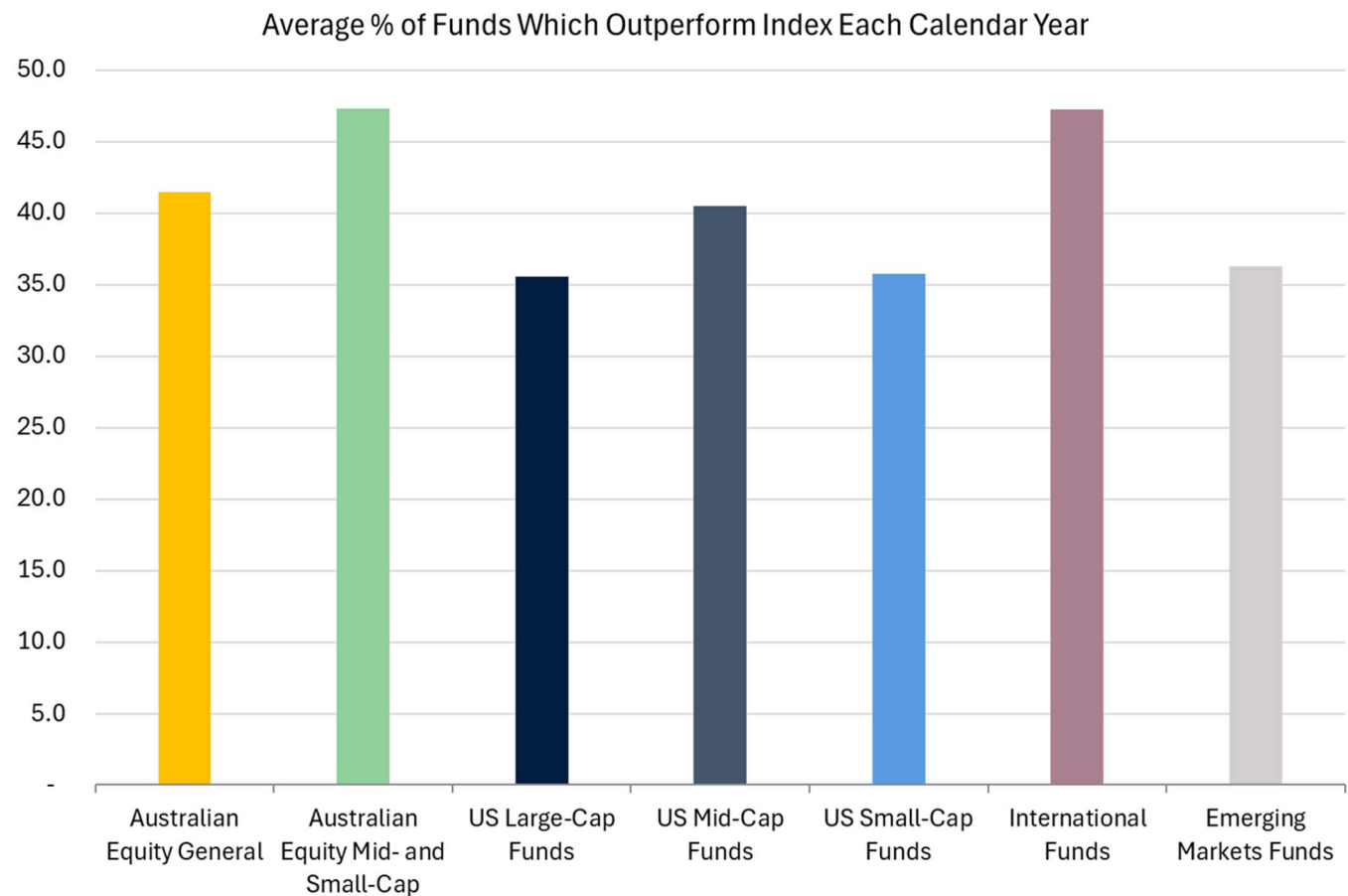
Charging More for Less

The only guarantee in active versus passive management is that fees are higher for active. That makes sense, researching stocks, managing a portfolio and marketing your results takes people, time and effort. Not actively choosing what to invest in is much easier. On average, even with significant falls in fees over time, off-the-shelf fees for active equity managers are around three times those of passive products. The chart below shows the relative fee distributions based on the universe of open-ended actively managed funds and passive, or index linked ETFs and open-ended funds in Australia. Importantly, few investors with scale would be paying the off the shelf fee. Rebates or individual mandates at a lower fee level are very common, which narrows the gap between the cost of active and passive somewhat.



Source: LSEG Refinitiv

Active managers, though consistently more expensive, have on average underperformed. The chart below shows that for most markets, only around 35% to 45% of active managers outperform in any given year. The underperformance seems to be most consistent in large cap stocks, likely because they are more well researched and there is smaller opportunity to identify market mispricing. When you look at consistency of outperformance, which is what matters to the end investor (unless they think they can pick which active managers will outperform on a year-by-year basis), the numbers look even worse. Fewer active managers outperform their benchmarks consistently than would be expected from random chance alone.

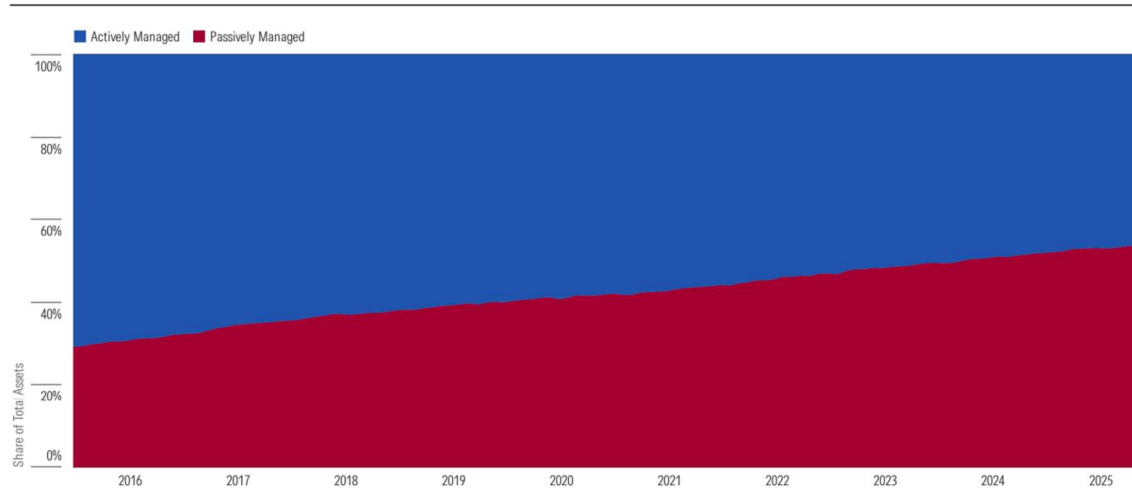


Source: S&P SPIVA Data

Changing Market Structure

The combination of higher fees and worse performance has not surprisingly taken the share of active management lower over time. For the US equity market, active management has fallen from around 70% of total assets in 2015 to around 50% today. The evangelists of active management argue that the higher weight of passively managed assets makes markets less efficient and can lead to misallocated capital. They are probably correct. They also argue that passive investors are free riding off the hard work done by active managers. That's also correct.

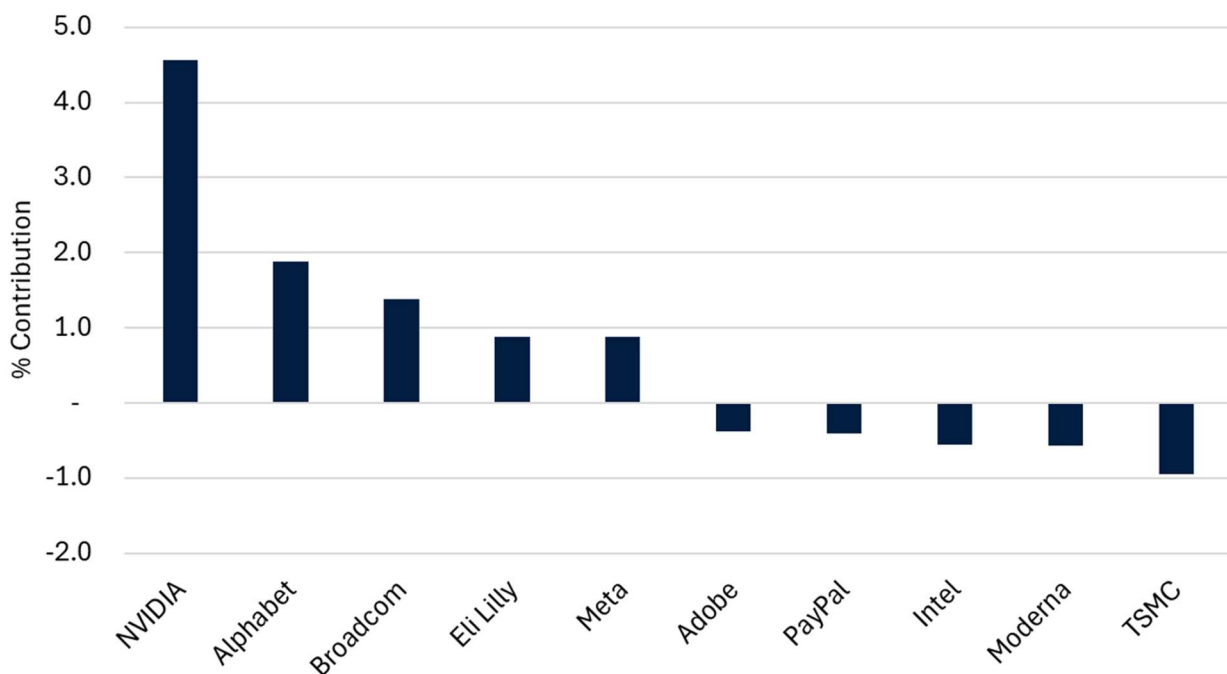
Active Versus Passive: Share of US Long-Term Fund Total Assets



Source: Morningstar

Why has passive investing outperformed? This is a contentious subject. In contrast to the above data, we think whether it has or not depends on your definition of passive. If your benchmark is global equities, then your passive investment has dramatically underperformed US equities. 20% of that underperformance was entirely due to 1.5% less weight to Nvidia (see below). 8% of the underperformance was because of 1.8% less Google/Alphabet exposure. If your benchmark is the market universe as a whole, including small and mid-cap names, which is consistent with the original philosophy around portfolio diversification and passive investing, then your benchmark has underperformed its large cap equivalent. If you are a true believer in diversification, perhaps managing against a benchmark which is more style and region neutral with something closer to equal weight representation in stocks, you probably rightly fear for your job. The outperformance of market cap weighted indexes has been mostly due to a handful of extremely successful US mega cap technology companies dominating that market as a whole.

Top and Bottom Performance Contributors US vs World Since Mid 2020



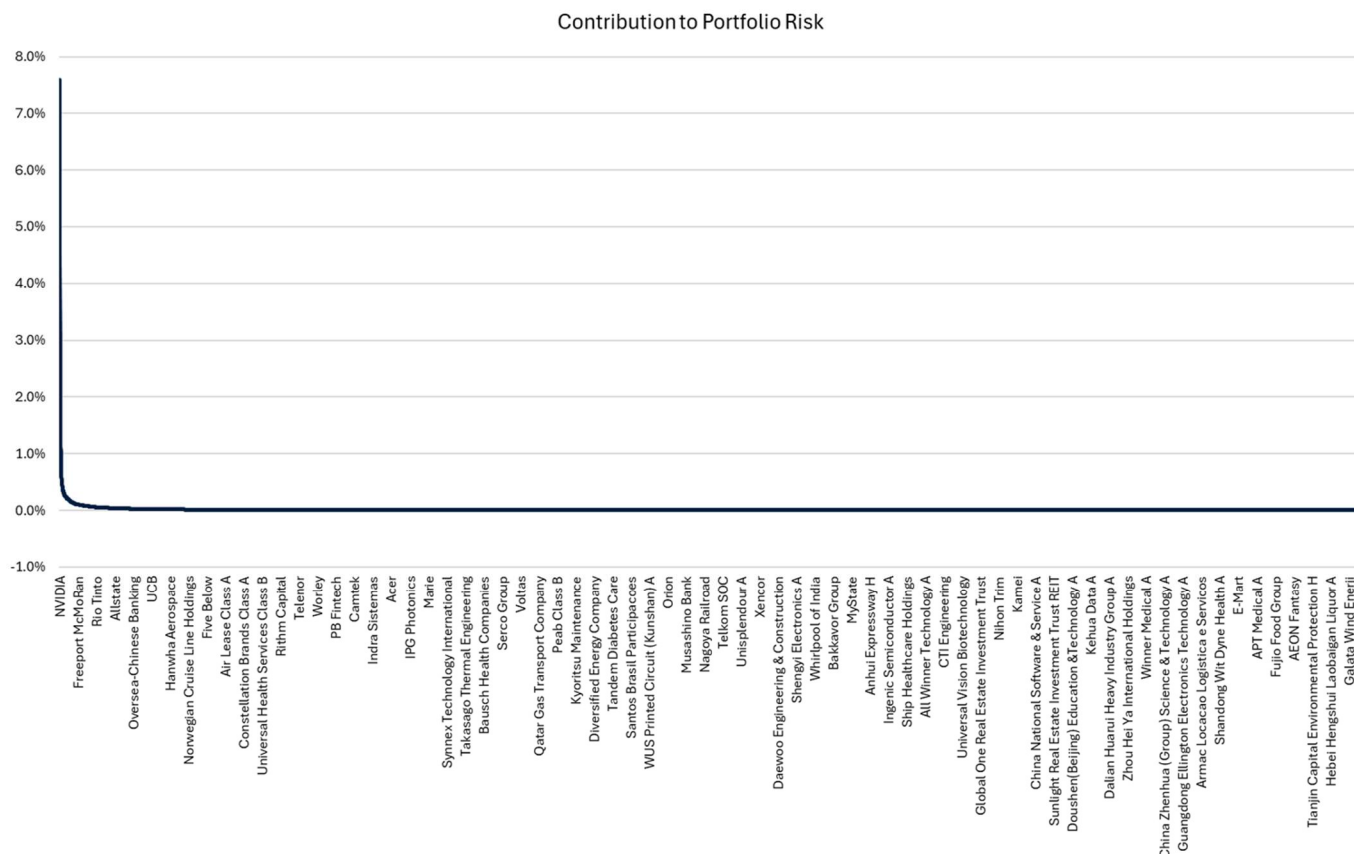
Source: LSEG Refinitiv

Putting that aside, there may be some behavioural and market structure reasons why market cap weighted indexes have outperformed many alternatives and could continue to be hard to beat in the future. For mega-scale institutional investors managing hundreds of billions, market cap weighting is often the only viable investment option. The strategy requires minimal rebalancing since winners automatically receive larger allocations as their prices rise, dramatically reducing transaction costs and market impact. Retail investors have been conditioned by decades of financial media, academic studies, and industry

marketing that passive indexing is the prudent choice. This has created a self-fulfilling prophecy. As more capital flows into market cap weighted indexes, the largest stocks receive disproportionate inflows regardless of fundamentals, potentially pushing valuations higher and creating the very outperformance that attracts more passive flows. There is a natural bid for passive which doesn't exist for active management.

The Great Irony of Passive

The great irony of the passive argument is that a passive portfolio looks nothing like what the original pioneers of the concept would have intended. Indeed, if market cap weighted indexes were deleted from the collective memory of all investors worldwide, and someone suggested building a portfolio where **one-third** of the expected portfolio volatility were to come from the ten largest stocks in a portfolio of more than 9000 names (as is the case today with passive world exposure, see below), they would be laughed out of the room. Passive indexes are contrary to the logical arguments about why investors should invest passively in the first place.



Source: LSEG Refinitiv

While that sounds terrifying, it's important to remember that these are ten of the best companies ever to have existed. They have been enormously successful in generating shareholder returns and there is little to suggest that they will suddenly fail. They are 30% of the passive portfolio's expected volatility – but they are also a huge proportion of the passive portfolio's earnings (see below).



Earnings reflect consensus forward 12-month estimates.

Source: Compustat, IBES, FactSet, Goldman Sachs Global Investment Research

The headline choice investors face when deciding between passive and active management is whether to diversify (again, ironically, given the origins of passive investing) against the risk that the largest companies in the world will not continue to perform as strongly as they have and to perhaps gain exposure to smaller companies with room to grow their earnings, or to assume that the best companies in the world will continue to dominate everyone else. While these companies are the best in the world right now, similar things were said about other market titans in the past and they were eventually assailed (see below). How long dominance persists is a really hard call to make, which is why it is very common for large investors to hedge their bets, blending passive and active exposure together.

Ten Largest Market Capitalisation Stocks in the World at the Beginning of Each Year

2021	2010	2000*	1990	1980
Apple	PetroChina	Microsoft	Nippon T&T	IBM
Microsoft	Exxon Mobil	General Electric	Bank of Tokyo-Mitsubishi	AT&T
Amazon	Microsoft	NTT DoCoMo	Industrial Bank of Japan	Exxon
Alphabet	ICBC	Cisco	Sumitomo Mitsui Banking	Standard Oil
Facebook	Wal-Mart	Wal-Mart	Toyota	Schlumberger
Tencent	China Construction Bank	Intel	Fuji Bank	Shell
Tesla	BHP Billiton	Nippon T&T	Dai-ichi Kangyo Bank	Mobil
Alibaba Group	HSBC	Exxon Mobil	IBM	Atlantic Richfield
TSMC	Petrobras	Lucent Technologies	UFJ Bank	General Electric
Berkshire Hathaway	Apple	Deutsche Telekom	Exxon	Eastman Kodak

New Addition to List

Drops Off List Next Period

Flip-Flop: New, Then Drops

Company is:

US

European

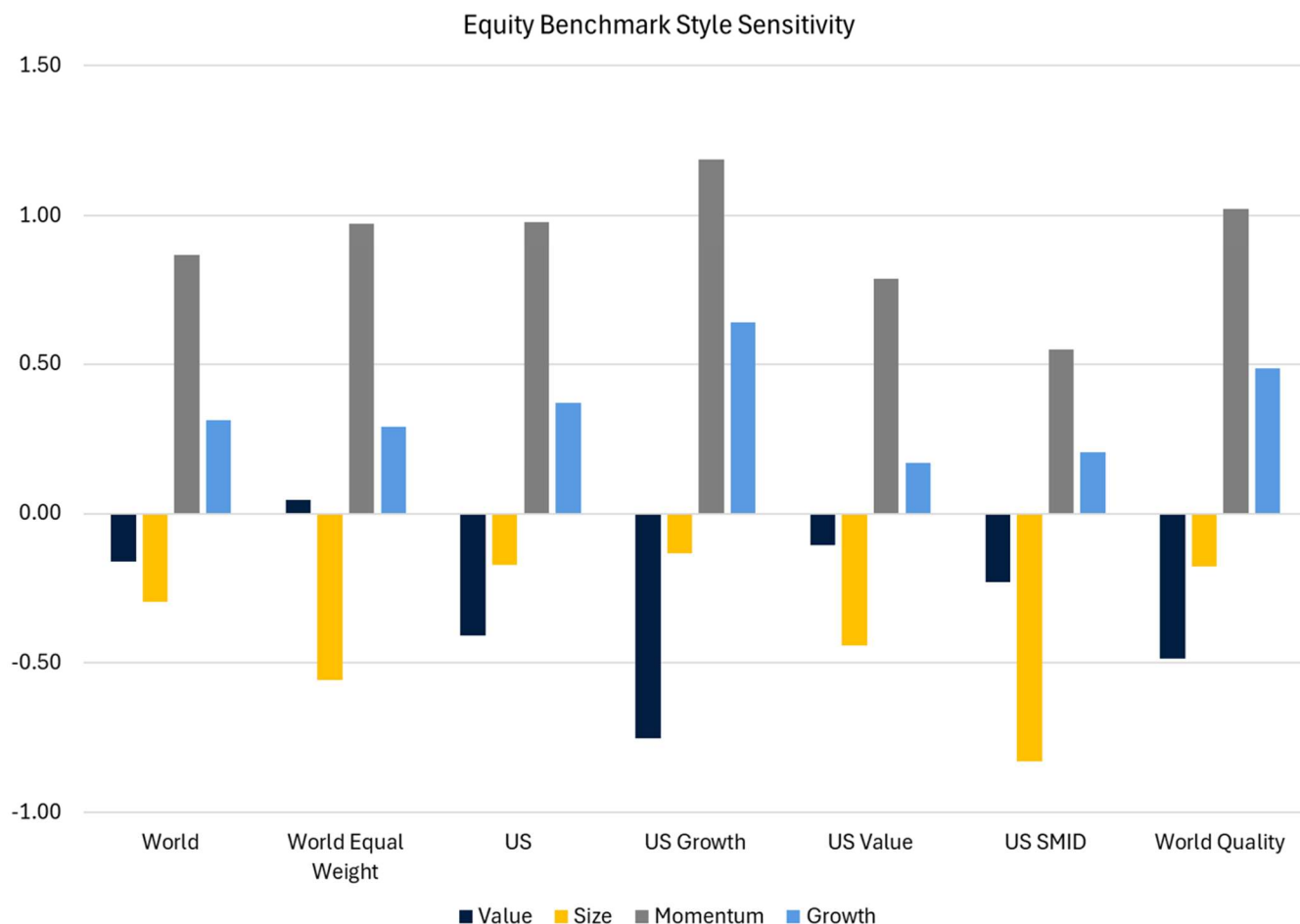
Emerging Markets

Japanese or Australian

Source: Research Affiliates

There is No Such Thing as Passive

We made the case in late 2022 that there was no such thing as passive investing, and we stand by that. Choosing to invest in a market cap weighted index tracking product is still an “active” choice and is only one of many decisions that an investor must make. Even building a passive portfolio involves significant portfolio construction considerations. What is the asset allocation? Do you want to be tactical? Within equities there are a legion of passive options giving a variety of regional, style and industry biases. All of these fit in the passive bucket, but they aren’t actually passive in the sense that you don’t have to think about them.



Source: LSEG Refinitiv

Portfolio Considerations

We think there is an important place in the market for active investing. Assuming passive continues to grow as a share of total, there will at some point be enough stupid money chasing the biggest names in the market that opportunities to outperform by investing using a bit of grey matter will be abundant. Given active managers tend to be less concentrated in mega-cap stocks than passive indexes, holding some active exposure is a good hedge against sharp momentum reversion in passive indexes, which is becoming an increasingly common pattern in markets. Our current suite of portfolios blend passive and active with this in mind.

That said, we understand that many investors have a philosophical objection to active management or have simply been burned by active manager underperformance and do not care about market concentration and the risk of momentum reversions causing sharp portfolio drawdowns. Some investors may simply prefer the certainty of lower portfolio fees over the uncertain prospects of active manager outperformance. With that in mind, we have launched a passive suite of portfolios built entirely using passive ETFs. These portfolios will still benefit from our strategic and tactical asset allocation processes but will be delivered at lower cost and won't be influenced by active manager relative performance.

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