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INVESTMENTS

HOW CONCENTRATION AND VALUATIONS MAY RESHAPE ACTIVE OPPORTUNITIES

By PPS Investments.

For years, the global investment landscape has been defined by a relentless shift towards passive strategies. By the end of 2023, a historic milestone was reached when US passive mutual funds and exchange-traded funds (ETFs) surpassed active funds in total assets. In South Africa, while the migration towards passive investments has not moved as quickly as in developed markets, the pace is accelerating.

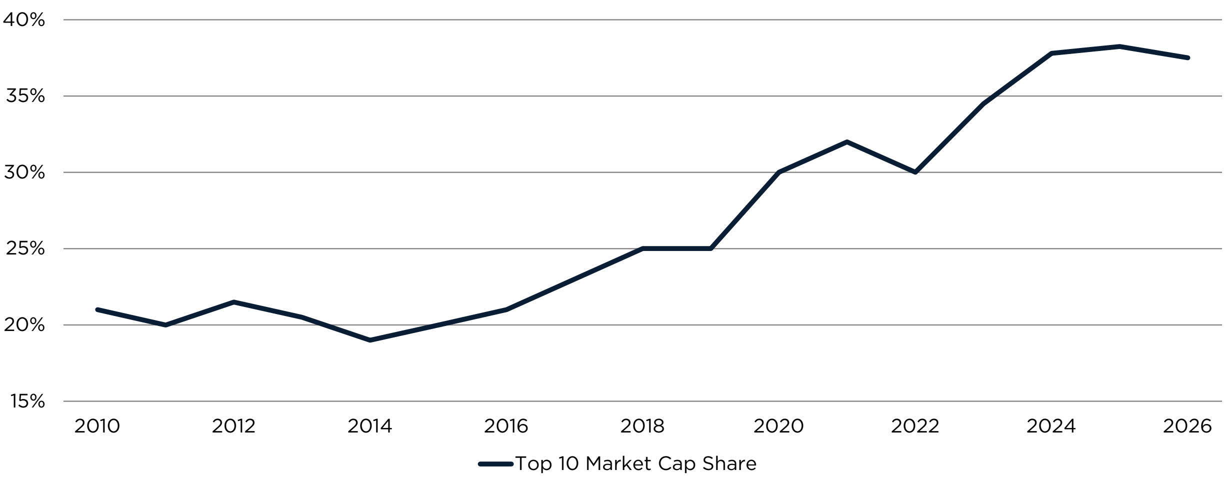
This shift has delivered clear benefits. Over the long term, a significant portion of active managers has struggled to justify their fees by outperforming broad market benchmarks. The data presents a stark picture: over the five-year period ending May 2026, only 17% of SA-only equity funds outperformed the JSE All Share Index (ALSI). For financial advisers, the appeal of low-cost, predictable beta through index tracking has therefore grown stronger.

However, the macroeconomic and structural market conditions that supported the golden age of passive investing, characterised by near-zero interest rates, abundant liquidity and benign inflation, are now behind us. Looking ahead, a convergence of high valuations, shifting market regimes and growing index concentration is creating an environment where the flexibility of active management is becoming increasingly attractive.

INDICES ARE GROWING MORE CONCENTRATED

One of the more pressing concerns for investors today is the concentration risk embedded in market capitalisation-weighted indices. The massive gains in global equities over recent years have been largely driven by a handful of mega-cap technology stocks.

Graph 1: The Top 10 stocks in the S&P500 make up 37.5% of the index



Source LSEG Datastream | as at June 2026

The impact of the artificial intelligence boom in the US highlights this trend. JP Morgan found that a basket of AI-related companies contributed 78% of S&P 500 returns since the launch of ChatGPT in 2022. While this has been profitable for passive investors, it has turned diversified indices into concentrated, thematic exposure to a single sector.

For South African advisers, this risk is even more pronounced. The local market is highly top-heavy, with the top 10 companies accounting for 49.5% of the JSE ALSI in May 2026.

While concentration can drive strong performance, it also increases downside risk. When market leadership shifts or dominant sectors correct, passive funds remain fully exposed. They cannot adjust valuations, reduce exposure or reposition defensively to manage losses.

VALUATIONS AND THE PASSIVE BUYING TRAP

This brings us to the critical issue of valuations. In a market where capital is continually funnelled into the largest index constituents regardless of price, a disconnect between fundamental value and market capitalisation can emerge.

This dynamic is evident in the next generation of tech and AI companies. As highly anticipated firms launch IPOs and scale rapidly, they will be included in major indices. Passive trackers will then be compelled to buy them mechanically, even if valuations are stretched. Passive strategies do not assess whether a stock is expensive; they simply follow index rules.

Active managers are better positioned to navigate this environment. They can assess intrinsic value, look beyond market hype and avoid speculative excess. An active approach also allows managers to identify opportunities in overlooked areas of the market. As structural inflation, higher interest rates and increased volatility persist, return dispersion between stocks is likely to widen. This dispersion creates the conditions for skilled stock pickers to generate alpha.

BUILDING BETTER PORTFOLIOS THROUGH BALANCE

Despite the compelling case for active management in the current environment, the discussion should not become a binary “active versus passive” debate. The reality of modern portfolio construction is more nuanced.

Passive investments will always have a role to play in portfolios. They remain efficient, cost-effective tools for securing core beta exposure, managing overall portfolio costs and implementing broad asset allocation decisions. A passive strategy is not flawed; it behaves exactly as designed.

Ultimately, active and passive are not competing ideologies but distinct tools in the same toolkit. A robust investment strategy can incorporate both, using the cost efficiency of trackers to anchor the portfolio while applying the flexibility of active managers to adjust exposures, increasing allocation to attractive opportunities that are underrepresented in the index and reducing or avoiding companies that may be overrepresented.

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