

# focus

## There's No Such Thing as Purely Passive



Passive investing has become a major feature of investment markets. It offers a rules-based way to invest in broad baskets of shares, bonds, or other assets. But passive investing is also sometimes misunderstood. It is often presented as simple, neutral, and almost decision-free. Passive investing does remove some decisions; it does not remove decision-making. You still have to choose which index your investments are going to track. That choice can have a very significant influence on what you actually own. Used without proper consideration, passive funds can quietly introduce large unintended active bets into your portfolio.

## ...The growth in passive has fuelled explosive growth in investment options...



### The rise of passive investing

Passive investing is often described as ‘tracking the market’. More precisely, a passive fund seeks to replicate the return of an index – a defined basket of shares, bonds, or other assets.

An index fund does not try to pick winners and avoid losers. It simply aims to own the securities in the index in roughly the same proportions.

Passive investing has benefits. Index funds are often cheaper because they do not need teams of analysts selecting securities. Passive investing is also simple to implement. Investors can buy a fund and know, broadly, what exposure they are getting. For many people, that is better than chasing the latest hot stock, fund, or theme.

Index investing became widely available in the 1970s – Vanguard launched the first index fund for individual investors in 1976. The growth since then has been dramatic. Today, passive funds have surpassed actively managed funds. As at March 2026, passive funds and exchange-traded funds (ETFs) in the US had around US\$19 trillion of assets, compared with around US\$17 trillion in actively managed funds and ETFs (where fund managers are choosing what to own).

### The proliferation of choice

When passive investing began, the choice was narrow. A passive investment typically meant buying a broad share market index such as the S&P 500 or the S&P/NZX 50. Not anymore. The growth in passive has fuelled explosive growth in investment options.

There are now indices for almost everything: global shares, US shares, New Zealand shares, Australian shares, emerging markets, small companies, large companies, technology companies, banks, infrastructure, healthcare, clean energy, dividends, quality, value, growth, low volatility, equal-weighted shares, market-cap weighted shares, government bonds, corporate bonds, inflation-linked bonds, high-yield bonds, commodities, and more.

**By one industry count, across all asset classes, there are more than three million indices globally – vastly more than the roughly 50,000 listed companies on global exchanges!**

This creates a paradox. Passive investing is often sold on simplicity. But the passive universe has become very complex.

A passive investor no longer just asks: ‘should I use a passive fund?’ They must also ask: ‘which index should I track?’ That question matters a lot.

### Passive portfolios can look very different from one another

The index you choose determines the portfolio you get. Investors sometimes talk about ‘buying the market’. But there is no single market. Different indices can produce dramatically different exposures by country, currency, sector, company size, and individual stock concentration.

Most major share market indices are weighted by company size. The bigger the company’s market value, typically the bigger its weight in the index.

**The compositional differences across indices can be stark:**

If you invest in the US S&P 500, you're not buying 'the US economy', you're investing in a portfolio with more than half tied to technology. The index is heavily weighted in the likes of Nvidia, Apple, Microsoft, Amazon, Alphabet, Broadcom, Meta, and Tesla.

There is also the choice of the equally-weighted S&P 500 index. This includes the same 500 companies as the traditional S&P 500 but gives each company the same weight rather than giving the largest companies the biggest weights. The result is a very different portfolio. The mega-cap technology companies have much less influence, while smaller companies and sectors such as industrials, financials, consumer discretionary, and healthcare have a larger role.

In contrast to the US, an investor buying an Australian index such as the S&P/ASX 200 index gets a very different portfolio. Australia's market is dominated by banks and resources. As at 30 April, the S&P/ASX 200 had 34% in financials and 25% in materials. BHP and Commonwealth Bank were each more than 10% of the index, and the top ten holdings made up 48%.

The New Zealand market is different again. Its smaller size creates concentration. The S&P/NZX 50 index tracks 50 of the largest NZX-listed companies, weighted by market capitalisation. But despite the 50 in the name, a large portion of the portfolio sits in a small number of companies. As at 30 April, Fisher & Paykel Healthcare was 16%, Auckland Airport 11%, Infratil 9%, and Contact Energy 7%. Six companies make up more than 50% of the index.

Emerging markets sound broad. The phrase conjures up exposure to China, India, Brazil, South Africa, Mexico, Indonesia, and many other economies. That is true, but the index mix can still be heavily skewed. As at 30 April 2026, the MSCI Emerging Markets Index had 1,204 constituents. On the surface, that looks very diversified. But Taiwan Semiconductor Manufacturing was 14% of the index on its own, Samsung Electronics was 6%, and SK Hynix was 4%. The index is heavily influenced by semiconductors – information technology accounts for around 37% of the MSCI Emerging Markets Index, while Taiwan and South Korea together represent about 44%.

The compositions above are not inherently bad. They may actually be attractive. But for investors who think they are buying broad exposure across different companies and sectors, they may come as a surprise. Each of these indices is very different. And in each one a handful of companies can heavily influence returns. Calling it passive does not make the concentration disappear.

**Passive can lean toward yesterday's winners**

Market-cap weighting means the largest companies have the biggest influence. Often, they are large for good reasons – strong earnings and long track records of success. But it also means investors end up with more exposure to companies and sectors after they have already performed strongly.

That is one of passive investing's less-discussed weaknesses. It does not ask whether the price is attractive. It simply follows the rules.

That is not necessarily a flaw. But it isn't a virtue either. It is a trade-off.

**WHAT ARE YOU REALLY BUYING?**

Index	What investors might think they are buying	What they are actually getting
S&P 500	Exposure to the US economy and market	Concentration in mega-cap technology and technology-related companies
Equal-weight S&P 500	The same 500 companies	Less mega-cap concentration, more exposure to smaller S&P 500 constituents
ASX 200	The Australian market	Banks and resources
NZX 50	The New Zealand market	A concentrated portfolio dominated by a handful of large companies
MSCI Emerging Markets	Broad developing-world growth	Significant exposure to semiconductors and North Asian technology

**...while a fund may be passive, the investment choice is not...**



**Passive is an active choice**

Many investors see passive funds as a relaxed way of owning a portfolio that is automatically diversified and sensible. That is not always accurate.

Every passive fund tracks an index. Every index is designed by someone. Every index has rules. Those rules decide what is included, what is excluded, when new companies are added, and how much weight each security receives.

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An index can be concentrated.

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An index can be heavily tilted toward one sector.

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An index can have large exposure to one country or currency.

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An index can include companies at valuations that later prove too optimistic.

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None of this means passive investing is bad. It just means that while a fund may be passive, the investment choice is not.

Before investing in a passive fund, an investor should ask: what index does it track? What countries does it include? What sectors dominate it? How concentrated is it in the largest companies? How does it fit with the rest of my portfolio?

These choices can have a very large influence on both the shape of your portfolio and your investment outcome.

Passive investing can be a good tool in an investment strategy. But it is not a substitute for having one. The aim should not be to avoid decisions. The aim should be to make decisions deliberately, understand the exposures you are taking, and build a portfolio that is fit for purpose.

**If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.**

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