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DYNAMIC LIVE IN CONVERSATION

A Passive Influence on Market Dynamics

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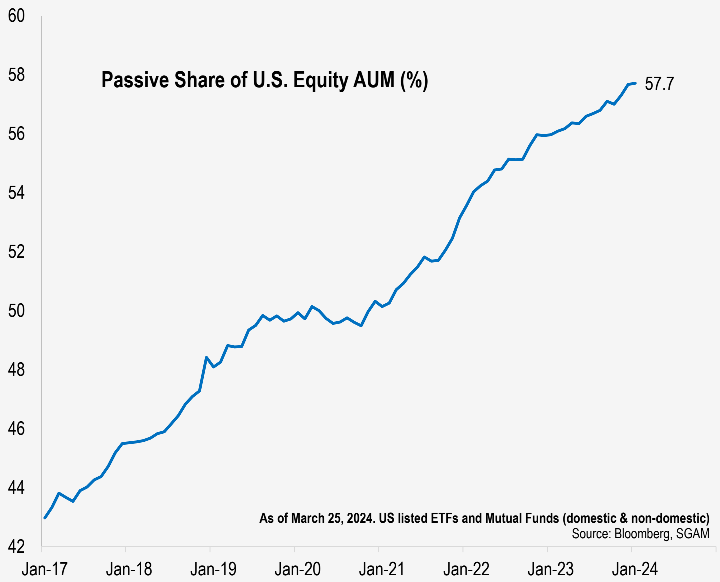
Passive Considerations

The Potential Impact of Passive Investing

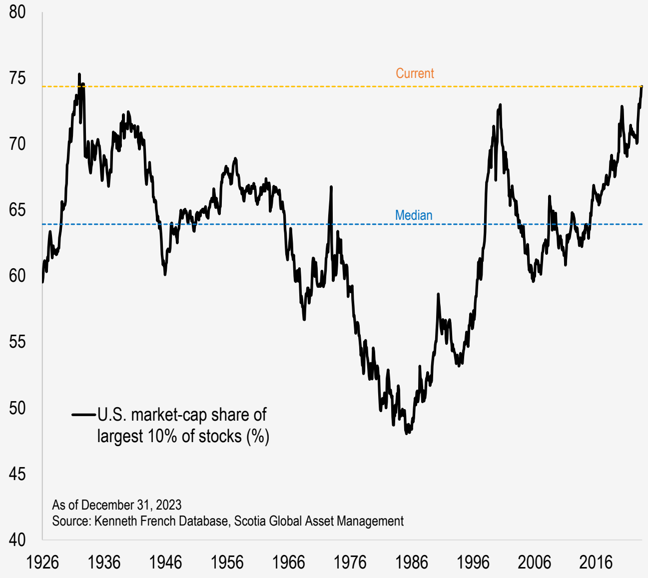
- Increase in market concentration
- Increase in correlation between securities
- Increase in valuation relative to fundamentals
- Increase in the risk of extraordinary price movements (tail risks)

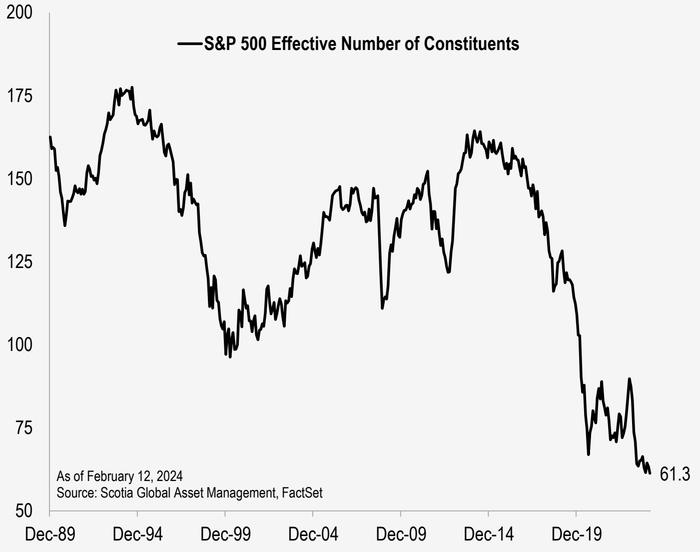
Growing Share for Passive Funds



➢ Passive funds now account for almost 60% of total U.S. equity assets under management.

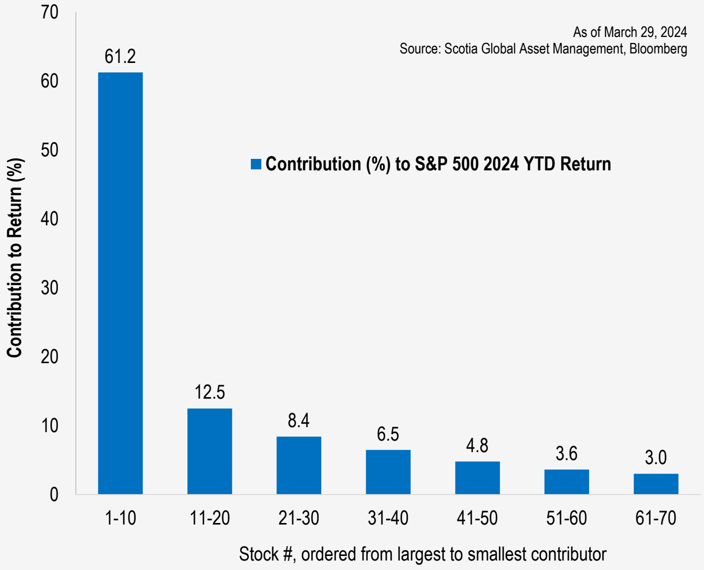
Implications – Market-cap concentration





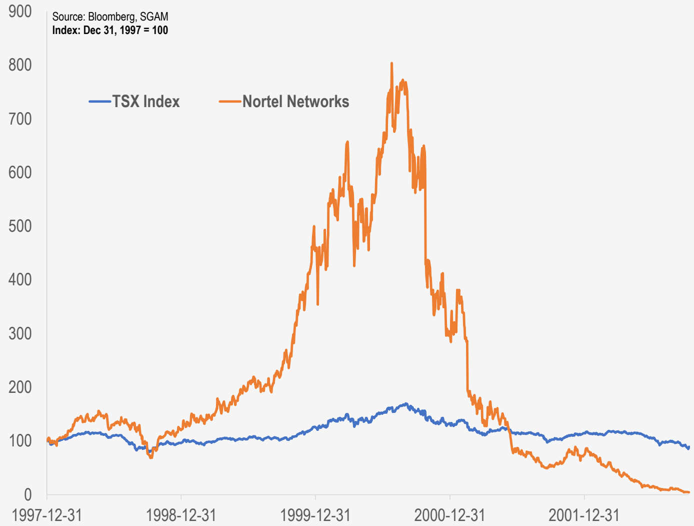
- The U.S. market is heavily concentrated relative to its long-term history.
- The S&P 500 is acting like it is an index comprised of 61 stocks, while the largest 10 companies now make up 32% of the Index's weight.

Implications – Return concentration



- The S&P 500's year-to-date gain of 484 points can be reached by adding up the 70 largest companies. The net contribution for the remaining 430 names is 0%.
- Even within this already concentrated group, the largest 10 companies account for 61% of that gain.

Remember Nortel?

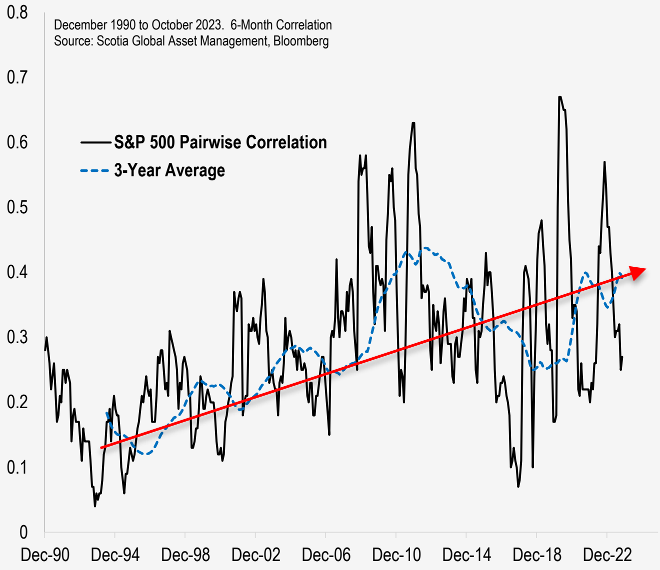


S&P 500's Top 10	Weight
Microsoft Corp	7.1
Apple Inc	5.7
NVIDIA Corp	5.1
Amazon.com Inc	3.7
Meta Platforms Inc	2.5
Alphabet Inc	2.0
Berkshire Hathaway Inc	1.7
Alphabet Inc	1.7
Eli Lilly & Co	1.4
Broadcom Inc	1.3
Total	**32.2**

As of March 27, 2024
Source: Bloomberg

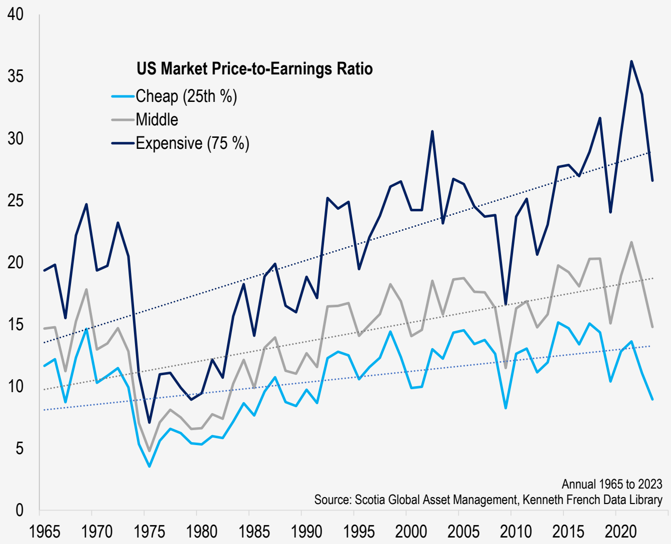
- At its peak, Nortel's weight was ~35% of the TSX. This single stock helped the index return 30% in 1999 but excluding Nortel (and its parent company BCE) the index would have been up 6.5%.
- Nortel peaked in July 2000 and proceeded to fall 62% by year's end, dragging the Composite down by 18%. By October of 2002, Nortel's stock price was down by 99% (from $124 to 47 cents) while the composite was down by almost 50%.
- The S&P 500 isn't at the same extreme as the TSX was in the late-1990s. However, the top 10 companies are 1/3rd of the S&P 500 weight.

Implications – Rising correlations



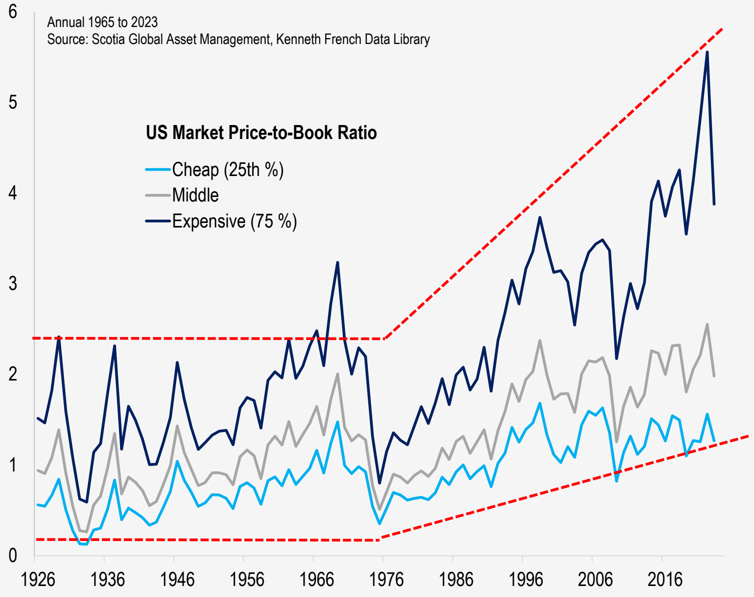
- The average performance correlation of stocks within the index has risen since the 1993 introduction of the SPY ETF. Higher correlation among securities reduces the opportunity to diversify and presents potential danger in periods of stress.

Implications – Fundamentals lost



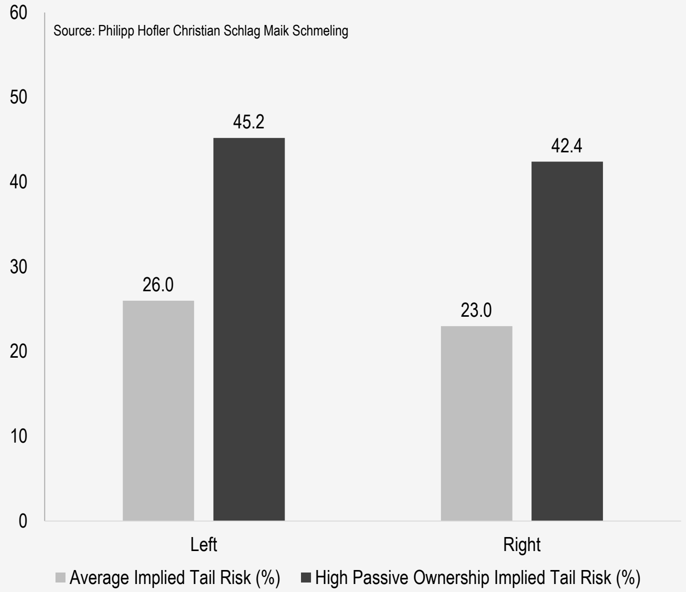
- The timing of the first index tracking fund was 1975, with rapid adoption of index tracking funds and ETFs following from the early 1990s.
- There has been a systematic expansion in equity valuation since the rise of passive index funds/ETFs, with valuations for the most expensive stocks rising at the quickest pace.

Implications – Fundamentals lost (cont'd)



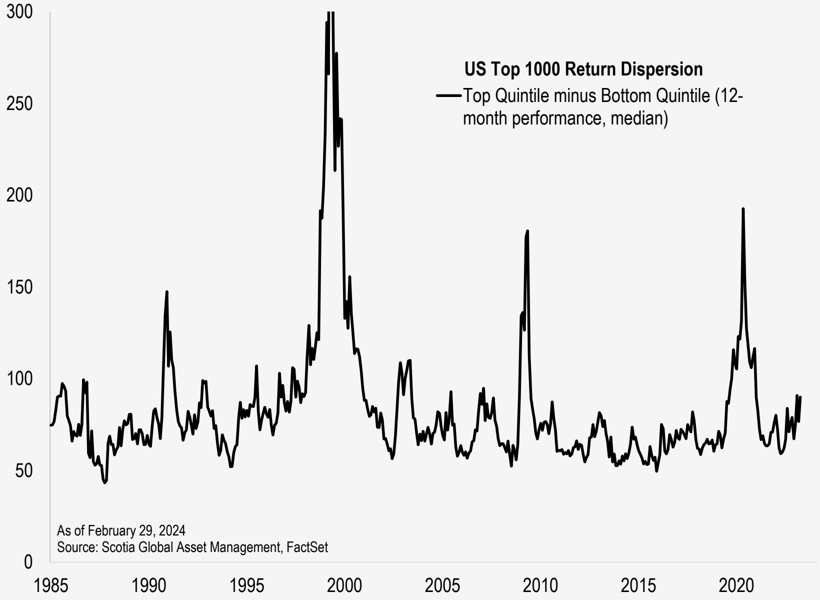
- ➢ We are paying more for companies today versus history. The valuation "boom" started after the launch of the first index fund in the mid-1970s.

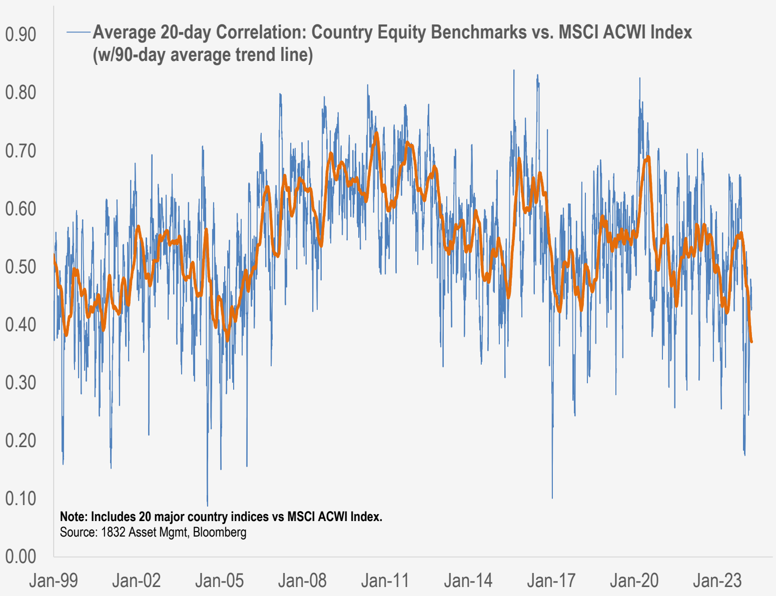
Implications – Passive ownership and 'tail risk'



- Stocks with high passive ownership face potential liquidity risks in major shocks, according to options investors.
- A one standard deviation increase in the passive ownership % results in a 19-percentage point increase in option implied tail risk for the left and right tails.

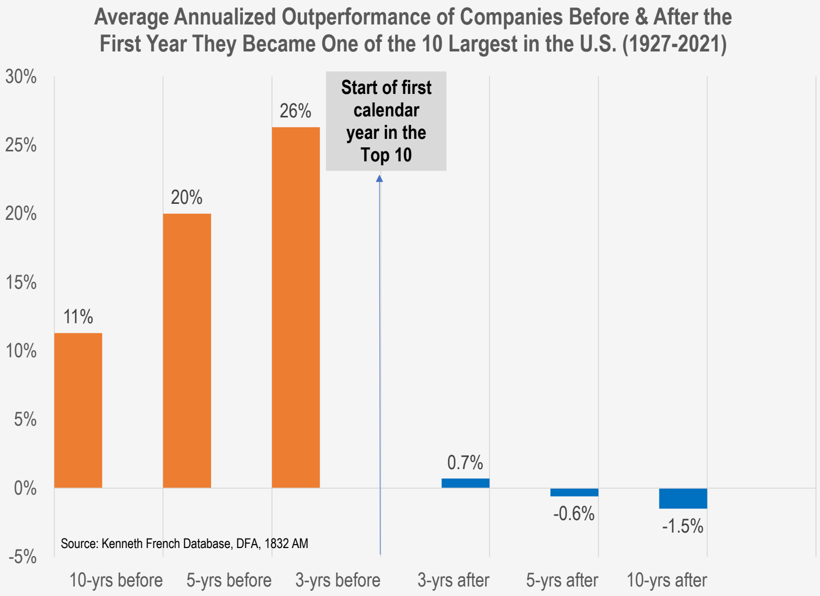
Active Management – Rising opportunity





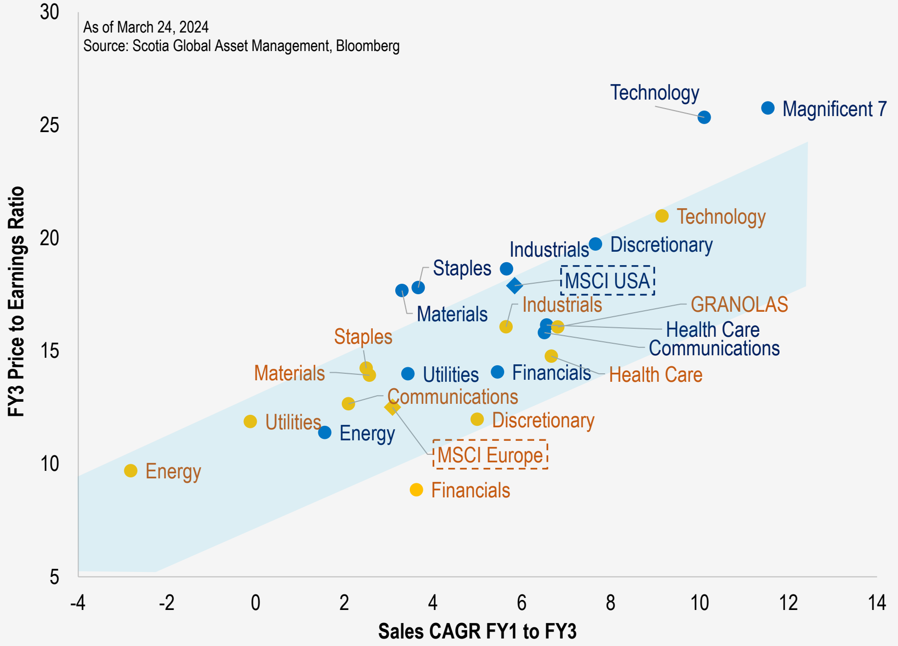
- Active management's opportunity is a function of the performance dispersion and the performance correlation for stocks within the market.
- The more recent trends of rising dispersion and declining correlation point to better opportunities for an active manager.

Active Management – It's not always what you own



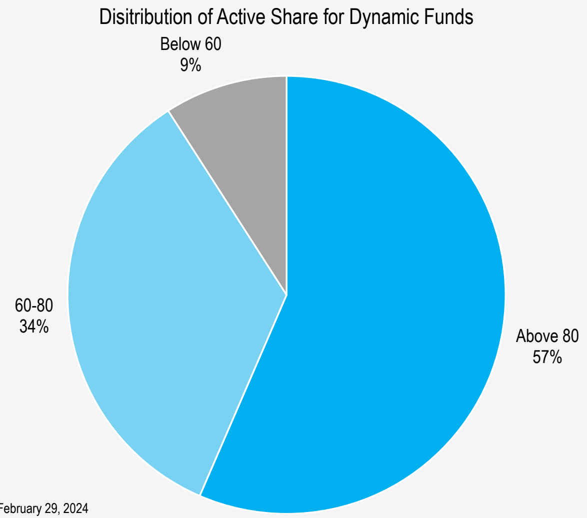
- Longer-term forward performance for a company that reaches the "top 10" list has typically been disappointing.

Active Management – Diversification by broadening the choice set

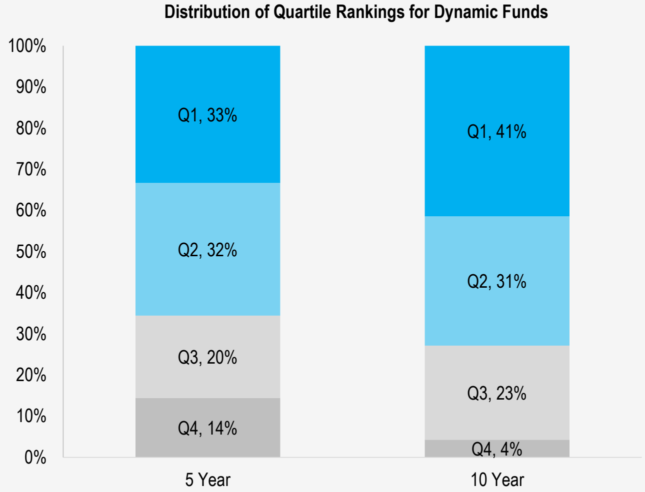


- Selectively diversifying away from hyper-momentum leadership (e.g. various mega-cap technology names) and into other sectors, capitalization domains, and regions can enhance long-term risk-adjusted portfolio performance.

Active Management – Legitimately active equity



As of February 29, 2024
Source: Scotia Global Asset Management



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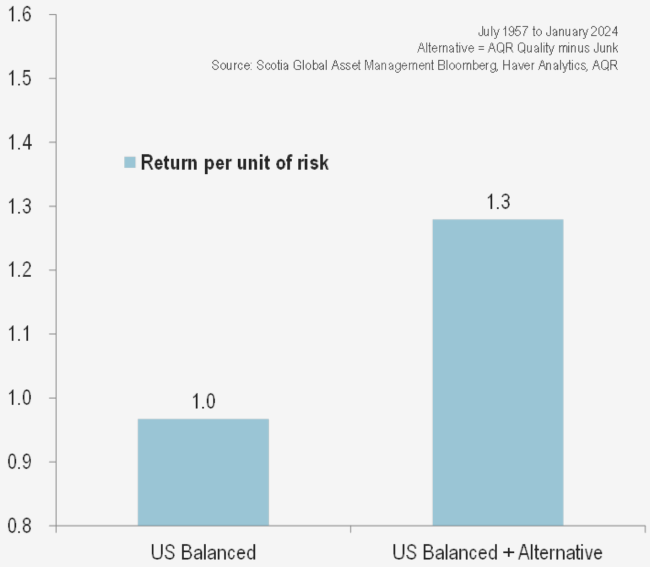
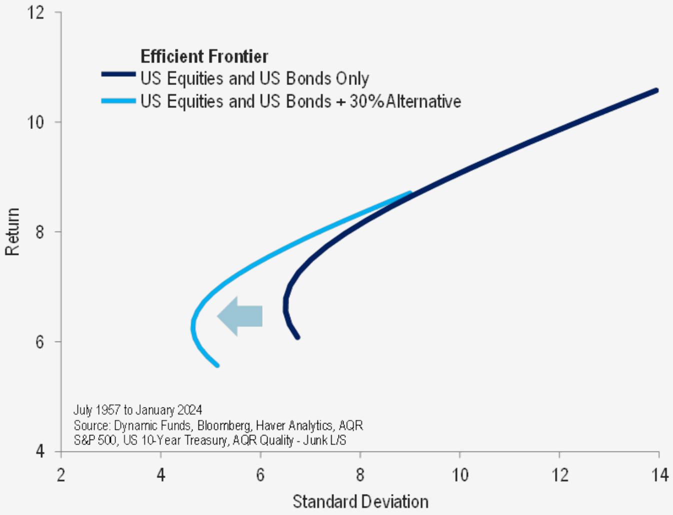
- Dynamic's funds are not "closet indexing" funds according to several industry adopted measures such as active share.
- A manager's skill matters. High active share reading has been important for long-term outperformance at Dynamic Funds. Almost three quarters of the funds sit in the upper quartile ranges for performance over a 10-year performance history.

Active Management – Thinking beyond equity





- Portfolio performance benefits from the inclusion of other assets, like bonds and alternatives. The latter remains the most under-appreciated asset class today.
- Alternatives can offer an important layer of performance resilience in the face of unexpected financial or economic developments.

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