ATTACHMENT 2

Passively Becoming Active

Understanding the implications of Passive Investing

3 March 2025

Prepared for: Institutional Investors
Prepared by: Equity Manager Research

Why bring you this?

Passive investing has gained significant popularity over the past decade, offering potential **low-cost exposure to broad market indices.** However, institutional investors need to be aware of the potential biases associated with passively tracking capitalisation-weighted indices, particularly in terms of **concentration risk.**

At a glance...

Investors are in danger of passively becoming active. By adopting a balanced approach that combines **passive, factor**, and **active strategies**, institutional investors can mitigate the growing concentration risks associated with passive investing into capitalisation-weighted indices while still benefiting from its cost-effectiveness.

Next steps...

The **Aon Investment Manager Research** team offers a selection of buy rated factor and active equity strategies to complement passive equity exposures. Staying vigilant and adaptable is key to long-term investment success in a continuously evolving investment landscape.

Concentration Risk: A Growing Concern

Country Exposure

The rise of passive investing has led to an **increase in country concentration**, particularly favouring the United States largely due to strong performance from the region versus other markets.[1] As of January 1, 2025, the share of the US market in the MSCI ACWI Index has grown substantially to **66%**[2], resulting in a disproportionate allocation to a single country. Concentration exposes investors to heightened country-specific risks and reduces global diversification benefits.

Sector Exposure

25% of the MSCI ACWI Index is invested in information technology. By contrast, the weights of energy, materials, utilities and real estate are **less than 5% each.** High exposure to a single sector creates possible **portfolio vulnerability** to sector-specific risks.

MSCI ACWI: Regional and Sector Breakdown

	Comm Serv	Cons Disc	Cons Staples	Energy	Financials	Health Care	Industrials	Info Tech	Materials	Real Estate	Utilities	Total %
Africa	0.0	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.1	0.0		0.3
Americas	5.8	7.7	3.7	2.7	10.2	6.7	6.4	20.2	1.9	1.7	1.6	68.7
Asia	0.8	1.2	0.4	0.3	1.5	0.4	0.7	2.4	0.4	0.2	0.2	8.4
Europe	0.6	1.3	1.3	0.6	2.8	1.9	2.5	1.0	0.8	0.2	0.5	13.7
Middle East	0.1	0.0	0.0	0.1	0.4	0.0	0.1	0.1	0.1	0.1	0.0	1.0
Pacific	0.5	1.2	0.4	0.1	1.7	0.6	1.5	0.8	0.6	0.4	0.2	7.9
Total %	7.7	11.5	5.8	3.8	16.7	9.6	11.2	24.5	3.9	2.6	2.5	100.0

Source: Style Analytics. Analysis as of 31 December 2024.

Stock Exposure

Concentration at the individual stock level is significant. The top 10 stocks in the S&P 500 now represent **over 35%** of the index, surpassing previous highs dominated by the so-called Magnificent 7[3][4]. This extreme concentration amplifies **idiosyncratic risks** associated with these few dominant companies that have historically shown market dominance, sector leadership, strong financial performance, and innovation. Similarly, the top 10 stocks in

[1] Over the past 10 years ending December 31, 2024 the S&P 500 returned 15.6% and the MSCI EAFE returned 7.5%. Past performance is not indicative of future results.

[2] MSCI ACWI Index

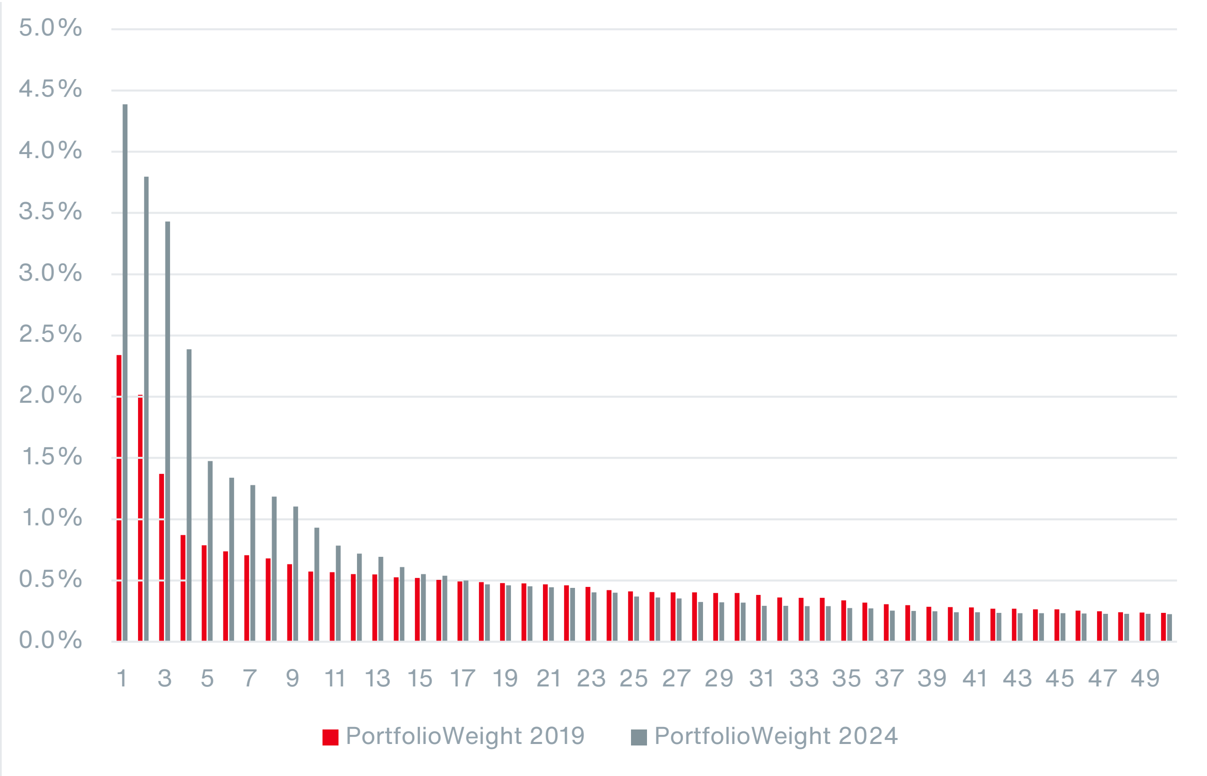
[3] Apple (AAPL), Microsoft (MSFT), Amazon (AMZN), Alphabet (GOOGL/GOOG), Meta Platforms (META), NVIDIA (NVDA) and Tesla (TSLA)

[4] S&P 500® | S&P Dow Jones Indices

4431115-NRC

MSCI ACWI account for 23% of the index as of January 1, 2025. This concentration has notably increased since the COVID-19 pandemic.

Evolution of the Top 50 stocks in MSCI ACWI



Source: Aon. Data from 31 December 2024 evaluating the MSCI All Country World Index.

When a small number of companies account for a significant portion of an index's value, fluctuations in their stock prices can have an **outsized impact** on the entire market. This unintended concentration means that investors in passive equity funds could be taking on more stock-specific, sector, and country risk than desired.

Mitigating Risks: The Case for Factor and Active Management

To address these concerns, institutional investors could consider incorporating **active management** or **factor-based strategies** into their portfolios in the context of their specific investment objectives, risk tolerance and time horizon.

Active equity strategies offer institutional investors the potential to **outperform benchmarks** by leveraging skilled managers to identify opportunities and **exploit market inefficiencies**. Factor investing represents a **middle ground** between traditional active and passive investment strategies. It seeks to systematically capture the returns associated with specific characteristics, or “factors,” that have historically delivered higher risk-adjusted returns over the long term.

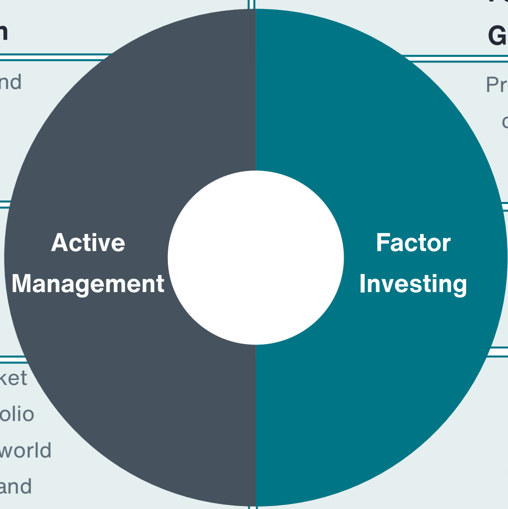
Considering the rising concentration in global equity markets, as we’ve highlighted, these strategies have underperformed in recent years. Prudence and diversification have not been rewarded.

Active Management: Navigating Concentration

Adapting to market changes and exploiting investment opportunities not captured by passive indices.

Focusing on undervalued sectors and companies, potentially reducing exposure to overvalued, concentrated areas of the market.

Providing resilience during market volatility through dynamic portfolio risk adjustments. A multi-polar world with ongoing geopolitical risks and higher yields will likely create more differentiation and opportunities.



Factor Investing: A Middle Ground

Provides systematic exposure to characteristics associated with excess risk-adjusted returns.

Employs a transparent, rules-based approach to portfolio construction.

Offers potential excess returns while seeking to maintain lower costs compared to traditional active management.[1]

Four Considerations for Institutional Investors

1

Consider the risk profile of “passive” allocations

Review exposure to passive strategies tracking highly concentrated capitalisation-weighted indices.

2

Enhance Diversification[2]

Seek out strategies that focus on less correlated assets or market segments to improve overall portfolio diversification.

3

Consider active management

Consider allocating to skilled active managers to help reduce concentration risks. Where active management is deployed, have patience in evaluating their skill given the concentration of the benchmarks in recent periods.

4

Regular portfolio rebalancing

Implement a disciplined rebalancing approach to maintain desired risk exposures and prevent unintended shifts in asset allocation.

[1] Past performance not indicative of future results. There is no guarantee that results or savings will be achieved if you should select Aon and/or its affiliated entities to provide services to you. The experience described does not represent all recommendations made to clients nor does it represent the experience of all clients. The reader should not assume that an investment in any securities identified or a particular recommendation was or will be profitable or favorable.

[2] Diversification does not ensure a profit nor does it protect against loss of principal. Diversification among investment options and asset classes may help to reduce overall volatility.

About Aon

Aon plc (NYSE: AON) exists to shape decisions for the better — to protect and enrich the lives of people around the world. Through actionable analytic insight, globally integrated Risk Capital and Human Capital expertise, and locally relevant solutions, our colleagues provide clients in over 120 countries with the clarity and confidence to make better risk and people decisions that help protect and grow their businesses.

Follow Aon on LinkedIn, X acebook and Instagram. Stay up-to-date by visiting Aon's newsroom and sign up for news alerts here.

aon.com

Contact Us

Oliver MacArthur
European Head of Equity Manager Research
oliver.macarthur@aon.com

Thomas Stork
Equity Manager Researcher
thomas.stork@aon.com

Lucy Ashworth
Equity Manager Research Analyst
lucy.ashworth@aon.com

The Aon Centre
The Leadenhall Building 122
Leadenhall Street London EC3V
4AN

Aon Investments USA Inc. 200 E.
Randolph Street Suite 700
Chicago, IL 60601
USA

Aon Solutions Canada Inc./Aon
Investments Canada Inc.
20 Bay Street, Suite 2300 Toronto,
ON M5J 2N9 Canada