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THE HIDDEN RISKS OF INDEX FUNDS AND PASSIVE INVESTING

Few developments have shaped the asset management industry over the past twenty years as profoundly as the rise of passive investing. Index funds and ETFs enable investors to gain broad exposure to entire markets at very low cost. For many investors, this approach has proven to be exceptionally successful.

The academic foundation for this investment philosophy was established in particular by Nobel Prize winner Eugene Fama. His research on market efficiency suggests that security prices rapidly reflect publicly available information. As a result, it is difficult for most investors to consistently outperform the overall market over the long term through frequent trading or careful stock selection. At the same time, active investment strategies often involve higher management fees and transaction costs, which further reduce overall returns.

Passive Index Investing as a Cost-Efficient Investment Strategy

For these reasons, we are fundamentally supportive of passive investing. We also make targeted use of low-cost index investments to help our clients achieve attractive long-term returns while maintaining low costs and broad diversification. Index funds replicate an index—such as the SMI or the Dow Jones Industrial Average—by holding the underlying stocks in the same proportions as represented in the index.

Precisely because this investment approach has become so successful, it is worth examining its limitations as well. Every investment concept offers advantages, but it also carries risks. Some of these risks are relatively unknown and are becoming increasingly important as index investing continues to grow.

The Risks of Index Investing

One of the defining characteristics of a market index is that the weighting of each company is determined by its market capitalization. As the market value of a company rises, its weight within the index automatically increases. All funds tracking that index must adjust their holdings accordingly. This creates a self-reinforcing mechanism: rising share prices lead to higher index weights, higher index weights trigger additional buying, and those purchases may push prices even higher.

This effect is far from being purely theoretical. In recent years, we have witnessed a small number of large technology companies account for an ever-growing share of major equity indices. Billions of dollars flow automatically into ETFs and index funds every month. A significant portion of these investments is not driven by new fundamental analysis, but simply because a company's weight in the index has increased.

A similar mechanism applies to major initial public offerings (IPOs). When a significant company—such as SpaceX in the future, or another globally leading technology company—goes public and is subsequently included in major indices, substantial buying demand is created automatically. Not because millions of investors have simultaneously conducted a new fundamental analysis, but because every index fund must purchase the stock in order to replicate the index accurately.

This automatic buying mechanism can further increase valuations. The more successful a company becomes in the stock market, the greater the capital inflows it receives through passive investment vehicles. This creates a dynamic that can reinforce rising valuations even further.

Index Funds Create a 'Lemming Effect'

Market bubbles rarely emerge because investors behave completely irrationally. More often, they develop gradually. A compelling growth story leads to rising share prices. Rising prices attract additional investors. New investors push valuations even higher. Eventually, stock prices become increasingly disconnected from the long-term earnings potential of the underlying businesses.

Passive investing can unintentionally reinforce this process. Passive funds do not evaluate whether a company is expensive or attractively valued. They simply invest according to each company's weighting within the relevant index. As a result, the largest amounts of capital flow into those companies whose share prices have already risen the most. In this way, index investing reinforces existing market trends: one investor follows another. A classic "lemming effect" emerges.

If Everyone Invests Passively, Who Performs the Analysis?

The theory of efficient capital markets, which forms the basis of passive investing, assumes that a sufficient number of market participants actively analyse companies and make investment decisions based on those analyses. It is precisely these active investors who ensure that new information is reflected efficiently in stock prices. Without their work, markets could not function efficiently.

However, the larger the share of purely passive investing becomes, the smaller the group of investors who critically evaluate business models, balance sheets, competitive positions and company valuations. As more and more capital is invested automatically without regard to intrinsic value, stock prices increasingly reflect investor capital flows rather than solely the underlying quality of the businesses.

The consequence may be that overvaluations persist for longer periods and market movements reinforce themselves. Prices then reflect not only fundamental information but increasingly the collective enthusiasm of market participants.

Combining Passive Investing with Active Risk Management – Our Investment Philosophy

None of this suggests that index funds are fundamentally problematic. On the contrary, for many investors they remain an excellent instrument for long-term wealth creation. Nor does it imply that active asset managers automatically achieve superior results. Numerous academic studies demonstrate that this is far from guaranteed.

Our approach is therefore pragmatic. We do not trade constantly, nor do we attempt to predict short-term market movements. Where markets appear efficiently valued, we deliberately rely on

low-cost passive investments. At the same time, we continuously analyse the valuations of individual companies and sectors. When certain holdings reach valuation levels that, in our view, can no longer be justified by their long-term earnings prospects, we consciously limit their portfolio weight. In doing so, we prevent our clients from automatically taking on increasing levels of risk simply because a company has grown ever larger within an index.

Particularly during periods of strong market optimism, we believe this combination of passive investment principles and active risk management is especially valuable. Long-term investment success is not achieved through low costs alone. Equally important is the ability to identify risks early and consistently avoid excessive concentration.

In our view, passive investing therefore remains an essential component of modern asset management. However, it is not a self-running strategy, nor does it guarantee that overvaluations or market bubbles will be avoided. Investors who wish to benefit from passive investing should therefore understand the mechanisms involved and intervene where risks begin to accumulate.

HAS GOLD LOST ITS SHINE?

Gold has been one of the best-performing asset classes over the past eighteen months. From the beginning of 2025 until reaching its peak in the spring of 2026, the gold price recorded an exceptionally strong rally and reached new all-time highs. Since then, however, the picture has changed. Gold has given back part of its gains and is currently trading at around USD 4,150 per ounce—well below its spring peak. Against this backdrop, many investors are asking whether gold has lost its shine or whether the recent decline merely represents a normal correction within a long-term upward trend.

Gold as a Safe Haven in Turbulent Times

This development is not particularly surprising. Gold has long been regarded as the classic safe-haven asset. Whenever geopolitical tensions rise, economic uncertainty increases or inflation concerns emerge, demand for the precious metal typically strengthens. Unlike equities or corporate bonds, gold is not dependent on the economic success of an individual company and therefore plays a particularly important role in many investors' portfolios during periods of crisis.

In recent weeks, however, several of the underlying factors have eased. The conflict in the Middle East has recently shown signs of stabilisation, and indications of a gradual de-escalation have become more apparent. At the same time, the Strait of Hormuz appears likely to reopen, reducing concerns about major disruptions to global energy supplies. Likewise, the war between Russia and Ukraine currently offers few indications that Russia will achieve decisive military progress in the near term. Overall, the risk of further geopolitical escalation has therefore declined.

As geopolitical tensions have eased, concerns about a renewed surge in inflation have also diminished. At the same time, financial markets are currently pricing in a higher interest-rate environment for an extended period. Higher interest rates increase the attractiveness of income-generating investments relative to gold, which itself does not produce ongoing income. Consequently, demand for gold has weakened, placing downward pressure on its price. The recent decline should therefore be viewed less as a sign of structural weakness in the precious metal and more as a reaction to changing economic and geopolitical conditions.

Gold Continues to Hold an Important Place in Long-Term Portfolios

For long-term investors, however, this does not mean that gold has lost its place within a well-diversified portfolio. Recent years have demonstrated how quickly the geopolitical environment can change. Conflicts often emerge unexpectedly and regularly trigger increased demand for safe-haven assets. During such periods, gold fulfils an important stabilising function within a broadly diversified investment portfolio.

In addition, the structural challenges facing the global economy remain firmly in place. High levels of government debt across many developed economies, uncertainty regarding future inflation and ongoing political tensions between the world's major economic powers all suggest that periods of heightened uncertainty are likely to remain a recurring feature of financial

markets. Gold can therefore continue to make an important contribution to portfolio diversification and risk management.

In our view, there is therefore no reason to fundamentally question gold's role following its recent price correction. Short-term price fluctuations are a normal characteristic of every asset class and are often driven by changing market expectations. What ultimately matters is the role that gold plays within a long-term investment strategy.

We Continue to Maintain Our Strategic Gold Allocation

For this reason, we continue to maintain a strategic allocation to gold. Gold remains an important component of a balanced asset allocation, providing protection against geopolitical risks, unexpected market disruptions and potential inflationary shocks. The recent decline in price does not alter this fundamental assessment. Rather, it serves as a reminder that, despite its role as a safe-haven asset, gold is also subject to short-term market fluctuations while continuing to provide valuable long-term diversification benefits. Lower prices may therefore present attractive entry opportunities for long-term investors.

RISKS ARE BUILDING IN THE TECHNOLOGY SECTOR

Some time ago, we pointed out in our investor newsletter that valuations in the technology sector appeared increasingly ambitious. At the same time, we referred to an old stock market saying: market trends usually last longer than even experienced investors expect.

This has proven to be exactly the case over recent months. Share prices of the major technology companies have continued to rise, new record valuations have been reached, and companies of unprecedented scale have been listed on the stock market. In particular, investor optimism surrounding artificial intelligence (AI) currently appears to know almost no bounds.

A Technological Revolution Is Underway

This development is understandable. The technological revolution driven by artificial intelligence, robotics, new generations of semiconductors and the construction of massive data centres is likely to transform both the economy and society for many years to come. Today, the leading technology companies are investing hundreds of billions of dollars in new AI models, high-performance processors, data centres and the energy infrastructure required to support them. An infrastructure is being created that is comparable to those built during previous industrial revolutions.

History shows, however, that every technological revolution is accompanied by an investment wave that extends well beyond what ultimately proves to be economically justified. During the railway boom of the nineteenth century, far more railway lines were built than could later be operated profitably. During the dot-com era, enormous fibre-optic networks were constructed whose capacity remained underutilised for years. Yet it was precisely these oversized investments that later formed the foundation for the economic success of the Internet.

A similar pattern is likely to emerge once again. A substantial proportion of today's AI investments will prove successful over the long term and enable entirely new business models. At the same time, many projects will never generate the returns currently anticipated. Not every software platform, data centre or semiconductor developer will succeed. As with every technological revolution, a small number of companies will become exceptional winners, while many others will fail despite substantial investments or fall well short of expectations.

The Market Capitalisation of Big Tech Has Reached Unprecedented Levels

The scale of this development has become truly remarkable. The leading U.S. technology companies are now commonly referred to as the "Magnificent Seven": Apple, Microsoft, Nvidia, Alphabet, Amazon, Meta and Tesla. Together, these seven companies now represent a combined market capitalisation of approximately USD 21 trillion. Their combined value exceeds the total market capitalisation of all European equity markets by roughly 10 to 15 percent. This comparison alone illustrates the extraordinary importance these few companies have attained within global capital markets.

These companies are, of course, exceptionally profitable. They enjoy outstanding competitive positions, generate substantial cash flows and possess enormous financial resources. Many of

them will undoubtedly emerge as winners of the AI revolution. Nevertheless, the question remains whether today's valuations already reflect an almost perfect future scenario and whether reality may ultimately prove significantly more challenging.

Nor are the Magnificent Seven alone in trading at elevated valuation multiples. Hundreds of other companies are currently valued primarily on expectations surrounding artificial intelligence. In some cases, merely announcing an AI strategy is enough to trigger substantial share price gains. Investors appear to assume that virtually every technology company will fully execute its most ambitious business plans while simultaneously achieving exceptionally high profit margins.

High Valuations Leave Little Room for Disappointment

Artificial intelligence will undoubtedly deliver significant productivity gains. Many companies will become more efficient, develop new services and strengthen their competitive positions. This development fundamentally justifies higher valuations than in previous years.

However, valuations become unrealistic when financial markets assume that every company will successfully execute its most ambitious business plans simultaneously. Economic reality tends to be quite different. Not every AI product will gain widespread market acceptance. Not every provider will attract sufficient customers. Moreover, highly attractive markets inevitably become increasingly competitive, placing pressure on profit margins. In the end, a small number of companies will achieve extraordinary success, while many others will fall short of today's lofty expectations.

History provides numerous examples of this phenomenon. During the so-called Nifty Fifty bubble of the early 1970s, a small group of seemingly invincible growth companies in electronics, software and consumer goods traded at extremely high valuations. Many investors believed these stocks could be purchased "at any price." Only a few years later, a painful correction followed. In 1973, the stock market suffered a major crash that destroyed enormous amounts of wealth.

An even more striking example occurred during the dot-com bubble around the turn of the millennium. At that time, many investors believed the Internet would replace virtually all traditional business models. In the long run, that assessment proved largely correct. Amazon, Google and many other Internet companies fundamentally transformed the global economy. Nevertheless, between 2000 and 2003, numerous technology stocks lost more than half of their market value because valuations had risen far beyond economically justifiable levels. Many companies disappeared altogether.

The lesson is straightforward: a technological revolution does not automatically make every company within that sector an attractive investment. There is a fundamental difference between an outstanding technology and an attractive valuation.

Despite the Risks, We Continue to Invest in Technology

Investors who completely avoid technology stocks today are foregoing one of the most important long-term growth drivers of the global economy. Artificial intelligence, cloud

computing, robotics and digitalisation will create substantial economic value in the years ahead. Investors should therefore participate in these long-term trends.

At the same time, concentrating exclusively and uncritically on technology would be equally misguided. Investors whose portfolios consist almost entirely of highly valued AI-related stocks expose themselves to considerable risks. Should today's enthusiasm begin to fade, or should companies fail to meet the exceptionally high expectations currently embedded in their valuations, significant market corrections could follow.

For this reason, we deliberately pursue a balanced investment approach. We continuously analyse developments within the technology sector and selectively invest in companies whose long-term prospects we consider compelling.

There is little doubt that technological revolutions create enormous value. At the same time, they also regularly give rise to periods of excessive optimism that are eventually corrected. Successful investing therefore does not mean becoming carried away by market euphoria, nor does it mean ignoring transformative technologies. Rather, successful investing means consistently capturing opportunities while never losing sight of the risks.

HAVE WE REACHED ANOTHER ERA OF "IRRATIONAL EXUBERANCE"?

Few expressions have left as lasting an imprint on financial market history as "irrational exuberance." The phrase was coined by Alan Greenspan, one of the most influential central bankers of the twentieth and early twenty-first centuries. Greenspan served as Chairman of the U.S. Federal Reserve from 1987 to 2006 and shaped international monetary policy for almost two decades.

On December 5, 1996, Greenspan first used the term "irrational exuberance" in a widely noted speech. With this expression, he questioned whether equity markets were becoming increasingly detached from their economic fundamentals. At that time, stock markets were rising sharply, driven in particular by rapidly increasing valuations of technology companies and the beginning of the Internet boom. His remarks were not directed against technological progress itself. Rather, they served as a warning against the human tendency to abandon caution during periods of widespread market euphoria.

At the time, many market participants dismissed Greenspan's concerns. Equity markets continued to rise, and many investors became convinced that an entirely new economic era had begun. The Internet was expected to revolutionise every industry, traditional valuation methods were considered outdated, and virtually every company with an Internet-related business was expected to generate enormous profits within a short period.

Following his 1996 speech, stock prices continued to rise for several more years. More and more investors wanted to participate in what appeared to be an unlimited success story. Those who were already invested enjoyed substantial paper gains. Those who had not yet invested feared being left behind. A classic herd mentality emerged. Investors increasingly based their decisions not on the long-term earnings potential of companies, but on which stocks had delivered the strongest gains the previous day.

High Valuations Driven by Herd Behaviour

With the term "irrational exuberance," Greenspan described precisely this phenomenon of herd behaviour among investors. One investor simply followed another, buying shares without conducting any meaningful analysis, solely because they expected prices to rise further the next day. Everyone wanted to own the apparent winners. Ever-higher prices seemed justified because investors believed they could later sell their shares to someone even more optimistic. As long as new buyers continued to enter the market and were willing to pay higher prices, the system appeared to function without difficulty. In the long run, however, economic reality cannot be ignored.

By 2000, enthusiasm surrounding technology and Internet stocks gradually began to fade. During 2001, the dot-com bubble finally burst. Many companies were never able to meet the exceptionally high expectations placed upon them. Numerous firms generated little or no revenue and produced no profits at all. Others burned through enormous amounts of capital without developing sustainable business models. Many companies disappeared completely or filed for bankruptcy.

Share prices in many cases fell by more than ninety percent. Even numerous high-quality technology companies lost a substantial portion of their market value because their valuations had previously risen far beyond economically justifiable levels.

Looking back, it became clear what Alan Greenspan had recognised years earlier: technology itself was never the problem. The real problem lay in investors' expectations and the blind herd mentality that led one investor simply to follow another. That lesson has lost none of its relevance today.

"Irrational Exuberance" in Today's Market

Artificial intelligence will undoubtedly transform both the economy and society in profound ways. The resulting productivity gains could be substantial, and many companies will benefit from these developments. In this respect, today's environment differs from previous speculative episodes. Behind today's massive investments stand genuine innovation and financially strong companies. Nevertheless, the question remains whether market expectations have once again moved too far ahead of economic reality.

Many companies are currently trading at valuations that can only be justified if they fully execute their most ambitious business plans while generating exceptionally high profit margins over many years. Some of these companies currently produce only modest profits—or none at all. Equity markets are therefore pricing not today's earnings power but rather the expectation of an extraordinary future. This is precisely the point at which Alan Greenspan would most likely once again urge investors to exercise caution.

Every market bubble begins with a compelling story. Railways changed the world. Electricity changed the world. The Internet changed the world. Today, artificial intelligence is changing the world. All of these developments were real.

The excesses emerged whenever investors assumed that virtually every company operating within these new industries would automatically become an extraordinary success. History has consistently shown that this assumption never proves correct.

For this reason, we believe Alan Greenspan would observe today's developments with considerable interest. He would most likely once again remind investors that financial markets can periodically become gripped by collective enthusiasm. Such enthusiasm is understandable and often justified. It only becomes dangerous when valuations leave virtually no room for disappointment.

Implications for Investors

The lesson of "irrational exuberance" is that valuations deserve particularly careful scrutiny today. We do not invest simply because other market participants are buying the same companies. Instead, we carefully analyse whether a business model is sustainable over the long term and capable of generating the earnings and profit margins necessary to justify its current valuation. In some cases, our analysis leads us to conclude that market expectations are simply unrealistic. For example, it appears questionable whether Tesla will ever be able to sell enough vehicles at

sufficiently high profit margins to fully justify its current market valuation. Similar questions can be raised regarding other companies as well. Particularly among smaller technology firms, there is an additional risk that their market niche could disappear quickly if larger competitors introduce competing solutions.

In today's environment, rigorous fundamental analysis is therefore more important than ever. Only investors who carefully weigh opportunities against risks are likely to achieve long-term investment success.

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This publication was prepared by Erlen Capital Management AG, Florastrasse 44, CH-8008 Zurich, telephone +41 44 267 99 47 (www.erlencapital.com).

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Erlen Capital Management AG
T +41 44 267 99 47
info@erlencapital.com
www.erlencapital.com