

Why active management is missing its mark

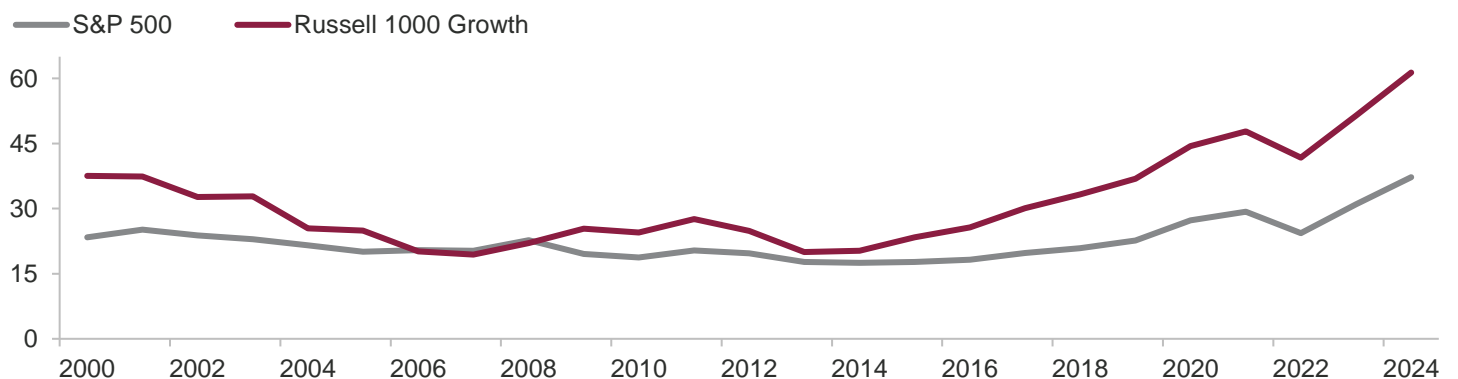
By investment analyst, [Angela Williams, CFA](#)

Active managers have faced headwinds lately, with many strategies struggling to consistently outperform their respective indices. In 2024 alone, out of all actively managed equity strategies, only a third of large-cap funds outperformed.¹ Recent factors such as index concentration, a momentum—or “herd-like”—market environment, and the proliferation of low-cost passive investment options, made it more difficult for active managers to deliver meaningful outperformance. Is active management facing an existential challenge, or is there more to the story behind its relative performance shortfalls?

Market concentration and shifting index dynamics

As seen in Exhibit 1, the top 10 holdings of major US equity indices increased to their highest weights in recent history. The S&P 500—arguably the best representation of the US stock market—tracks the 500 largest companies, yet its top 10 holdings represent 37% of the index’s total market capitalization (a 60% increase since 2000). This concentration is even more stark in the Russell 1000 Growth Index, which tracks the performance of US large-cap stocks that exhibit strong growth characteristics. Here, 10 stocks make up 61% of the index, while 387 stocks make up the other 39%.

Exhibit 1: Percentage of top 10 holdings by index



Source: FactSet as of December 31, 2024.

What created this dynamic of concentration, where the large names get larger? In a market ripe with uncertainty over interest rates, tariffs and geopolitics, investors sought a bright spot. And a consensus quickly emerged around the importance of artificial intelligence (AI). Investor preference for AI “winners” caused the market capitalizations (market caps) of these companies to increase dramatically. Alternatively, stocks without clear ties to being an AI “winner” plodded along, while suspected AI “losers” suffered sharp losses. As a result, a select few large tech names became even larger, as nothing else could keep up. Specifically, AI “winners” were led by a group of familiar companies known as the “Magnificent 7” (Mag 7): Microsoft, Apple, Nvidia, Alphabet, Amazon, Meta and Tesla.

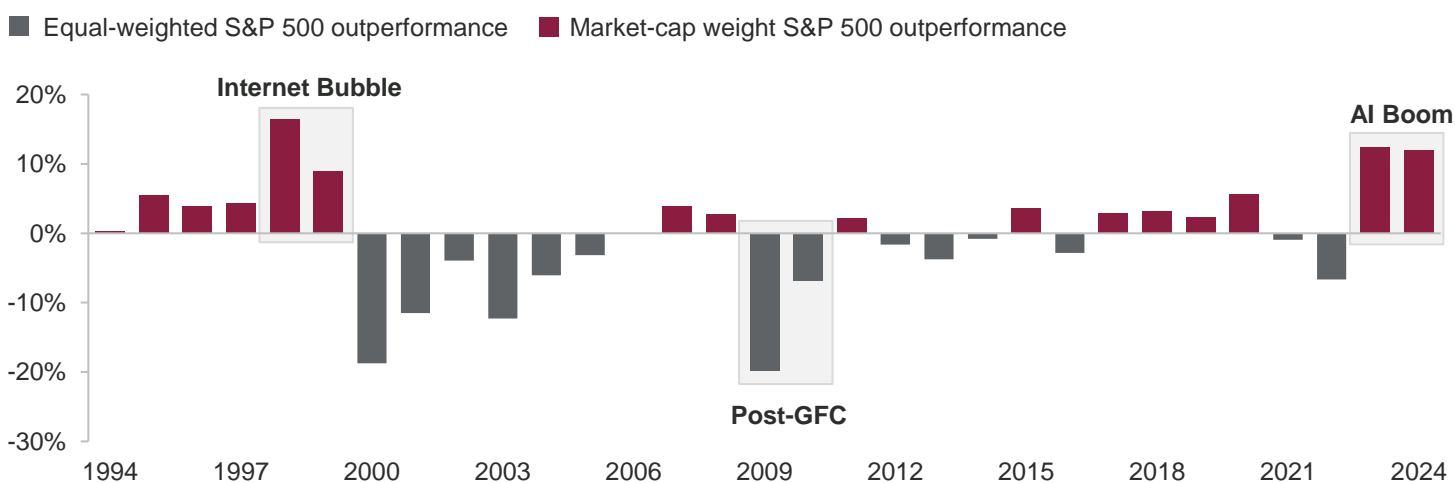
Why is this important? Larger companies make up correspondingly larger parts of an index. Therefore, the larger the company is, the more influence that company has on an index’s performance. For large-cap indices, the performance contribution of the top 10 holdings has been exceptional. In 2024, the top 10 holdings accounted for approximately 59% and 76% of S&P 500 Index and Russell 1000 Growth Index returns, respectively. Overall, indices are currently markedly more concentrated than they were during the last technology revolution (the 1990s internet bubble).

Heavy index concentration can help to drive returns when the top holdings outperform, but it is likely to pose a significant challenge when these holdings perform poorly. For investors who seek to replicate the performance of the S&P 500, for example, last year's dominance of the Mag 7 benefited them greatly. However, it's important to keep in mind that this hasn't always been the case. As recent as 2022, the Mag 7 dropped 40.0%, more than twice the decline of the S&P 500 Index. And recovering from large declines can be difficult.

S&P 500 Index: market-cap-weighted versus equal-weighted performance

If concentrating a large part of an index into a handful of holdings leads to those companies driving returns, what happens if we equally weight each holding instead? Equal-weighted indices contain the same stocks but in equal portions, regardless of the company's size. As evidenced in Exhibit 2, the last time the S&P 500 significantly outpaced its equal-weighted counterpart for multiple years was during the aforementioned internet bubble, followed by years of outperformance for the equal-weighted index after the bubble burst. The S&P 500 outperformed in the lead-up to the Global Financial Crisis (GFC), with the equal-weighted index significantly outperforming the market-cap-weighted index in 2009 and 2010, as well as in the last down year for equities in 2022.

Exhibit 2: S&P 500 vs. S&P 500 Equal-Weighted Index



Source: FactSet.

Overall, with less concentration in down markets, the equal-weighted index outperformed the market-cap-weighted index in the last 30 years, returning 11% vs. 10.6%, respectively. While concentration is a benefit in a momentum-driven market (such as today's current market environment), diversification has historically protected in down markets. Why does this matter? While history may not repeat itself, it often rhymes. New technology can be transformative, and it is part of human nature to want to participate and profit from such transformations. However, momentum has faded in other bull markets, so what drives long-term performance? Company valuations and fundamentals.

Russell Index: reconstitution

The Russell Index reconstitution (the adding or removing of index securities to reflect current market conditions) reshuffles benchmark constituents across market caps and styles in a way that exacerbates the momentum dynamics already present in the market. On an annual basis, companies may be added or removed from indices overnight based on their size and recent performance. Companies that are doing well may be added to more prominent indices, attracting more investors and driving their prices higher.

On the other hand, companies that are underperforming may face selling pressures as they are removed or downgraded. For example, within the Russell 1000 Growth Index, there were 442 companies in the benchmark the day prior to the 2024 reconstitution; the very next day, 45 companies were removed. In the last 10 years, the difference is even more pronounced with a drastic 42% decrease in index constituents, amplifying concentration over time.

This cycle of buying the winners and selling the losers not only creates exaggerated market moves and volatility but intensifies the market's focus on short-term trends. For active managers, the abrupt and dramatic changes to the benchmarks they are measured against pose an obvious question: how should they handle these shifts? While it may be tempting to overhaul portfolios to match the reconstituted indices, doing so risks abandoning long-term investment strategies and creating unnecessary turnover that can harm client portfolios.

Impact of passive investing

The ascendancy of passive investing may be contributing to momentum and therefore concentration in benchmarks. As of October 2024, the total combined assets in passive mutual funds and exchange-traded funds (ETFs) surpassed the total amount in active funds.² And in the 12 months ending September 2024, passive mutual funds and ETFs experienced inflows of \$754.2 billion, while active funds saw net outflows of \$429.8 billion.³ As passive investing has grown in scale, these investors are in effect investing into momentum. In addition, with the growth of AI-related ETFs, investors may have more AI exposure in their overall portfolio than they realize.

Alternatively, active mutual funds registered as diversified with the US Securities and Exchange Commission (SEC) cannot concentrate their holdings to the extent indices and passive strategies have. Active diversified funds are limited to holding no more than 10% of any company's outstanding voting stock, while passive strategies have "no action relief" from the SEC. This means that passive strategies can exceed diversification limits by holding concentrated positions in order to track their respective indices.

While the rise of passive investing has lowered costs overall and democratized investing to a large scale, it's important to note that passive investing does not take valuation, fundamentals or concentration risk into account. By focusing solely on passive funds, investors may not have portfolios as diversified as intended, particularly given the diversification exemption afforded to passive funds. If the tenet that earnings drive equity returns over the long term holds, then focusing on company valuation and fundamentals will matter for investor returns.

What are active fund managers doing?

It's clear that this dominance of a handful of mega-caps is creating a challenging backdrop for core and growth funds. Because of this, managers are forced to make a choice: chase short-term performance by mirroring heavily concentrated index weightings or maintain a chosen investment process and philosophy to focus on attractive long-term results. Given recent performance, managers who are underweight mega-cap holdings due to valuation or risk management concerns have much higher hurdles to overcome to outperform their indices. Despite this, many fund managers across the style and market cap spectrum will opt to maintain their investment process—knowing it will lead to relative underperformance in short-term momentum-driven markets but trusting it will provide ballast in down markets.

Conclusion

Active management offers investors the flexibility to adapt to changing market conditions, manage risk proactively, align with specific investment objectives, and navigate the complexities of inefficient markets. Over short-to-medium timeframes, diversification could result in investor disappointment if they're not participating in the full upside of a bull market, but the investor could be missing out on the benefits of loss mitigation seen over longer investment periods. Passive market-cap-weighted investing is a bet that the size of a company is the best determinant of future return prospects. But skilled managers who can uncover opportunities before they rise to prominence and move on from over-owned issuers ahead of broad momentum reversals can enhance long-term results.

With this in mind, a well-diversified portfolio benefits from the strengths of both active and passive strategies. Passive strategies provide cost-efficiency and broad market exposure, while active strategies offer quality investments based on company valuations and fundamentals, as well as the potential for outperformance. Together, they create a balanced approach that positions investors for long-term success. While we can't say when current market dynamics will change, there is historical precedence for market regimes to change course—and active managers will be ready.

*For more information on active and passive management,
please reach out to a member of your CIBC Private Wealth team.*

1. Jefferies.
2. ICI.
3. Financial Times.

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