Schroders

The job is to beat the index, not be correct

QEP Investment Team

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Executive summary

- **Active equity managers have endured a difficult decade.** Less than 15% of active funds analysed in a recent UK study beat a passive alternative over the past ten years, in large part because they were underweight mega-cap stocks.
- **Concentration is only one issue.** Market structure post COVID has shifted, with higher single stock volatility and lower correlations driven by speculative trading.
- **Not owning a large benchmark constituent is no longer a modest expression of discipline.** It can dominate relative performance even if the long-term view is ultimately right.
- **Trading avenues are amplifying stock specific moves.** ETFs, baskets short, dated options trading and leveraged products make price action faster, more mechanical and less tied to fundamentals over short horizons.
- **Risk management needs to evolve.** Larger stock weights alongside significant single stock moves mean relative risk management is more important than ever.

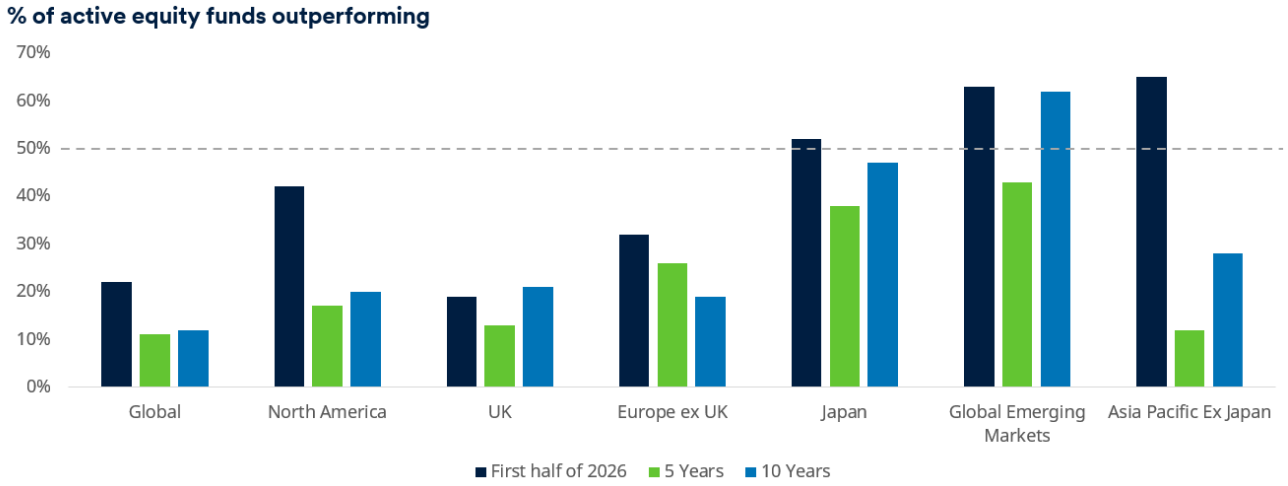
> ***"Managers have been so focused on being fundamentally right about these mega-cap stocks that they have forgotten the job is to beat the index, not be correct!"***

That observation, put to us bluntly by a frustrated superannuation fund CIO, gets to the heart of a problem that has been building for a decade. The point is not that fundamentals no longer matter. It is that fundamental conviction now must be expressed with far greater awareness of benchmark relative risk.

Drawing from observations seen over the first half of 2026, we examine why delivering consistent alpha today depends less on getting individual company calls correct and more on how deliberately risk is managed against an increasingly concentrated index, with shifting underlying dynamics.

A difficult decade led by concentration

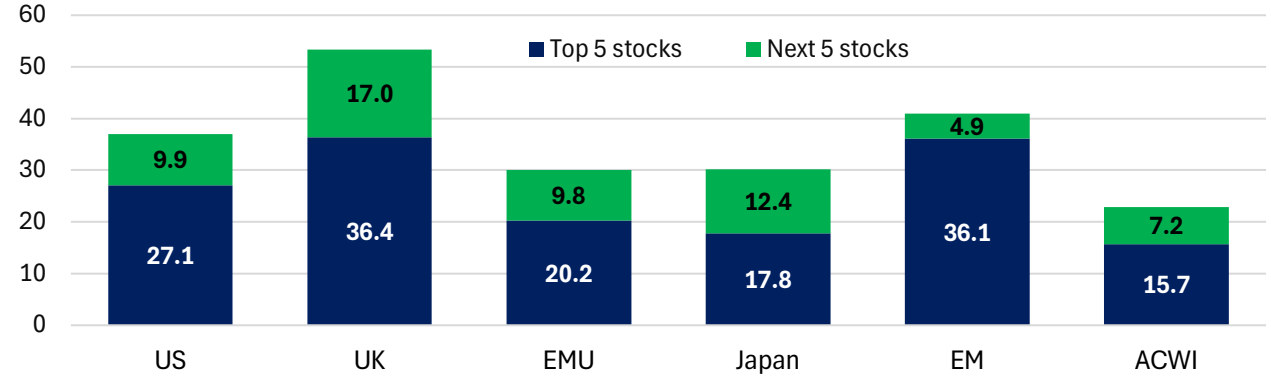
Over the ten years to June 2026, a recent study by AJ Bell found that less than 15% of active equity funds in the global peer group beat a comparable index fund. Results were better in some regions (especially in EM), but the majority of active managers fell short almost everywhere. It would be easy to read this as the final verdict on active management itself, but we think the dominant driver has been persistent. Traditional active managers have tended to be structurally underweight all of, some of, or even one of the largest stocks, and each of those positions would have led to a challenging outcome given this cohort has been the main driver of market beta for almost a decade.



Source: AJ Bell https://www.ajbell.co.uk/news/are-active-funds-keeping-their-tracker-counterparts Data as at June 2026. The above shows the percentage of active funds, based on regional investment universe, outperforming the average passive index fund for the same region. Regions are based on IA sectors. Chart is provided for illustrative purposes.

Unsurprisingly, the study finds that riding concentration alongside being underweight large companies has been the key source of this underperformance. Seen below, the top ten stocks now account for roughly 37% of the S&P 500, with other developed markets similarly top-heavy.

% Weight of top 10 stocks in regional equity markets

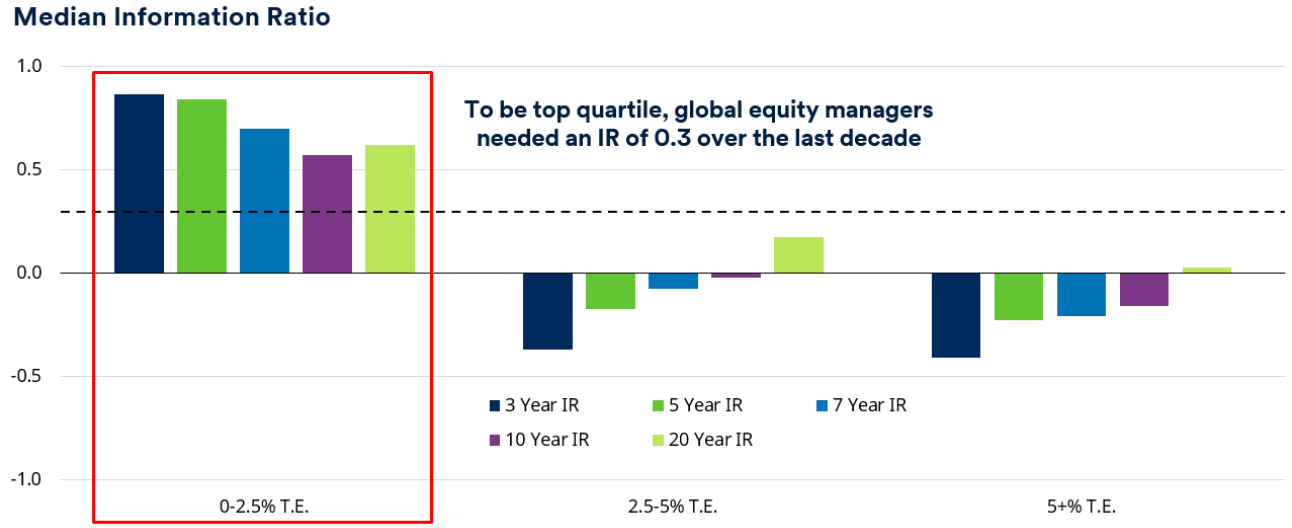


Source: MSCI, as at June 2026.

The problem is most acute for traditional or high active share/concentrated managers, for whom index concentration has changed how conviction can be expressed. As the tail of the benchmark shrinks in weight, it provides progressively less capacity to fund meaningful overweight positions. For example, as at June 2026, the bottom half of MSCI ACWI constituents accounted for only about 5% of the index. Even taking every one of those stocks to zero would create no more funding capacity than omitting NVIDIA or Apple from a portfolio. In this environment the largest constituents consequently become natural funding sources, even when the manager's underweight reflects portfolio construction more than strong

negative conviction. When those mega caps continue to lead, the drag from one or two such positions can overwhelm successful stock selection across dozens of smaller companies.

As we set out in last year's *Winning by not losing*, the managers who held up best through this period were not those with the highest conviction, but those operating at the lower end of the active risk spectrum, whose breadth left them less exposed to the performance of any single index constituent.



Source: eVestment. Schroders. Gross of fee returns as of March 2026. Buckets created using 5yr Tracking Errors. Universe names in full: eVestment Global Enhanced Equity, eVestment Global All Cap Core Equity, eVestment Global Large Cap Core Equity, eVestment Global All Cap Growth Equity, eVestment Global Large Cap Growth Equity, eVestment Global All Cap Value Equity, eVestment Global Large Cap Value Equity. Funds without any relevant data are omitted. A number funds have been removed, including Passive/Sector Specific/Thematic and those not managed against MSCI World or MSCI ACWI and its variations.

None of this is new, though. Concentration has been discussed for years and, on its own, is a largely static problem of index weights. What has made it more consequential is a simultaneous change in the way the market now trades around those weights.

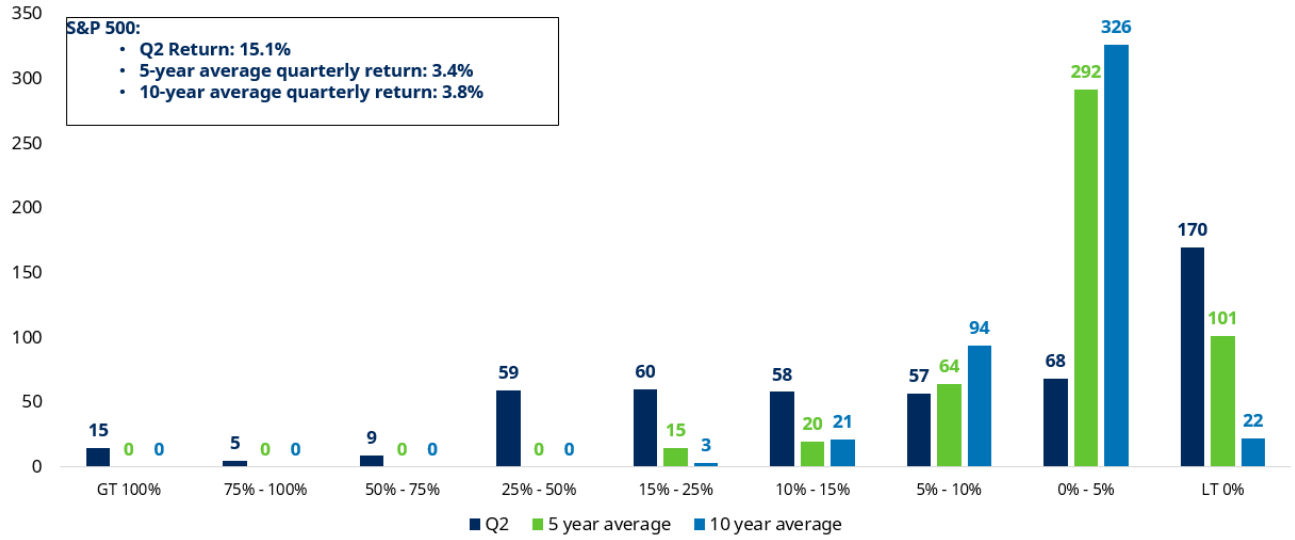
Amplifying the issue

While concentration of this order is difficult enough to navigate, what has made it more consequential is the simultaneous impact of four related shifts in market structure. Each of these amplifies the others, and none are easily captured by traditional fundamental analysis.

Winner Takes All

Narrow leadership has been one of the defining features of equity markets for the better part of a decade. More striking today is the extreme form it has taken, with the most recent quarter demonstrating this. The S&P 500 returned 15.1% in Q2, though that headline return did not come from a broad advance. Fifteen constituents returned in excess of 100%, with close to 90 names returning over 25%, while 170 stocks fell. This stands in stark contrast to the historic norm. Short-term stock price performance is well ahead of the long-term norm, with significantly more companies posting negative returns. These swings feel commonplace today but are unusual when viewed against history. This has served to magnify idiosyncratic risk and its impact, as the performance and active risk outcome from relative exposures within a portfolio is exacerbated.

Market Breadth



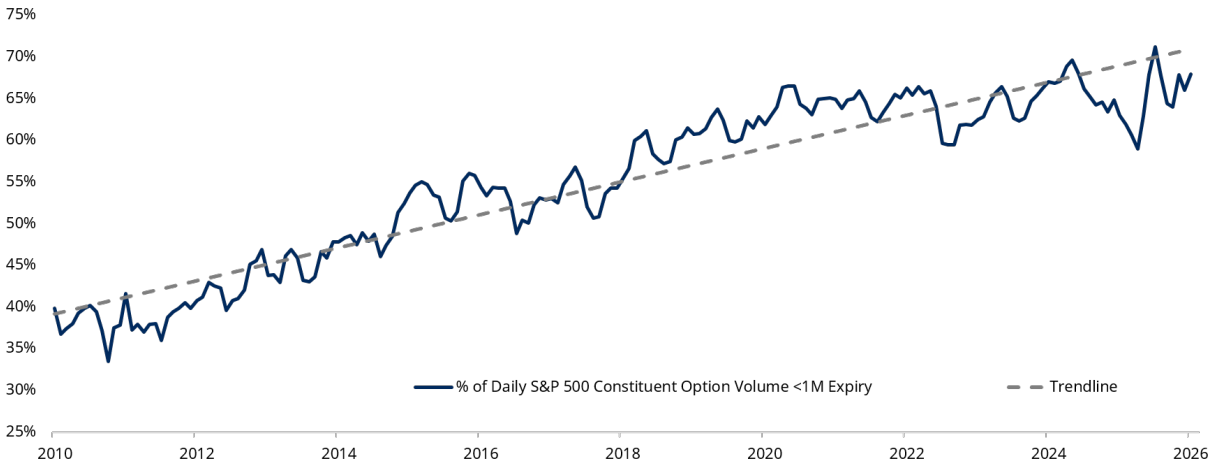
Source: Schroders, MSCI, QEP as at June 2026. Market Breadth=number of stocks outperforming the index over period mentioned / total number of stocks in the index as calculated by QEP. Data starts 1st January 1997. Regional indices are defined by MSCI.

Missing even one or two of those names left little elsewhere with which to make up the ground. And when these markets persist for longer periods – as we've seen in recent years – a single underweight to a key stock can do outsized damage to relative performance.

The rise of speculative trading

An increasing share of activity is concerned less with the long run value of a business than with its direction over the coming days or hours. Options trading has now set records for six consecutive years, and the growth has been concentrated in short-dated contracts. Same day expiries have gone from a rounding error at the start of the decade to close to half of index options trading. The chart below shows the effect in the names that matter most to a benchmark relative investor, capturing contracts traded on S&P 500 constituents rather than on the index itself. In fact, for the largest stocks, options activity now frequently exceeds the notional volume traded in the underlying shares themselves as views on a company are increasingly expressed via the options market.

Average Short-Term Equity S&P 500 Trading Volume[1]

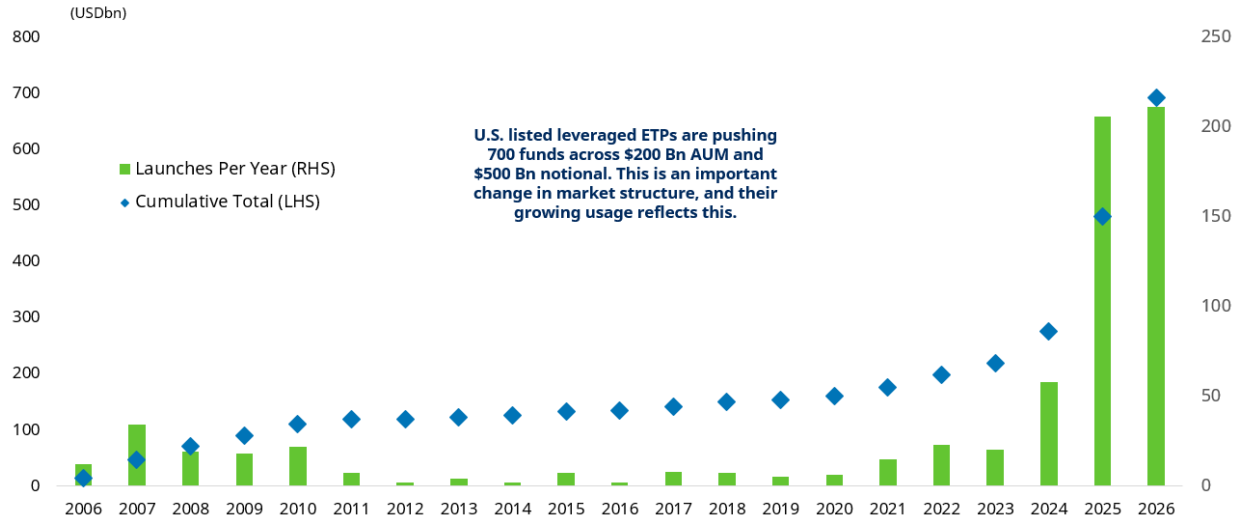


Source: Schroders, QEP, as at March 2026. 1Includes all S&P 500 constituent equity options. Data has been smoothed using a 3-month moving average

Flows have become faster, larger and more mechanical

Passive and ETF flows, basket trading, leverage utilisation and an explosion in short-dated options (as above) all concentrate activity in an outsized fashion and often in a narrow cohort of stocks. These flows are often price insensitive and event driven rather than fundamental. They buy what is big because it is big, and they transact in size at the market close. The result is price action that is quicker, more clustered and less aligned to company fundamentals in the short term but instead focused on thematic exposures. Leveraged and single stock ETFs are examples of this mechanism at work. In the US alone, the asset class has grown into roughly $200 billion of assets across 700+ funds, of which around 400 track single stocks with most delivering technology (or adjacent) exposure. This translates to over $500 billion of notional exposure, since many of these products track two or three times their underlying asset exposure.

Leveraged ETP's on the rise



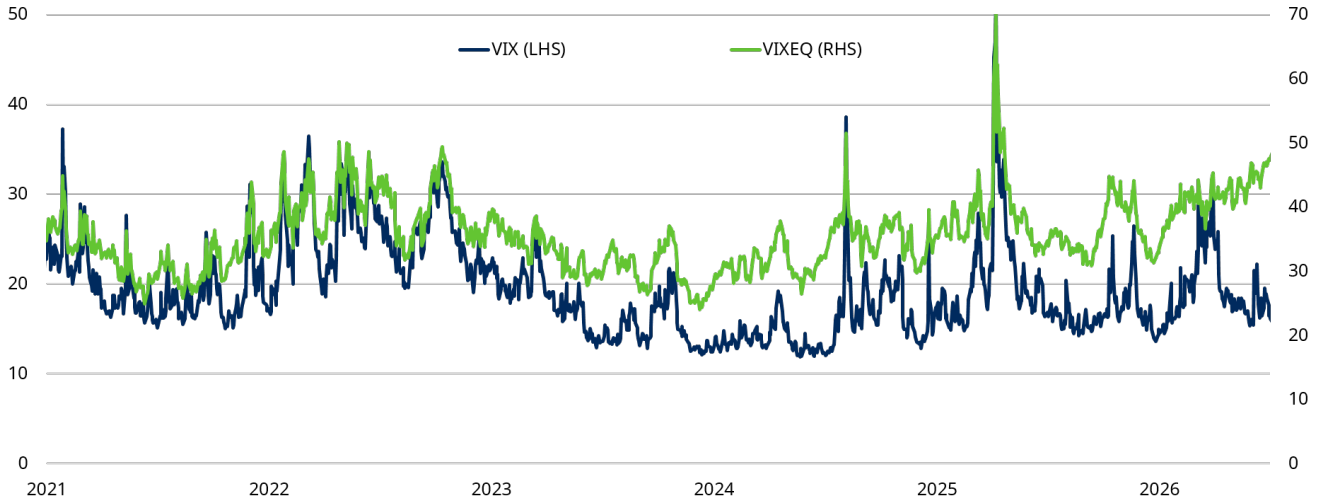
Source: Schroders, based on estimated data from Baird Strategas July 2026

The mechanics of these products further impact markets given the need to keep the leverage multiple in line with expectation. They buy exposure when the underlying rises and sell when it falls, rebalancing into the close each day. As the funds grow, that daily reset adds to end of day volatility. While leveraged ETFs alone are not the driver, they are a contributor and it's clear that more of the tape is now set by mechanical activity agnostic of fundamentals and hindering effective price discovery.

Heightened volatility under the bonnet

This fourth shift follows from the others. Whilst headline index volatility has continued to appear contained, this has masked what is happening beneath the surface. Individual names swing far more violently than the index they comprise. As an example, in the options market, the VIX measures the implied volatility of the S&P 500 as a whole, whilst the VIXEQ measures the implied volatility of its underlying constituents aggregated into a single index. Whilst the two once tracked closely, the gap between them has widened markedly. Single stock implied volatility now runs persistently above the headline figure as the constituents swing sharply around earnings releases and news flow.

VIX vs. VIXEQ



Source Schroders, Datastream as at June 2026. The chart shows the closing price history of the VIX & VIXEQ indices. VIX index is a measure of option market implied S&P 500 volatility. VIXEQ index is measure of option market implied volatility of the underlying S&P 500 constituents aggregated into one index.

The consequence for an active manager is that the largest companies can now demonstrate the volatility profile of a much smaller name.

The view of active risk has changed

These market structure changes amplify when managing portfolios against concentrated indices. Larger index weights mean a given active position is a bigger bet. Higher single stock volatility means each of those bets moves further while the heightened speculative trading means the moves can be faster and more violent than fundamentals alone or that regular trading would justify.

While historically expressing a large underweight in an expensive stock may have been a low-risk expression of conviction, today the relative risk associated with it has markedly increased. That same underweight can now be one of the largest sources of tracking error in a portfolio. It may still work out over the longer term, but delivering consistent performance through the market cycle means conviction must be sized for the environment it is expressed in, not for fundamentals alone.

Portfolio implications: Managing active risk in thematic markets

If larger weights and higher volatility change the size of the bet, the way the market now trades those bets changes their character. The same ETF, basket and options flows described earlier increasingly move stocks in thematic clusters, and that has direct consequences for portfolio risk management.

Considering the traditional view of active fundamental equities, a manager owns the companies they like, avoids (or is underweight) the ones they don't, and expects the fundamentals to win over time. That remains valid, though with the large caveat that you need a longer time horizon.

Given these market dynamics, individual stocks are now increasingly being driven by themes before the market has time to distinguish between business models, fundamental quality, balance sheets or management. That creates a harder environment for high active share or concentrated portfolios, because they can be right on company fundamentals and still be overwhelmed by a thematic move. The Iran-US war provided these challenges in wholesale. The market didn't simply trade oil. It quickly moved into adjacent baskets i.e. energy security, shipping, fertiliser, food inputs and agricultural supply chains. Fertiliser stocks, in particular, traded sharply as a cohort as investors focused on gas prices, urea

supply and the role of the Middle East in global input markets. For traditional fundamental managers, this created two separate challenges. First, they had to be on the right side of the thematic trade. Then, even if they were, they still had to pick the right stocks within the sector during a period of unusually high idiosyncratic volatility.

The same pattern has been visible in AI. The market has traded AI infrastructure as a broad basket, rewarding semiconductors, memory, data centres and power. Yet dispersion within that basket has been enormous. Memory has dominated while software has struggled. Some hardware names have benefited from genuine earnings upgrades, while others have simply been carried by the theme. In other words, identifying the right theme is no longer enough and investors also need to understand how that theme is being traded, where the crowding sits, and which stocks actually have the earnings durability to justify any price moves. This matters because thematic baskets are a major part of market trading behaviour. AI infrastructure, defence, energy security, reshoring, electrification, private credit proxies and food input exposure are all traded as clusters. ETFs, baskets, options and leveraged products make it easier to express those views quickly, often without much regard for the underlying fundamentals of each company. In that environment, stock prices can move first as part of a basket and only later differentiate according to fundamentals.

A concentrated portfolio may take 30-50 stock specific views, but in practice those positions may all depend on a handful of underlying themes. Conversely, a large underweight to a crowded index theme may look like valuation discipline, but it can dominate relative returns if that theme continues to move higher. The risk is not just being wrong. It is being right too early or being right on the company but wrong on the basket. A position should therefore not be sized only according to the strength of the stock level view. It should also reflect how volatile the stock has become, how crowded the theme is, how much of the index it represents, and whether flows from ETFs, options or thematic baskets are likely to amplify moves. Put another way, consistent alpha today is less about being right on a list of stocks in isolation, and more about how those stock views are translated into benchmark relative risk. While the benchmark may have previously been a neutral measuring stick against which performance was measured, it is now a concentrated exposure to a small number of larger, volatile and increasingly flow sensitive stocks which clients still expect to outperform.

Active management must evolve

This brings us back to the pattern noted at the outset. The managers who have most reliably outperformed have not been the highest conviction cohort but those operating at the lower band of the risk spectrum, whose edge lies in consistency, tight risk control and the breadth to spread their views across an extensive global investment universe - rather than in a handful of bold calls. The reason, we believe, is structural. When index weights are this large and single stock moves this violent, breadth and relative risk management are worth more than they used to be.

As we wrote in *Winning by not losing*, through this period of rising concentration the 'Core' or 'lower risk' group has outperformed both its benchmarks and its more aggressive peers, and it has done so by winning more often rather than by winning big; outperforming in a majority of months and limiting drawdowns rather than chasing spectacular calls. Long term success comes far more from avoiding mistakes and compounding small advantages than from a handful of heroic bets.
In the world as we see it today, with the structural market shifts examined earlier, the approach best suited to delivering outcomes over shorter time horizons has shifted. Conviction, valuation and business quality still all matter. However, conviction cannot be sized on fundamentals alone. It must be sized for the market environment. The benchmark weight of the stock, its volatility, its correlation to the rest of the portfolio, the liquidity around it, the crowding in the theme and the flows that may amplify its moves. In today's market, risk management is not a constraint on alpha. It is increasingly the mechanism through which alpha becomes repeatable.

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