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ACTIVE VS. PASSIVE IN THE 2021 – 2025 REGIME: SEGMENT RESULTS AND PORTFOLIO IMPLICATIONS

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Executive Summary

Using the 2021–2025 regime as a stress test, this paper examines where active managers did (and did not) keep pace with passive benchmarks across major equity segments—and what that implies for allocating scarce active risk.

5-year underperformance (risk-adjusted returns):

U.S. Large-Cap Equity
91%
of active funds trailed index over the last 5 years

Mid-Cap U.S. Equity
67%
of active funds trailed index over the last 5 years

Small-Cap Equity
61%
of active funds trailed index over the last 5 years

Non U.S. Developed Equity
83%
of active funds trailed index over the last 5 years

Emerging Markets Equity
78%
of active funds trailed index over the last 5 years

Based on the results above, active management has struggled to outperform on a risk adjusted basis for the last five years. The question for investors is how to translate these findings into portfolio decisions, specifically where to allocate (and conserve) active risk and how to use this risk in portfolios.

Where active risk is (and isn't) likely to be rewarded. In U.S. large-cap equities, a sustained resurgence in active performance would likely require a fundamental shift in market structure or investor behavior—neither of which appears imminent. Small- and mid-cap U.S. equities have offered a somewhat more favorable backdrop over the past two years, but the advantage has been episodic and has not consistently translated into superior outcomes over longer horizons. Non-U.S. large-cap equities remain challenging for active managers in aggregate, though conditions could incrementally improve if dispersion rises through policy divergence, macroeconomic normalization, and broader market leadership across regions and sectors. As with U.S. equities, we believe active risk in Non-U.S. markets is best deployed selectively, favoring emerging markets rather than broad Non-U.S. equity benchmarks.

Taken together, the analysis suggests active management is most effective when applied judiciously. Even where conditions are more favorable, fewer than half of active small- and mid-cap managers have delivered outperformance on a risk-adjusted basis over 5 and 10 years. Accordingly, an active risk budget—how much benchmark deviation an investor is willing to accept in pursuit of excess return—should be allocated deliberately, focusing on segments where inefficiencies are more persistent and the potential reward justifies the risk and cost.

Portfolio implementation. Evaluating active versus passive at the segment level is informative; however, the portfolio-level question is more consequential.

A central portfolio decision is where to take, and where to avoid, active risk, given each investor's objectives, constraints, and tolerance for tracking error. Every portfolio has an "active risk budget," defined as the amount of benchmark deviation an investor is willing to accept in pursuit of excess return. That budget varies by investor and objective (e.g., conservative, moderate, aggressive) and should also account for implementation considerations, including fees, liquidity, governance complexity, and the degree of inefficiency in the targeted market segment.

Based on the evidence, our research as outlined in the paper suggests:

+ High conviction for private markets, fixed income, and specialized strategies.
+ Some conviction for small-/mid-cap and Non-U.S. equities, particularly emerging markets.
+ Little to no conviction for broad U.S. large-cap equities, unless in pursuit of specific opportunities (e.g., thematic, ESG, etc.).

In practice, this implies a passive core (cheap beta in efficient segments such as U.S. large cap and, for some investors, core developed international) plus active satellites in higher-dispersion segments (e.g., a carefully selected SMID manager, an EM manager, selected thematic/values-aligned strategies, active fixed income, and private assets), with a periodic review and rebalancing process to reassess opportunities as dispersion and market structure evolve.

Introduction

From 2021 through 2025, active equity management experienced one of its most challenging multi-year stretches in decades across both U.S. and Non-U.S. markets. In U.S. large-cap equities, extreme index concentration and sustained mega-cap leadership created conditions that systematically favored passive exposure. Small- and mid-cap results were comparatively better, though most managers still underperformed over longer horizons. Outside the U.S., the pattern was similar: many managers trailed benchmarks net of fees, with outcomes varying by segment. Developed ex-U.S. markets were persistently difficult to outperform, while emerging markets and international small cap exhibited higher dispersion and periodic opportunity.

Several forces contributed to this backdrop. In the U.S., concentration was reinforced by sharp macro regime shifts and AI-driven narrative rotations. More broadly, unusually rapid factor and sector leadership changes raised the cost of being early (or late) to defensiveness or cyclicality. Notably, quality-oriented approaches—often relied upon for downside resilience—were penalized during portions of 2021–2025, particularly in 2023 and 2025 as lower-quality, higher-beta exposures led performance.

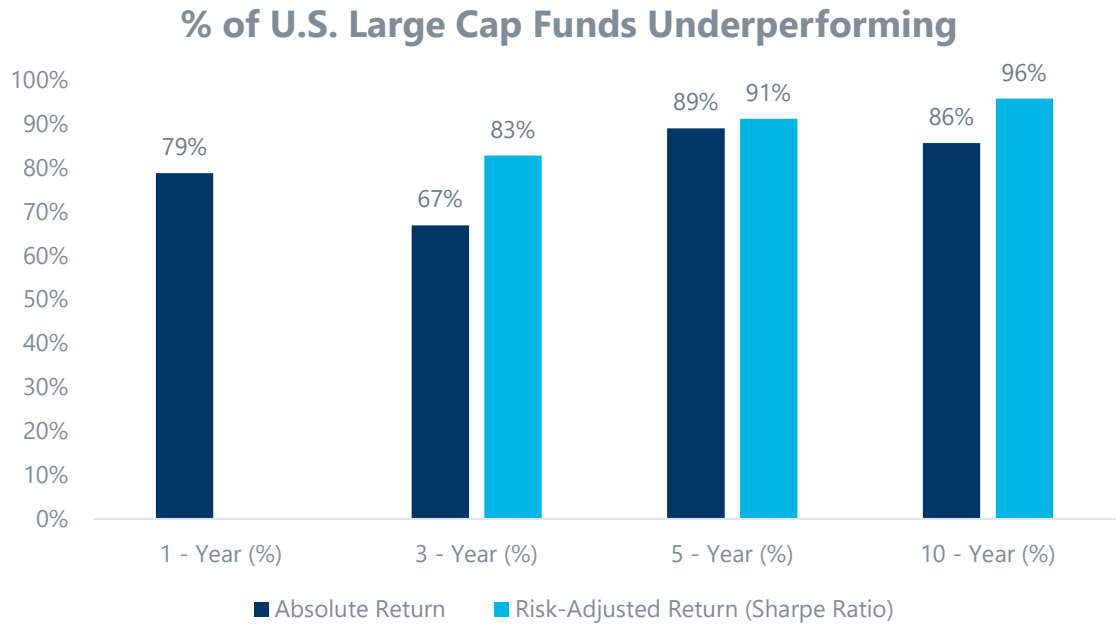
This piece reviews active management results in public equity markets over 2021–2025, the market-structure and macro forces that shaped those outcomes, and the conditions under which the environment for active management may—or may not—improve.

Equity Segment Performance: A Scorecard Across Major Markets

Large-Cap U.S. Equities: Active Management Under Fire

Active Manager Performance (Risk-Adjusted): Broad Underperformance

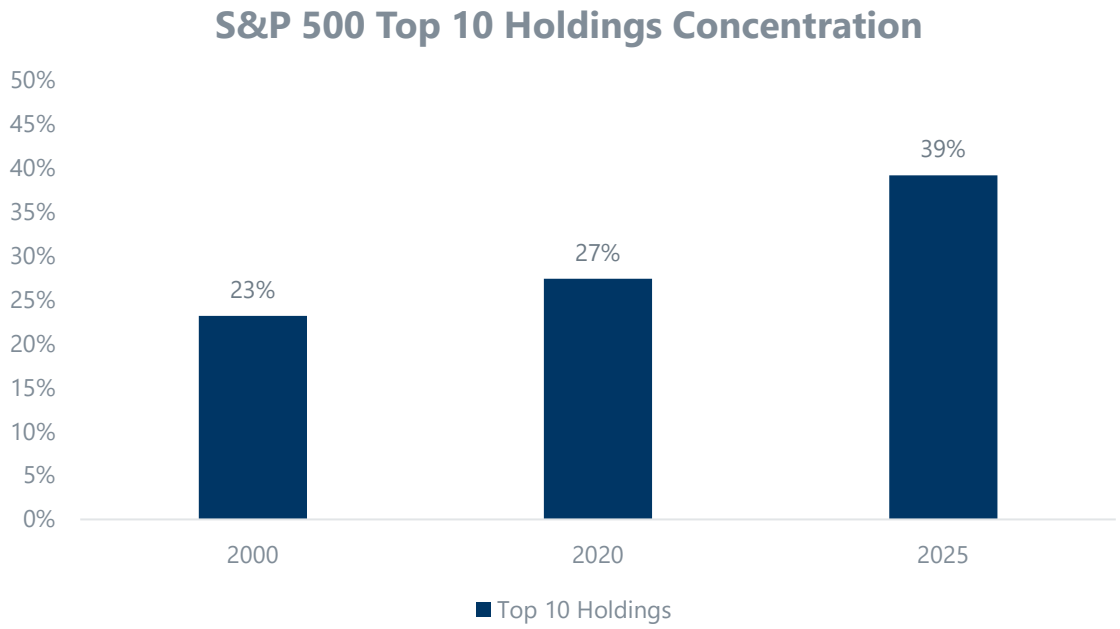
The past five years were exceptionally difficult for U.S. large-cap stock selection. According to S&P Dow Jones Indices' SPIVA U.S. Scorecard, 79% of large-cap equity funds underperformed the S&P 500 in 2025 (up from 65% in 2024), marking one of the weakest years for active large-cap managers in the 25-year history of the SPIVA report. Over the five-year period ending 2025, approximately 89% of U.S. large-cap funds lagged their benchmarks net of fees. Risk-adjusted results were similarly challenging. Based on Sharpe ratios, 91% of large-cap managers underperformed the S&P 500. In aggregate, these results indicate that large-cap U.S. equities have been a difficult segment in which to generate persistent positive risk-adjusted performance in recent years.



Source: S&P Dow Jones Indices, SPIVA® U.S. Scorecard – Year-End 2025. Risk-adjusted return statistics are not reported for one-year periods due to insufficient sample length for meaningful statistical comparison.

Market Concentration: Benchmark Drag from Mega-Cap Leadership

A primary driver of this pattern was the extraordinary concentration of returns in a small number of mega-cap stocks. By the end of 2025, the "Magnificent Seven", Apple, Microsoft, Amazon, Alphabet (Google), Nvidia, Meta, and Tesla, accounted for 34.9% of the S&P 500's market capitalization (versus approximately 20% in 2020). The top 10 stocks comprised roughly 39% of the S&P 500 at year-end 2025, above levels observed at prior peaks (approximately 27% in 2020 and 23% during the dot-com period in 2000).



Many active strategies are constrained by diversification and risk controls (e.g., position-size limits), which can make it difficult to match benchmark exposure when a narrow set of names drives a disproportionate share of index returns. Consistent with this, the S&P 500 cap-weighted index outperformed an equal-weighted version by approximately 7% in 2025, 12% in 2024, and 13% in 2023. When one-third (or more) of market capitalization and return contribution is concentrated in a small set of stocks, diversified portfolios face a higher hurdle to keep pace unless they take unusually large active bets in those same names.

Sectoral Performance: Tech-Heavy Leadership Raised the Hurdle

The dominance of a few sectors magnified the challenge. For the third year in a row, the S&P 500's performance in 2023–2025 was led almost entirely by the Information Technology and Communication Services sectors.

SECTOR PERFORMANCE	2023	2024	2025	5-YEAR
Communication Services	55.8%	40.2%	33.0%	105.1%
Information Technology	57.8%	36.6%	24.4%	150.9%
S&P 500 Index	26.3%	25.0%	17.8%	80.0%

This narrow breadth of leadership created an additional headwind for managers that maintain sector-neutral exposures for risk control, particularly given the index's large, combined weight in Information Technology and Communication Services during this period.

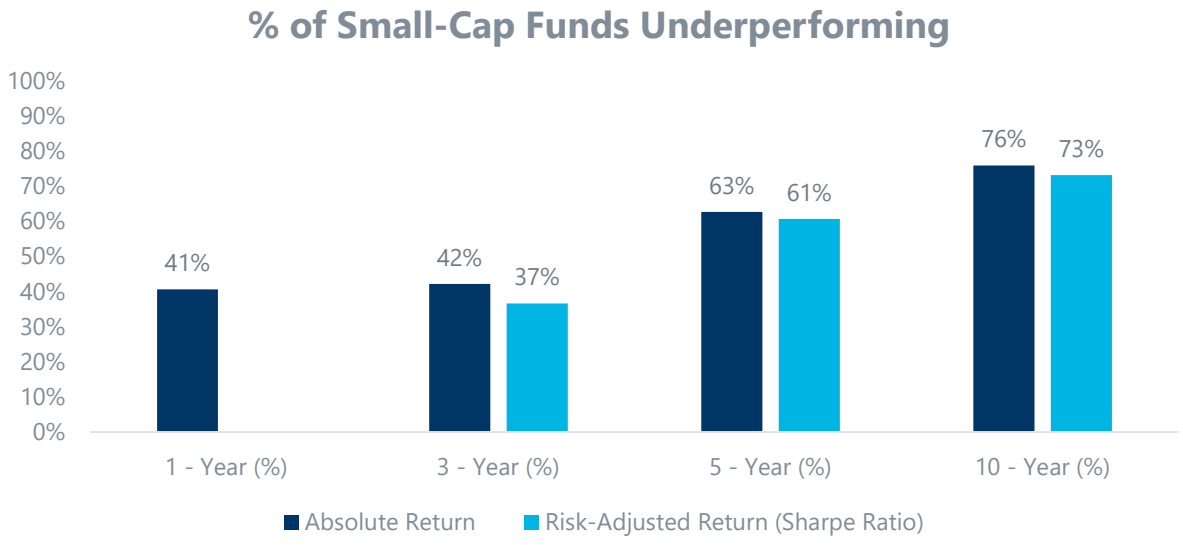
In summary, large-cap U.S. active equity managers faced a confluence of adverse conditions: concentrated index leadership, persistent growth/technology dominance, rapid macro regime shifts, and periods in which traditionally defensive factors (including quality) did not provide their typical diversification benefits. Over 2021–2025, broad low-cost large-cap index exposure generally provided a higher probability of achieving benchmark-like outcomes than selecting the average active large-cap strategy net of fees.

Small- and Mid-Cap U.S. Equities: A More Mixed Record

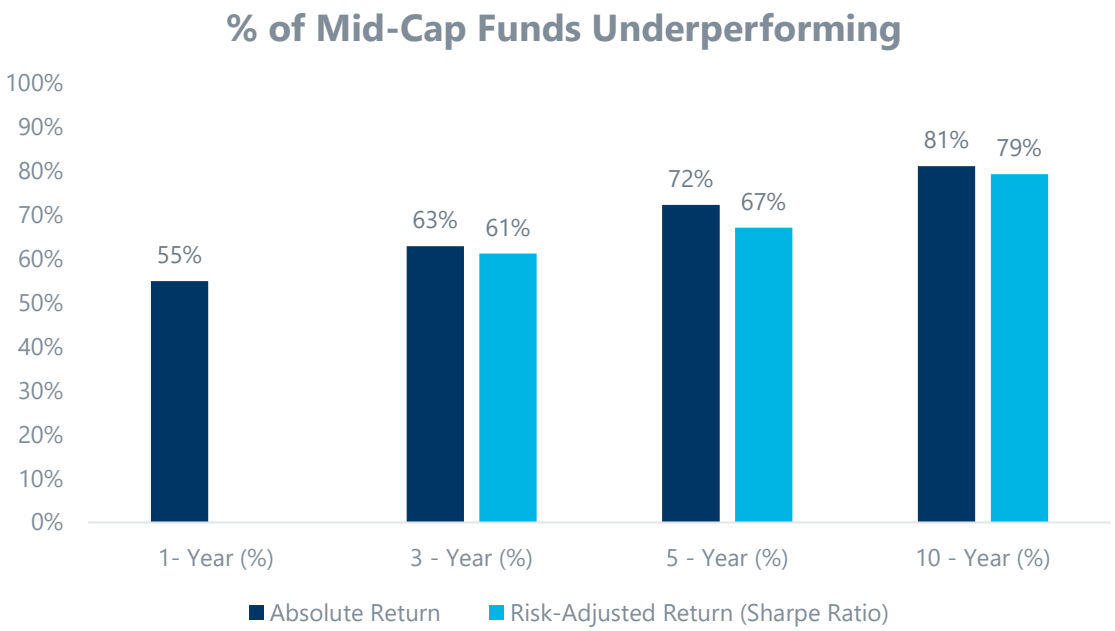
Active Manager Performance (Risk-Adjusted): Better Odds, Still Inconsistent

Relative to large caps, active management in U.S. small- and mid-cap equities has been more competitive, particularly over shorter horizons. In 2025, 41% of small-cap funds underperformed the S&P SmallCap 600 (up from 30% in 2024). Mid-cap results were also comparatively better, with 55% of mid-cap funds underperforming the S&P MidCap 400 in 2025 (down from 62% in 2024). Over a five-year horizon, however, the segment-level hurdle remains meaningful: 63% of small-cap managers and 72% of mid-cap managers lagged their benchmarks. On a risk-adjusted basis (Sharpe ratio), outcomes were similar, with 61% of small-cap managers and 67% of mid-cap managers underperforming.

Taken together, the data suggests that the probability of outperformance in SMID equities can be closer to a coin flip in certain years, but declines meaningfully over longer measurement windows, with only roughly 30%–40% of managers outperforming on either an absolute or risk-adjusted basis over five years.



Source: S&P Dow Jones Indices, SPIVA® U.S. Scorecard – Year-End 2025. Risk-adjusted return statistics are not reported for one-year periods due to insufficient sample length for meaningful statistical comparison.



Source: S&P Dow Jones Indices, SPIVA® U.S. Scorecard – Year-End 2025. Risk-adjusted return statistics are not reported for one-year periods due to insufficient sample length for meaningful statistical comparison.

Market Concentration: A Less Top-Heavy Benchmark Helps Active

Unlike large caps, small and mid-cap indices are not dominated by a few names. The entire Russell 2500 has no companies with the weight that Apple or Microsoft has in the S&P 500. In fact, the largest stock in the S&P 600 (small-cap index) is only about 0.6% of the index. This means a small-cap manager's decision to not own a specific stock doesn't hurt performance as severely as a large-cap manager's decision to underweight Apple or Nvidia. Additionally, small-cap indexes naturally have more diverse leadership, for example, in 2023–24, while large-caps were led almost solely by technology, small-cap performance was more evenly spread (though still with a technology bias). Without a structural concentration problem, small-cap managers can potentially outperform via broader stock selection, not just by riding one trend.

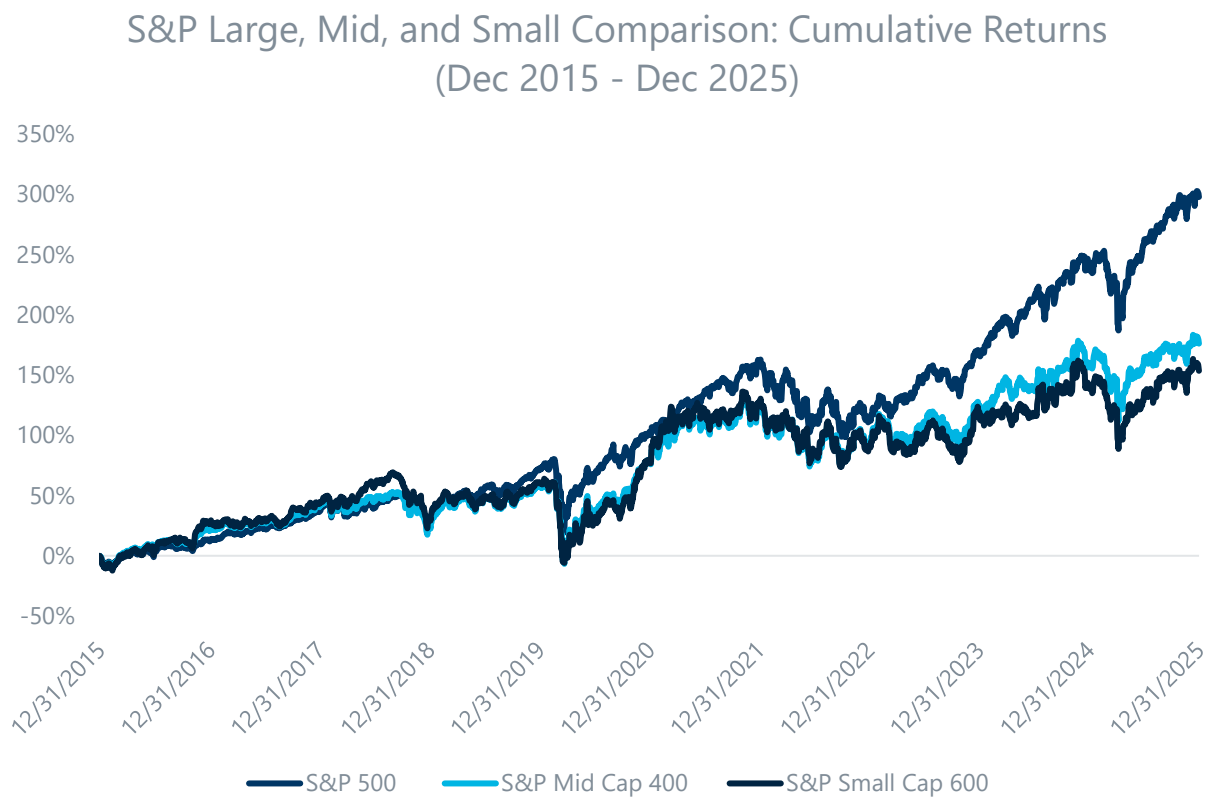
Mispricing Dispersion: Wider Return Spread Creates Opportunity

Smaller-company universes typically exhibit a wider range of outcomes, including both significant compounders and companies that experience severe drawdowns. This dynamic tends to increase cross-sectional dispersion in returns. Higher dispersion increases the potential payoff to identifying winners and avoiding structurally impaired businesses, which can support active stock selection. MSCI has linked cross-sectional volatility and stock-level dispersion to a more favorable opportunity set for active managers; the 2021–2025 period exhibited elevated dispersion in SMID equities relative to many prior regimes.

Sectoral Performance: Rotation Helped, but Cycles Still Matter

Small and mid-cap indices also experienced sector rotations over the years. In 2022, small-cap value stocks (including many energy companies) dramatically outperformed small-cap growth, the S&P Small Cap 600 Value index fell only 11.32%, versus 21.24% for S&P Small Cap 600 Growth. Many small-cap managers had a value or quality tilt and thus weathered the storm better than growth-oriented index segments.

From 2023 through 2025, as market leadership shifted back toward growth stocks, small-cap benchmarks generally lagged large caps, for example, the S&P SmallCap 600 returned approximately +9% in 2024 versus +25% for the S&P 500. In this environment, relative performance in small-cap and SMID strategies has been less influenced by broad index concentration and more driven by company-specific dispersion. More broadly, SMID managers can add value by reallocating toward cyclically advantaged industries or avoiding companies with structurally weaker balance sheets—tilts that may be immaterial in large-cap indices but can be meaningful in smaller-cap benchmarks. While outcomes can be mixed over full market cycles, the SMID segment has generally provided a more favorable opportunity set for active management than U.S. large cap.



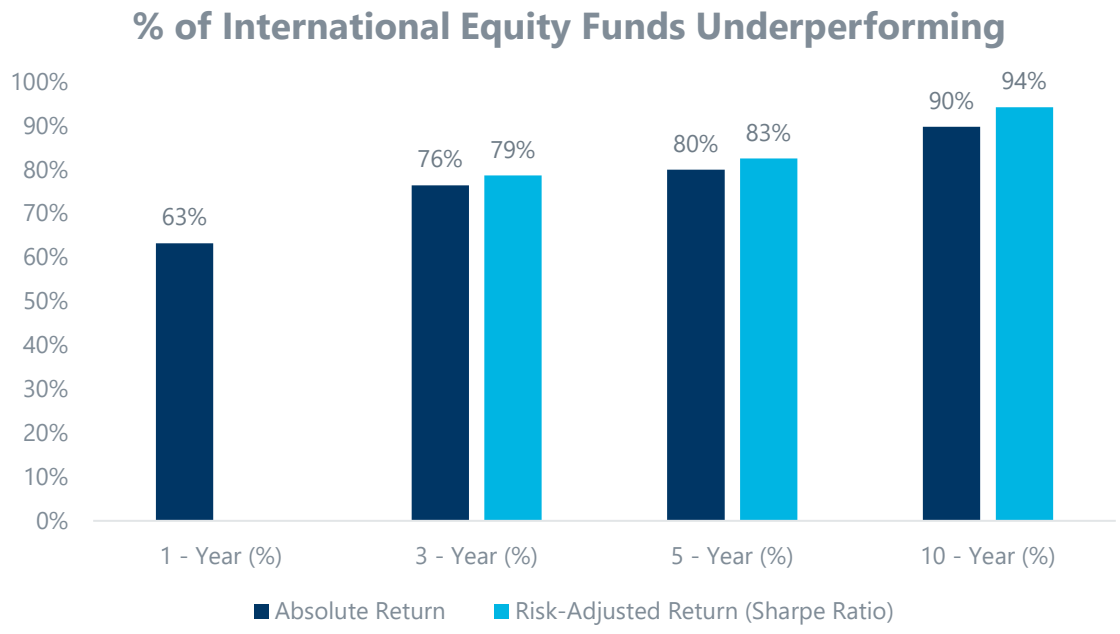
Source: S&P Dow Jones Indices

International Equities: Active Results Echo the U.S., With Nuance

International equity markets largely mirrored the U.S. experience from 2021–2025. Most active managers underperformed passive benchmarks net of fees, though there were pockets of better outcomes in less efficient segments. International markets (e.g., S&P 500 World ex US) remained difficult for active managers, while emerging markets and international small caps offered more theoretical inefficiency but still produced mixed aggregate outcomes.

Developed Markets: Active Struggles Persist

Across developed international equities, most active funds lagged their benchmarks during 2021–2025. In 2025, roughly 63% of international stock funds trailed their index (S&P World Ex-US), and over the last 5 years roughly 80% underperformed. Risk-adjusted outcomes were also weak; the average international fund underperformed on a risk adjusted basis (Sharpe ratio) by 8333% over the last 5 years.

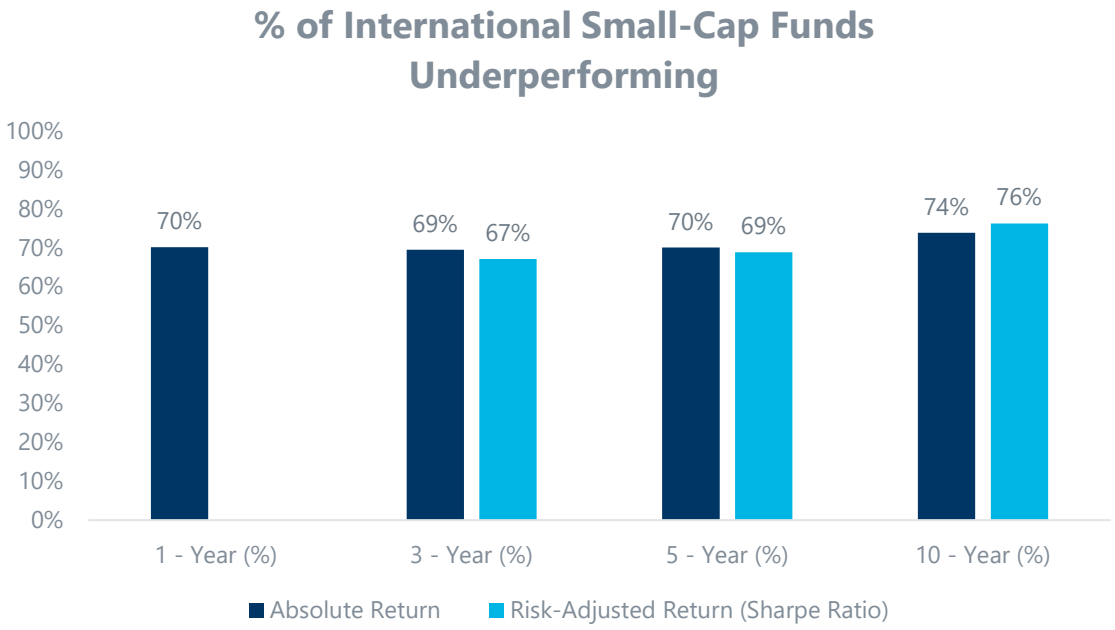


Source: S&P Dow Jones Indices, SPIVA® U.S. Scorecard – Year-End 2025. Risk-adjusted return statistics are not reported for one-year periods due to insufficient sample length for meaningful statistical comparison.

International Small-Cap: Better Hunting Ground, Still Not a Free Lunch

International small caps showed more evidence of active opportunity, reflecting lower analyst coverage and more frequent mispricings. 2024 was notably strong, with 57% of international small-cap funds outperforming. But the improvement was not persistent. 2025 was challenging (only ~30% outperformed), and over longer trailing periods more than half still underperform.

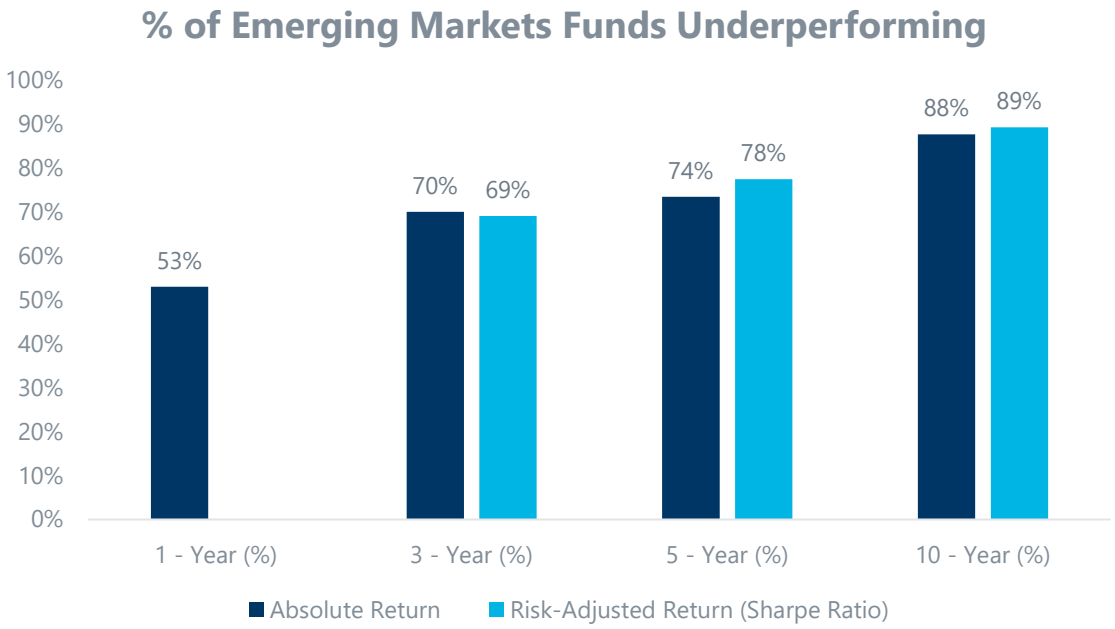
International benchmarks were generally less dominated by a small set of mega-cap technology names than the S&P 500, but non-U.S. active managers faced additional layers of currency, country, and sector risk that could dominate company-level selection.



Source: S&P Dow Jones Indices, SPIVA® U.S. Scorecard – Year-End 2025. Risk-adjusted return statistics are not reported for one-year periods due to insufficient sample length for meaningful statistical comparison.

Emerging Markets: Higher Dispersion, but Underperformance Still Common

Emerging markets are often viewed as more "inefficient," with substantial dispersion across countries and sectors. However, the overall record still points to broad underperformance, roughly 74% of funds failed to beat the S&P Emerging Plus Index over a 5-year span, though that improved in 2025 with 53% of funds underperforming. On a risk adjusted basis (Sharpe Ratio), the story is uncompelling with 78% of funds underperforming its benchmark. Even in strong EM years (e.g., 2025's sharp rally), stock selection could be offset by country/sector allocation mistakes, leaving the average fund slightly behind the benchmark.



Source: S&P Dow Jones Indices, SPIVA® U.S. Scorecard – Year-End 2025. Risk-adjusted return statistics are not reported for one-year periods due to insufficient sample length for meaningful statistical comparison.

Market Themes: Why Active Struggled (2021–2025)

Macroeconomic Whipsaw: Fast Regime Shifts Punished Positioning

Across U.S. large cap, U.S. small/mid cap, and non-U.S. equities, 2021–2025 was defined by unusually fast and frequent macro regime changes that made positioning difficult for active managers. The backdrop shifted from post-pandemic stimulus and near-zero rates (2021) to the fastest tightening cycle in 40+ years (2022), followed by disinflation, growth rebounds, and renewed late-cycle/recession concerns that culminated in rate cuts in late 2025. These turns drove abrupt factor and sector rotations—value leadership in 2022 followed by growth/AI leadership in 2023–2025—often at a pace faster than typical quarterly portfolio re-positioning.

Macro shocks also had a distinct global dimension. The U.S. dollar surged to multi-decade highs in 2022 (particularly versus the euro and yen), then fell approximately 10% in 2025, creating meaningful currency headwinds and tailwinds that dominated underlying stock selection results for non-U.S. managers. At the same time, geopolitical events (Russia–Ukraine, Middle East conflict, and periodic political crises) and renewed tariff/inflation concerns repeatedly disrupted risk sentiment, energy markets, and supply chains. In the U.S., rapid risk-on/risk-off swings punished both "late" defensiveness (missing snapback rallies) and "late" cyclicality (being caught by tightening or growth scares).

The impact of the whipsaw varied by segment. U.S. mega-cap growth proved unusually resilient even as rates rose, reinforcing index concentration and disadvantaging diversified large-cap managers who did not mirror the market's exposure. By contrast, small and mid-caps were typically

more sensitive to domestic growth and financing conditions, making them vulnerable to rate shocks in 2022 but also creating a wider range of outcomes (dispersion) for skilled stock pickers when the cycle turned. International markets experienced less single-stock concentration than the S&P 500, but currency moves and country/sector tilts added another layer of macro risk, meaning active managers could be "right" on companies but still lag due to FX or regional exposures.

Quality Paradox: Resilience Lagged in a Momentum Market

From 2023 through 2025, "quality" investing delivered an unintuitive outcome, the factor that is typically associated with resilience (high profitability, balance-sheet strength, stable earnings, and prudent leverage) lagged as markets repeatedly rewarded revenue momentum, long-duration growth narratives, and, at times, outright speculation. This was especially visible in 2025, described as quality's worst year since the mid-1990s, when investor attention centered on AI beneficiaries and AI infrastructure spend.

In U.S. large caps, several dynamics contributed to the paradox. First, AI winners often looked "lower quality" by traditional metrics. Heavy datacenter and semiconductor capital expenditure, reinvestment, and shifting capital structures could depress near-term return ratios even as long-term opportunity expanded. Second, many quality-oriented processes embed valuation discipline; trimming or avoiding expensive mega-cap technology leaders (or maintaining sector neutrality) proved costly when a narrow set of stocks continued to dominate index returns. In effect, quality screens and risk controls sometimes pushed portfolios away from the very names powering the benchmark.

In small and mid-caps, the same theme appeared in a sharper form during the 2025 "junk rally," when highly shorted, unprofitable, and highly levered companies briefly surged, often driven by sentiment, short covering, and risk-on positioning rather than fundamentals. This left quality-screened strategies behind in the short run and forced a tradeoff between style drift and discipline. Importantly, the small-cap episode also illustrates why the paradox may be cyclical rather than permanent. Once speculative bursts fade, quality has historically reasserted an advantage over full cycles.

Artificial Intelligence (AI): Narrative Shock and Narrow Leadership

Speed of Disruption: AI Repriced Winners Faster Than Fundamentals

The emergence of generative AI during this period (notably the release of ChatGPT in late 2022) was a game-changer for markets. AI not only created new winners, but it did also so at a breakneck pace. For instance, Nvidia, the leading designer of AI-focused semiconductors, saw its stock price soar 239% in 2023 and 171% in 2024, and by the end of 2025 Nvidia's market cap had surpassed $4 trillion, briefly making it the world's most valuable company. This surge was driven by demand for its GPUs to power AI models, and Nvidia's CEO projected $1 trillion in cumulative AI-chip sales by 2027. Other AI-leveraged mega-caps experienced gains as well (e.g., Alphabet +66% in 2025, partly on AI cloud revenue, Microsoft +16% in 2025, on the back of integrating AI into products and its OpenAI stake, and Meta +13% in 2025, as AI improved its advertising efficiency).

For passive investors, these rapid moves were pure upside, the index naturally increased exposure to these names as their market caps grew. But for active managers, especially quality- or value-oriented ones, the AI boom posed challenges around valuation, certainty, and narrow leadership, as described in the performance sections of the equity segments. Most importantly though, many fundamental investors misjudged the timeline of adoption, growth, and impact of AI. In past tech cycles, adoption and monetization took years, giving investors time to react. Since the arrival of ChatGPT in 2022, AI has become an important driver of growth and generative AI tools were used by 55% of people and 37% of workers in the U.S. as of August 2025. Analysis from the Federal Reserve Bank of St. Louis suggests that recent investments in AI related categories in the first three quarters of 2025 have contributed significantly to gross domestic product, surpassing four quarters of the contribution to IT components in 2000 (0.97% versus 0.81%).

Active managers who waited for more evidence of the economic or revenue impact of AI were behind from the market's perspective.

AI's Impact on Software: Valuation Reset Hit Quality Exposures

Beyond the winners, AI also created perceived losers, notably in the software industry. In 2024, McKinsey frames generative AI as a disruptive force to traditional software-as-a-service (SaaS) business model. The argument stated that advanced AI agents might one day handle tasks directly (querying databases, automating workflows, writing code), reducing the need for human users to interface with many software applications. If this is true, this could undermine certain software vendors' pricing power or growth prospects. Banks and research firms began sounding alarms, and investors reacted by dumping software stocks in 2024–2025.

This had a pronounced effect on quality indices, which tend to be overweight software companies (given their historically high margins, returns on equity, and low debt). As software stocks sold off, quality indices underperformed significantly.

A Bain & Company report in late 2025 warned of "agentic AI" potentially cannibalizing SaaS products, contributing to what some in the industry dubbed a "SaaSpocalypse." Meanwhile, a 2025 AI Cost Governance survey found that 84% of software firms saw AI initiatives squeezing their gross margins by over 6% (due to the high computational costs of AI and necessity of investing in AI features), feeding fears that AI was eroding the profitability of even the best software businesses.

The result was a significant valuation reset in parts of the software complex. Software-heavy quality indices lagged broader benchmarks during portions of this period. For example, in 2025 the S&P SmallCap 600 Quality Index returned approximately +1.4%, versus approximately +6% for the full S&P Small Cap 600, reflecting the drag from weaker software performance.

Some active managers were able to adapt by differentiating between software firms, likely to be AI winners versus those at risk, though that did not protect against a broad-based software sector sell-off. Some active managers were able to rotate capital to companies providing AI infrastructure (data

center REITs, cloud service providers) or to software firms in niche areas less likely to be displaced, though it was a challenge given return on equity criteria.

In short, the "AI will destroy software" thesis exemplified how a rapid narrative shift hurt quality-focused strategies. Quality indices, in particular, that follow fixed rules, dumped, or underweighted many software names at the worst time, whereas some active managers were able to selectively hold on to high-quality software firms if they believed those companies would integrate AI rather than be killed by it. It's a reminder that while factors go in and out of favor, active management can potentially add value by looking past fearful headlines, provided one has the conviction and patience to stay the course.

Challenges and Catalysts for Active Management: What Broke – and What Could Reset

Convergence of Challenges: The "Perfect Storm" for Active (2021-2025)

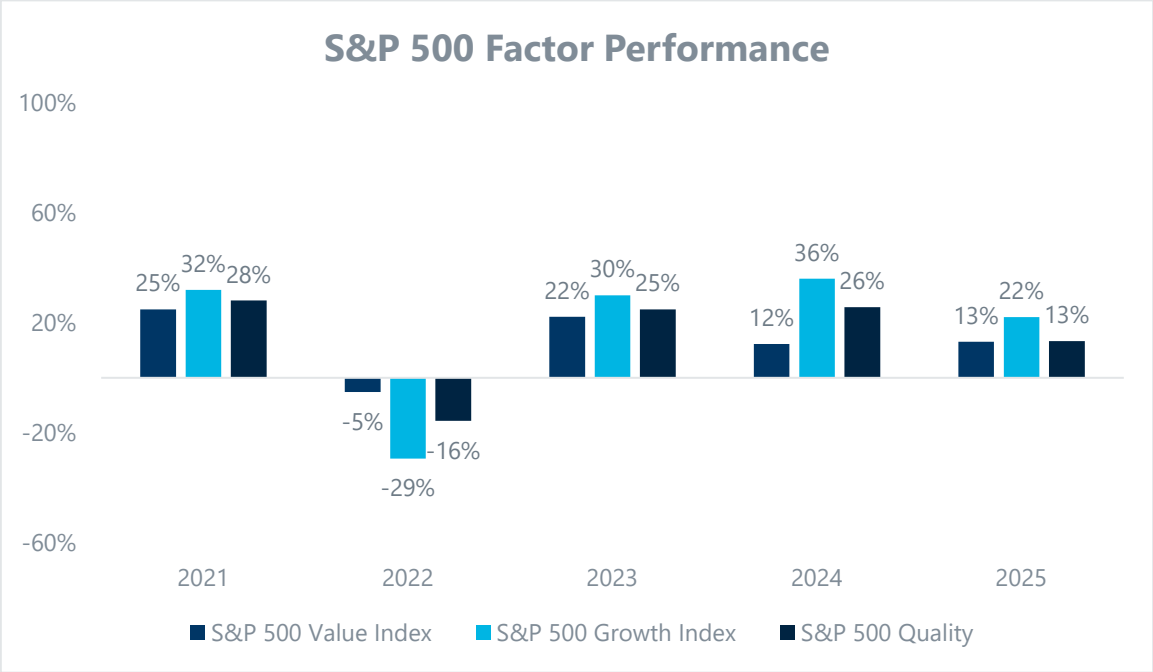
The experiences above underscore how multiple challenges converged to create a "perfect storm" for active management during 2021–2025:

Unprecedented Market Concentration: Diversification Helped Less Than Usual
A handful of stocks dominated returns, limiting the benefit of diversification.

Single-Style Dominance (Growth/Tech): One Trade Drove the Benchmark
Three years of the same narrow leadership rewarded a one-dimensional strategy (long big tech/growth) that is hard for diversified managers to replicate.

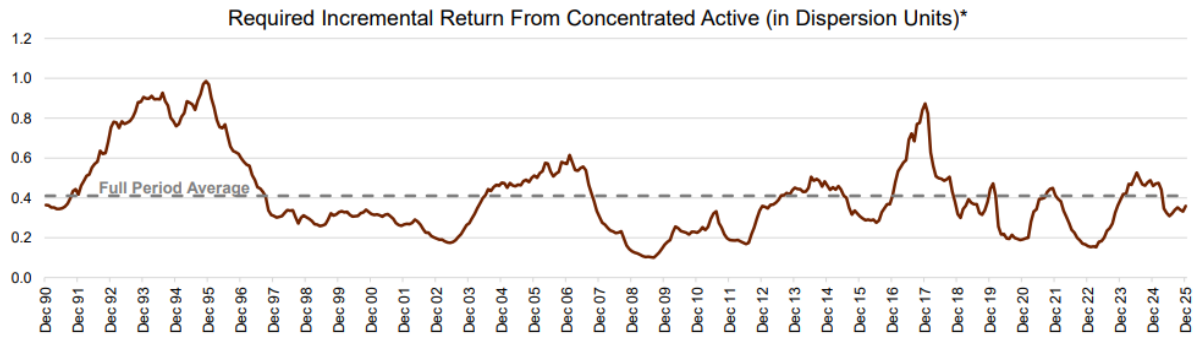
Rapid Regime Shifts: Being Early or Late Was Expensive
The whipsaw changes in macro conditions (pandemic crash, stimulus boom, inflation, rate hikes, tariffs) and investor sentiment meant that backward-looking strategies underperformed. By the time an active manager adjusted, the market had moved on.

Factor Volatility: Traditional Relationships Broke Down
Traditional factor relationships broke down. Value trounced growth in 2022, then growth destroyed value in 2023; quality normally provides shelter, but not in 2023–2025. Such instability is tough for managers who stick to a consistent style.



Low Dispersion in Large Cap: Fewer Idiosyncratic Winners to Find

Outside the largest constituents, correlations across many large-cap stocks have been rising and dispersion (see chart below) declining limiting opportunity for stock selection. This reduced the set of idiosyncratic winners available to diversified active managers. By contrast, dispersion was generally higher in small caps, which can provide a more favorable backdrop for stock selection.



Source: S&P Dow Jones Indices as of March 31, 2026, Required Incremental Return From Concentrated Active (in Dispersion Units) provides the excess return, in multiples of 12M trailing average dispersion, required from a concentrated position in a single index constituent with 12M trailing volatility equal to the index-weighted average, such that the ratio of return to volatility of the position matches that of an investment with volatility matching the index's trailing 12M volatility, and an annual return of 10%.

Fee Drag in a High-Return World: Matching the Index Wasn't Enough

With the S&P 500 delivering strong double-digit returns in four of the five years in this sample, active strategies charging approximately 0.72% annually faced a meaningful net-of-fee hurdle. In 2025, for example (when the S&P 500 returned approximately +18%), even a strategy that matched the benchmark gross of fees would have underperformed after fees.

Collectively, the 2021–2025 period challenged active equity management across multiple dimensions. Meaningful underweights to the largest index constituents created substantial tracking risk; benchmark-hugging approaches struggled to overcome fees; and rapid reversals in macro and factor leadership increased the cost of being early or late to defensiveness or cyclicality. The combination of these effects contributed to a regime in which low-cost indexing was a particularly effective implementation for core U.S. large-cap exposure.

However, these challenges were exceptionally intertwined during 2021–2025. Going forward, some of these trends could ease potentially improving the environment for active stock pickers.

Catalysts for Change: What Could Improve Active's Odds

Large-Cap Catalysts

Several developments could tilt the playing field back toward active managers:

Mean Reversion in Concentration: Market history suggests that when index weights become extremely top-heavy, they eventually revert (often suddenly). For instance, the late-1990s dot-com bubble saw extreme concentration give way to more diverse leadership. A similar mean reversion now, whether caused by profit cycles, regulation, or investor rotation, which would allow active managers' diversification to pay off. If the top stocks stumble or even appreciate more slowly while the other 490 stocks appreciate, active managers may have a better chance of beating the index.

*Valuation normalization***:** As of year-end 2025, the Magnificent Seven traded at materially higher forward valuation multiples than the remainder of the S&P 500 (average forward P/E 55 as of year-end 2025, versus 23 for the rest of the S&P 500) If these valuation differentials compress, due to discount-rate changes, slowing growth, regulation, or profit-taking, benchmark performance could become less dependent on a narrow set of mega-cap names, which would typically be more supportive of diversified active portfolios.

*Wider Market Breadth***:** In late 2023 and portions of 2024, there were periods when market gains broadened beyond Information Technology. Small-cap and international equities rallied strongly in the second half of 2023, and market leadership broadened again in 2025 as more sectors and smaller constituents participated in returns. If more sectors and smaller constituents drive the market's gains (rather than just the top few companies), active managers will find it easier to add value by picking stocks outside the former behemoths. A less tech heavy-dominated rally, or a cyclical bull market in areas like manufacturing, finance, or healthcare, would play to the strengths of many active investors.

*Regulatory Action or Tax Changes***:** There is growing bipartisan scrutiny of the largest tech firms. Any regulatory action, whether antitrust breakups, new taxes on monopolies, or stringent regulations, may lead to declining valuations for the mega technology companies. This could reduce their stock market dominance. Similarly, changes to corporate tax law or global minimum tax agreements could disproportionately affect the largest multinationals, shifting relative advantages toward smaller firms.

Innovation from Below: The next wave of innovation could come from new companies that are initially small or mid-sized. If, say, a cohort of new innovative firms (outside the Magnificent Seven) drives the next technological revolution, active managers who identify and invest in those future stars early will reap rewards while they're underrepresented in the indices.

Active ETFs and Lower Fees: One barrier to active success has been high fees. An emerging trend is the rise of active ETFs, which deliver active strategies at lower costs and with full transparency. BlackRock estimates that global active ETF assets are expected to roughly triple by 2030 to over $4 trillion. If this were to play out, investors could get the benefit of active stock selection with a fee closer to that of an index fund. This could improve the net-of-fee performance of active approaches and potentially draw in more assets, creating a virtuous cycle (more scale -> lower fees -> better odds of beating the benchmark).

In combination, these catalysts could improve the large-cap active landscape. However, none are guaranteed. For now, we still believe prudent investors in large-cap equities are justified in remaining largely passive until there is clear evidence of a more favorable regime for active management.

Small/Mid-Cap Catalysts

The case for active management in smaller-cap equities may be somewhat stronger, and there are several trends that could continue to support or enhance that position.

Sustained Higher Dispersion: Small caps historically exhibit higher dispersion of returns than large caps, and this was true in recent years. If dispersion stays elevated (e.g., varying impacts from technology and/or supply chain shifts), it amplifies the value of careful stock selection. Any environment of economic change, from reshoring of manufacturing to swings in consumer behavior, can create such differentiation.

Rotation to undervalued segments: Small- and mid-cap equities underperformed large caps for much of the 2021–2025 period, leaving a number of fundamentally solid smaller companies trading at relative discounts. If investors rotate toward these segments (for example, if interest rates stabilize or market leadership broadens), smaller-cap equities could experience relative catch-up. At year-end 2025 the Russell 2500 forward P/E was approximately 21 versus approximately 23 for the S&P 500, implying some valuation room for mean reversion. If that gap closes, the segment may benefit on an absolute basis, and quality-oriented active processes may be better positioned to avoid weaker balance sheets in more volatile upswings.

Return of the quality premium: Quality's underperformance in 2023–2025 may prove cyclical rather than structural. Historically, profitable companies with stronger balance sheets have tended to outperform over full cycles, including in smaller-cap universes. If the market transitions away from speculative leadership and re-emphasizes earnings durability and balance-sheet strength, quality-focused SMID managers may see a more favorable opportunity set. As with all factor regimes, the

timing of such rotations is uncertain, but mean reversion in factor leadership would typically be supportive of disciplined quality processes.

M&A and External Opportunities: Small and mid-cap companies are potential takeover targets for cash-rich large corporations or private equity. A good active manager may be able to anticipate which companies are likely buyout candidates or strategically valuable. A company that gets acquired at a premium instantly boosts a fund's performance. Passive indices also benefit from M&A, but active managers can concentrate in a few likely targets if they choose wisely and have the mandate that allows for the concentration. An uptick in M&A or corporate restructurings in 2026–2027 would disproportionately favor active stock pickers with good research in the small/mid universe.

Less Passive Competition: Thus far, passive investing has a smaller footprint in small/mid-caps, meaning price discovery still largely depends on active trading. If the industry continues to allocate more to private markets and less to public small-caps (as some data suggests happened through 2025), that could actually increase inefficiencies in small-cap pricing. Fewer eyes on these stocks can equal more opportunities for mispricing. As long as that holds, skilled active managers should have more opportunity for stock-picking. Conversely, if passive flows into small-cap ETFs surge or if small-cap indexes become top-heavy due to a few big winners, then active's edge could narrow.

Non-U.S. Equity Catalysts

Several developments could modestly improve the opportunity set for active management in Non-U.S. equities, though outcomes will likely remain uneven by region and market segment.

*Broader market leadership and higher dispersion***:** Non-U.S. equity benchmarks are structurally less concentrated than the S&P 500, with the weight of the largest constituent at 2.10% and weight from the top ten at 11.9% for the S&P World ex US Index versus 7.6% and 36.5% respectively for the S&P 500. However, recent performance has still been driven by relatively narrow country (e.g., Japan, Taiwan, and South Korea) and sector leadership (e.g., export-oriented firms, semiconductors, and select technology platforms). A shift toward broader participation, across domestic cyclicals, financials, industrials, and healthcare, would increase cross-sectional dispersion and improve the potential payoff to stock selection.

Regulatory and Policy Divergence Across Regions: Unlike the U.S., Non-U.S. markets are shaped by diverse regulatory regimes and fiscal priorities. Changes such as European fiscal expansion tied to defense and energy security, reforms in banking and capital markets, or regulatory normalization in select emerging markets could create differentiated outcomes at the company level rather than index-wide effects. Greater policy dispersion across countries would favor active managers with strong country and sector research capabilities.

*Macroeconomic and currency normalization***:** Currency volatility and divergent economic cycles remain defining features of international markets. A stabilization, or reversal, of U.S. dollar strength, combined with differentiated inflation and rate paths across regions, could widen dispersion and

reward managers able to navigate balance-sheet strength, pricing power, and domestic-demand exposure. In such environments, passive implementations can be less targeted tools for managing region-specific macro and FX risks.

Valuation Dispersion and Style Mean Reversion: Non-U.S. equities continue to trade at valuation discounts to U.S. markets, but relative performance has still been dominated by growth-oriented themes in recent years. A sustained rotation toward value, dividends, and balance-sheet quality, particularly outside the largest global exporters, would likely benefit active strategies not constrained by index weights.

Structural Inefficiencies in Emerging Markets and International Small Caps: The most compelling case for active management within Non-U.S. equities remains in emerging markets and international small caps, where lower analyst coverage, higher political and governance dispersion, and less passive penetration create greater potential for mispricing. While aggregate results have been mixed, these segments continue to offer more ground for fundamental research than developed large-cap international equities.

Syntrinsic's View

Viewed through a portfolio-implementation lens, the evidence points to asymmetry across equity segments. In U.S. large-cap equities, the bar for persistent net-of-fee outperformance remains high, and a sustained turnaround would likely require a meaningful change in the market's concentration and leadership dynamics. U.S. small- and mid-cap equities have been a relatively better performing at times, especially over the last two year, but the advantage has been uneven and has not consistently compounded over longer horizons. In Non-U.S. equities, broad developed-market benchmarks have also been difficult in aggregate.

We see a more compelling case for deploying active risk selectively, with greater emphasis on emerging markets in the public equity markets rather than across the equities landscape with some opportunities for active small and mid cap managers in the U.S. depending on the manager.

The practical takeaway is not "active" or "passive" in the abstract, but selectivity allocate active risk where inefficiencies and dispersion are more persistent and be cautious in segments where the median manager's odds of risk-adjusted outperformance remain below 50%.

Portfolio Construction:
Budget Active Risk and Build for Regime Change

While segment-level results are informative, portfolio outcomes depend on how exposures interact in aggregate. The observations above therefore feed directly into portfolio strategy, active risk budgeting, and the design of portfolios intended to remain resilient across shifting market regimes.

Active Risk Budgeting: Spend Tracking Error Where it Pays

Every portfolio has an "active risk budget," meaning the level of tracking error (benchmark deviation) the investor is willing to accept in pursuit of outperformance. In light of the evidence reviewed in this paper, institutions may wish to reserve a larger share of that budget for segments where inefficiencies and implementation flexibility are more persistent, rather than allocating it broadly across highly efficient public equity benchmarks.

Below is some empirical data on net-of-fee alpha by asset class. Given the time horizon of private assets, we used 10-year data for this analysis.

ASSET CLASS	NET ALPHA (10-YEAR)	SUCCESS RATE (10-YEAR)	UNIVERSE
Private Equity	1.0%	52.0%	Pitchbook Private Equity Universe (2016 – 2025)
Private Credit	0.3%	93.0%	Pitchbook Direct Lending Universe (2016 – 2025)
Intermediate Fixed Income	0.4%	44.4%	US Fund Intermediate Core-Plus Bond
Emerging Market Equity	-0.4%	12.3%	US Fund Diversified Emerging Markets
International Developed Equity	-0.4%	10.2%	US Fund Foreign Large Blend
Small-Cap Equity	-0.6%	24.1%	US Fund Small Blend
Mid-Cap Equity	0.2%	18.9%	US Fund Mid-Cap Blend
Large-Cap Equity	-1.6%	14.4%	US Fund Large Blend

Sources: Data as of 12/31/25, Morningstar, Pitchbook, SPIVA, and Cambridge. Success Rate based on performance data (absolute return and IRR) versus a benchmark.

Fixed Income

Active management in fixed income has delivered solid results over the last five years, ~62% of general bond funds have outperformed their index, iBoxx $ Overall, on both an absolute and risk adjusted basis, aided by opportunities in credit selection and duration positioning. Over the last several years, with the volatility in yields and dislocations in certain credit markets, skilled fixed-income managers have been able to capitalize on mis-pricings in the fixed income market.

Private markets

Private equity, venture capital, private real estate, and private credit have historically offered higher potential for manager dispersion. For example, Cambridge Private Equity Index Benchmark has outperformed the MSCI World PME over the last 10 (shown above) and 15 years. For the last 15 years, private equity funds have outperformed approximately 300 basis points annually (net of fees). Similarly in private credit, particularly direct lending, our analysis shows approximately 140 basis points of net alpha over the last 15 years.

Consistent with this perception of opportunity, institutions have increased allocations to alternatives over time. Importantly, outcomes in private markets are highly manager- and vintage-dependent; for investors with access to strong managers and appropriate governance and liquidity structures, allocating a portion of active risk budget to private markets can be a more targeted use of active risk than deploying that budget broadly in highly efficient public large-cap equities.

Public Equities

As detailed above, broad public equity benchmarks—especially U.S. large-cap and developed non-U.S. large-cap equities—have been difficult to outperform in aggregate, net of fees. As a result, many institutions use passive implementation for core exposures and reserve active equity allocations for less efficient segments. Examples include:

+ Active emerging markets managers, where market inefficiencies, varying accounting standards, and political risks can reward research.
+ Thematic or ESG active strategies, where mandates deviate from standard indexes in pursuit of specific opportunities (these are essentially active bets on certain sectors or factors).
+ Active factor rotation or quant funds, which might not be traditional stock pickers but rather tactically tilt toward factors (value, momentum, etc.) based on market conditions.

Syntrinsic's View: Portfolio-Implementation Takeaways

As mentioned previously, based on research the evidence suggests allocating an active risk budget to the following:

+ High conviction for private markets, fixed income, and specialized strategies.
+ Some conviction for small/mid-cap and non-U.S. equities particularly Emerging Markets.
+ Little to no conviction for U.S. large-cap equities, unless in pursuit of specific opportunities (e.g., thematic, ESG, etc.)

In practice, this means Syntrinsic would structure a portfolio as follows:

*Passive core***:** Use index funds for broad U.S. large-cap exposure and possibly core international exposure. This provides cheap beta and frees up fee and risk budget.

Active satellites: Surround the core with actively managed allocations in areas where historical alpha has been positive. For example, maybe allocate to a carefully chosen U.S. small and mid-cap manager, if appropriate, or an EM manager, as well as to active values aligned, thematic, fixed-income, and private assets. In each asset class, focus on ensuring that each active manager is truly skilled, has high "active share," a strong track record, and clear edge in their niche. In addition, monitoring the manager's value-add over a full cycle (not just one year), though recognizing that changes may need to happen within a market cycle.

Ongoing review and rebalancing: Given the potential for regime change, portfolios benefit from periodic reassessment of both strategic and active exposures. If conditions become less favorable for active implementation in a given segment (for example, if dispersion compresses or passive penetration meaningfully alters market structure), consider shifting some exposure toward passive implementation until the opportunity set improves.

Building Adaptive Portfolios: Make Regime Shifts a Portfolio Level Decision

A further consideration is whether the overall portfolio is designed to adapt to rapid changes in economic, geopolitical, and technological conditions. Relying on individual active managers to address macro regime shifts has limitations, as many mandates and processes are not designed for rapid cross-asset repositioning. For example, long-only equity managers typically cannot move meaningfully to cash, increase duration, or reallocate across asset classes in response to shocks. Portfolio-level design choices (including diversifiers and tactical tools) can help mitigate this constraint.

Tactical Asset Allocation: Make Regime Shifts a Portfolio Decision

Every year, Syntrinsic produces our Capital Markets Forecast to guide both our long-term strategic asset allocation and inform near-term tactical decisions. The near-term tactical decisions are used to tilt overall asset allocations in response to changing market conditions. For example, in mid-year 2025 we moved our near-term sentiment on U.S. stocks from Neutral/Positive to Neutral believing that U.S. market strength was being tested but had not departed. We recommended that clients remain with a target of 70% of their total public equity investments allocated to the US. This was not a move that most individual equity managers in a specific asset class could make given that it crossed asset classes.

Mandate Limitations: Most Equity Managers Can't Pivot Fast Enough

Importantly, traditional active equity managers cannot be the main tool for rapid portfolio adaptation. They are simply not built for it. As discussed, they're often fully invested (can't go to cash easily), stick to their style (can't turn a value fund into a growth fund overnight), and trade infrequently (some positions are held for years). In 2025, for example, when a "low-quality rally" took off, virtually no quality-focused mutual fund manager suddenly started buying junky meme stocks – nor would we want them to. This was a decision that needed to be made at the portfolio level whether a quality focused portfolio will continue to add value, or the underlying market has changed.

Conclusion: Be Selective with Active Risk and Build to Adapt

The period 2021–2025 taught investors hard lessons about where active management is most and least effective. In U.S. large-cap equities, the case for passive investing became only stronger, the combination of structural headwinds and high fees made outperformance exceedingly rare. In small- and mid-cap equities, active management proved its worth, but even there, success required discipline and patience through tough stretches. External shocks like the AI revolution and policy swings reinforced that a modern portfolio needs both low-cost core exposures and adaptive tactical capabilities.

For a total portfolio strategy, it's clear that an investor should allocate the scarce active risk budget where it can earn the best "alpha per unit of risk," which today often means outside large-cap stocks (in private markets, fixed income, or truly inefficient public niches). At the same time, building an adaptive portfolio means having a plan for responding to regime changes at the aggregate level (through tactical shifts and diversifiers), rather than relying on each individual manager to navigate every storm.

These approaches are complementary. For example, a portfolio can use passive implementation for efficient core exposures, active implementation where dispersion and manager differentiation are more persistent (e.g., selected public-market niches, fixed income, and private markets), and portfolio-level tools to improve flexibility and resilience. The objective is to align active risk with segments where there is a higher probability of being compensated, while maintaining a governance process that can respond to regime shifts without forcing underlying managers to operate outside their mandates.

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