

The Long Game: Structural Change and the Case for Patient Active Management

The opportunity set for active public equity managers appears to be improving – but we believe investors will need to be steadfast in order to reap the returns.

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Key takeaways

- We believe the opportunity for public equity managers to generate long-term alpha is increasingly attractive; however, the consistency of that alpha may be more volatile than it once was.
 - Capturing active manager outperformance may require more patience and tolerance than it did historically, particularly as active portfolios look more different from increasingly concentrated indices.
 - For some investors, diversified index exposure could remain an appropriate path, especially where relative underperformance would be difficult to tolerate over time.
 - For investors who seek alpha, we see opportunities to outperform the index over the long term, particularly as more investors throw in the towel on active management. But the path is likely to be uneven and might include periods of significant relative underperformance.
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Background

During a recent cycle of meetings with current and prospective investment managers, conversations kept returning to a common theme: equity markets appear to be behaving differently than they did historically. This served as a tipping point for us to articulate a thesis that had been brewing in our minds for the better part of 2026 — namely, that structural changes to equity markets have led to return dynamics that are fundamentally different from past market cycles. In this note, we outline what has changed, what it means for prospective relative returns and how investors ought to prepare.

What has changed

The equity market landscape has evolved over the past decade or so in two profound ways:

- 1. Market structure** has changed as the composition of market participants has evolved materially (namely, the rise of passive strategies, multi-manager platforms, quantitative funds, and gamification in retail investing).
- 2. Index distortion** has become more significant. Most notably, the S&P 500, Russell 1000, and MSCI World have become unprecedentedly top heavy, with significant concentration in the tech sector and AI in particular.

1. Market structure

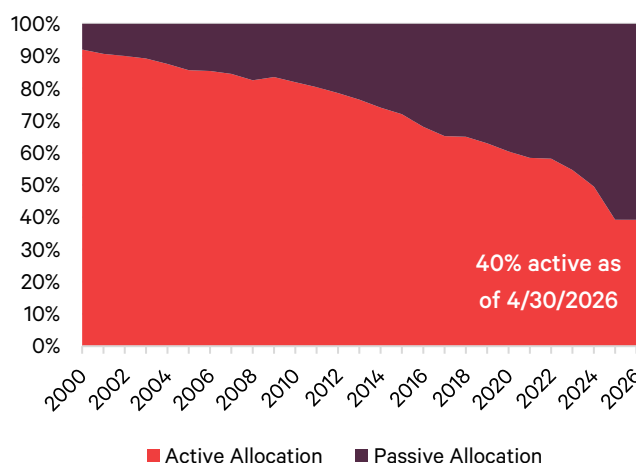
The market is increasingly dominated by a new swath of market participants who were either less relevant or didn't exist at all just 20 years ago. The most obvious example is the rise of passive index investors. Passive investment has grown from approximately 20% of market activity in 2009 to nearly 60% today (Figure 1). Index strategies are forced to buy companies based on their size in the index. As more money flows into passive strategies, more money buys the stocks in the index and the largest companies get the most capital, regardless of fundamentals or valuation. This has been a self-fulfilling prophecy of sorts: Capital flows from active to passive strategies thereby improve the relative performance of indices.

Less discussed but equally important has been the arrival and expansion of so-called multi-managers (aka "Pod Shops" such as Citadel and Millennium) and quantitative ("quant") trading firms. Because of the significant leverage used by quants and multi-managers (often upwards of 8x) and the frequency with which they trade, they have a more dramatic impact on price discovery and market movements than their collective AUM would otherwise suggest. Pod shops and quant strategies tend to focus on very short-term market movements, many of which are more technical and less fundamental in nature.

Retail trading has also evolved materially. Retail investors have been active since companies were first publicly traded, but the way they trade now is dramatically different. The friction of a broker call has given way to one-tap execution on platforms like Schwab, Fidelity, and Robinhood — putting large segments of the public in a position to trade at a velocity that simply wasn't possible a generation ago. 50 years ago, the average holding period on the NYSE was six years. Today, the average hold is 5-8 months.¹

While passive investors, pod shops, and retail traders may appear to have little in common, they are all to some extent playing a different game than long-term fundamental investors. We hold no particular objection to any of them — we utilize indexed exposure in many client portfolios for reasons of cost and tax efficiency, and many pod shops have delivered strong net returns, despite fees we consider steep. (We do worry high-velocity retail "investors" are playing a

Fig. 1: US Allocation to Active vs. Passive (2000-2026)



Source: Bloomberg, ICI Factbook.

difficult game.) Our broader point is that as these participants increasingly dominate market activity, price discovery reflects their shorter horizons — not the long-term fundamentals that ultimately determine a company's worth.

The net result is an increasing market emphasis on momentum (i.e., what has worked recently) and short-termism, with individual securities moving in ways that are dramatic and, at times, disconnected from underlying business value. While the overall market has exhibited modest realized volatility in recent years, underlying single stock volatility is historically elevated; according to Citadel Securities, single stock dispersion has been in the 97th percentile in 2026 and was in the 99th percentile in the beginning of February 2026.²

This suggests individual securities are less intercorrelated, particularly to those at the top of the index, an important point to revisit later.

2. Index distortion

Meanwhile, many indices, including most notably the S&P 500, are more concentrated than ever. This has been much discussed, in our view well in recent pieces by Ted Seides of [Capital Allocators](#)³ and by [GMO](#)⁴.

To recap, the top 10 constituents of the S&P 500 now comprise 39% of the index (as of December 31, 2025). The next highest top 10 concentration since 2000 was ~27% in 2001 (Figure 2).

Not only is concentration at all-time highs⁵, most of it resides in technology companies which are increasingly correlated to the advance of AI. As a result, index performance is more heavily influenced by a small set of companies and less representative of the overall market and economy. As an illustration, the delta in performance between the market-cap-weighted S&P 500 and the equal-weight S&P 500 has been historically wide in recent years (Figure 3). Notice that even in periods where the equal-weight outperforms, the magnitude is larger than it used to be. Here the point is less the direction of the outperformance, and more the amplitude.

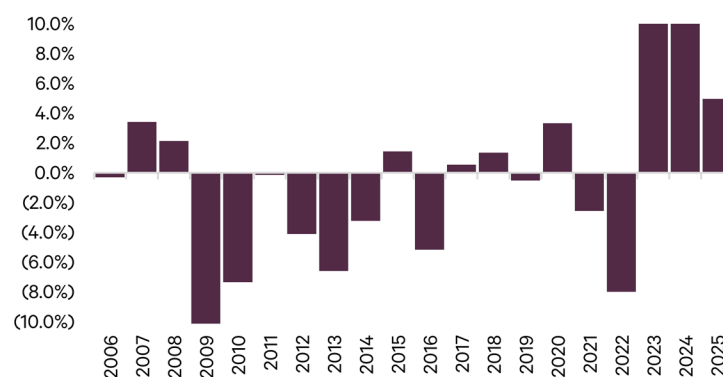
A related consequence of index concentration is that active portfolios are likely to look more different than the index. To illustrate the point, the active share of the S&P 500 equal-weight to the S&P 500 is now ~80%. Those two indices have the *exact same holdings*, but the differential in weights is significant enough to have an active share that is well higher than the average US large cap mutual fund – at 61% – according to Morningstar⁶.

Fig 2: Weight of the Top 10 Companies in the S&P 500



Source: Bloomberg.

Fig. 3: S&P 500 - S&P 500 Equal Weight Performance (12-06 to 12-25)



Source: Factset.

If two versions of an index with the same holdings can look so different, consider an active manager building a portfolio from a broad universe of stocks weighted by conviction, not market cap. That resulting portfolio will look very different than the index, especially if the manager is being thoughtful about risk management and diversification (principles not practiced in the index). Put simply, tracking error⁷ is high and for the benchmark-agnostic managers we prefer at Pathstone⁸, tracking error is especially elevated – a dynamic that appears likely to persist, in our view.

There is a high probability, we would posit, that active returns during a period of index concentration will be more detached from index returns – for better and worse.

What does this mean for active management?

As financial information has been digitized and market participants have become higher-velocity, new information is typically priced into the market almost instantly. However, as discussed earlier, the participants setting these prices are increasingly focused on short-term information and signals, not long-term intrinsic value.

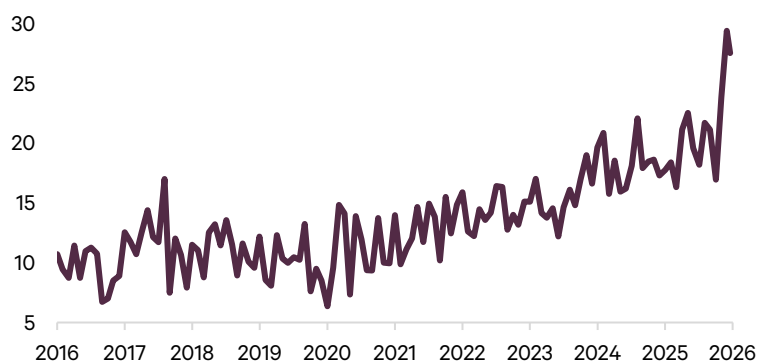
As Benjamin Graham famously wrote, “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” Well, the voting machine seems increasingly erratic (Figure 4).

Despite the short-term focus of the market, we believe the eventual value of a company still reflects its long-term earnings power. A standard discounted cash flow analysis⁹ is instructive here: depending on discount rate and growth assumptions, the substantial majority — often 70-85% — of a company's intrinsic value is derived from cash flows beyond year three¹⁰. If that is true, and we believe it is, then investors who can accurately assess a business's earnings have the potential over a five- or ten-year horizon to have a meaningful and durable edge — an opportunity that, in our view, the market, in its current form, is increasingly leaving on the table.

David Swensen, the longtime CIO of the Yale endowment, built one of the great investment track records of the modern era on a simple but powerful insight: outsized returns accrue to those who practice their craft where others are not. In his case, that often meant investing in illiquid markets, where there were far fewer sophisticated market participants. Today, paradoxically, fewer and fewer investors are conducting fundamental long-term analysis in traditional public equity markets. As fundamental long-term analysis becomes less common, the opportunity it creates becomes more valuable. What was old might be new again, so to speak.

One other thing to note about the long-term opportunity set: The range of outcomes for individual companies is perhaps wider than ever before as a result of AI, which we believe may be the greatest technological disruption in history. There is tremendous uncertainty and we would expect to see a significant performance gap between “winners” and “losers” as AI integrates throughout the economy. We are seeing this play out already with the performance of sectors such as software year-to-date. We do not purport to know how AI will play out, but we are confident the

Fig. 4: Single Stock Implied Volatility Premium (VIXEQ Index minus VIX Index)



Source: Bloomberg.

implications will be profound and the resulting stock dispersion dramatic. Such significant dispersion could further amplify the opportunity for stock selection, to the extent one can disproportionately identify the winners. These conditions should provide a secular tailwind for stock-picking over the next decade as AI plays out, and one that we think will be difficult to capture by focusing on short-term developments and historical financial precedents.

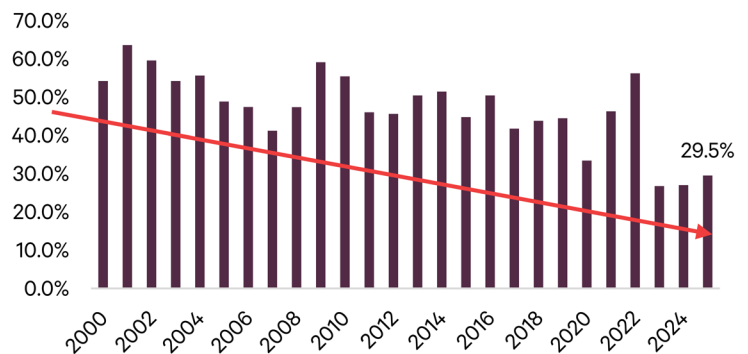
Framing performance expectations

Combining these points, we foresee a secularly and structurally attractive environment for long-term stock picking across the market universe, and market indices increasingly does not reflect that universe. Importantly, however, that alpha is likely to be much more episodic than it has been in the past. The last three years have been three of the four narrowest markets of the last 65 years¹¹ as mega-cap tech companies have driven a predominant share of index returns. Narrow markets provide headwinds to active managers.

We do not see this as sustainable; however, the dynamic highlights the cyclical nature of active manager alpha. While many of our active managers have generated strong absolute returns over this period, alpha has been more challenging given the narrow performance at the index level.

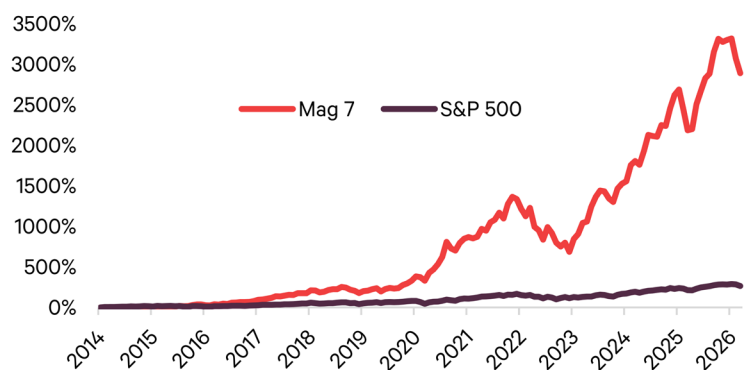
It is possible, perhaps even likely, that many of the best active managers over the coming decade will go through periods of relative underperformance. As tracking error is elevated, the magnitude of such periods may also be deep. We believe the conditions for skilled active managers to outperform over the coming decade are historically compelling, however, the path will require tolerating at time painful periods of relative underperformance.

Fig. 5: Percent of S&P 500 Stocks Outperforming the Index Since 2000



Source: FactSet.

Fig. 6: Cumulative Performance (Dec-14 to Mar-26)



Source: Bloomberg.

How should investors react?

To our main point: there is a reasonable likelihood that active management is quite strong for the coming decade but that many investors may not fully capture it. Why?

Psychological studies and empirical financial studies consistently show that investors are pre-disposed to sell when things are down and buy when things are up. According to a 2025 Morningstar analysis, the average dollar invested in US mutual funds and ETFs earned 1.2% per year less than the funds' aggregate total return over the prior decade.¹² That "investor return gap" is equivalent to approximately 15% of the funds' returns. That is sufficient to undo whatever alpha one might expect in aggregate over the next decade.

We believe the reason is simple: investors tend to follow behind strong performance and often exit when managers experience drawdowns. ARK Invest provides an extreme illustration of this dynamic in recent years. While we do not invest with ARK, the example serves as a cautionary tale for what might become more common in the years to come. In 2024, Morningstar looked at investors' experience in ARK's flagship mutual fund – ARK Innovation (Ticker: ARKK) – and found that the average investor in the mutual fund had earned an annualized return of -17%, compared to ARKK's annualized return since inception of 9.7% (at the time of the analysis)¹³. ARKK's situation is acute because their performance was very volatile, highlighted by sporadic periods of significant outperformance and underperformance.

Setting ARK aside, not every investor will be well served by strategies that require staying invested through prolonged or deep relative underperformance. As discussed, we believe the opportunity for alpha is compelling. The key is to be intellectually honest and self-aware enough to assess whether a more uneven return path is consistent with one's objectives, temperament, liquidity needs, and broader portfolio construction. Reactively selling underperformers to chase the strategy or manager that has been performing best is unlikely to be constructive and may also create tax inefficiency. Investors who are less comfortable with periods of *relative* underperformance may wish to focus on indexed equity exposure (even if we would argue that *absolute* risk is higher in the index today given the concentration).

For those who choose the active path, prepare yourself. Anticipate the frustration of watching the index climb while your portfolio lags, the discomfort of conviction tested by markets that seem indifferent to fundamentals. And prepare yourself to act, or more accurately not act, when a manager, or perhaps even large swaths of your portfolio go through a protracted period of underperformance. Remind yourself, this is the nature of the market today and was to be expected at some point. The psychology is genuinely hard, even for the most seasoned of professional investors, so the more you are ready for it, the more likely you are to reap the long-term benefits of today's market backdrop. It has been an unquestionably difficult period for active management. That will not last forever. In our assessment, good things will come to those who can wait.

Notes

¹ <https://www.guardiancapitalfunds.com/assets/pdfs/insights/Market-Timing-Commentary-2024-03.pdf>

² <https://www.citadelsecurities.com/news-and-insights/market-internals/>

³ <https://www.capitalallocators.com/when-the-benchmark-becomes-a-bet/>

⁴ https://www.gmo.com/americas/research-library/magnificently-concentrated_gmoquarterlyletter/

⁵ <https://www.deshaw.com/library/concentration-game>

⁶ <https://www.morningstar.com/business/insights/blog/active-equity-fund-benchmarking>

⁷ A measure of the differential in performance between one portfolio and an index expressed as one standard deviation.

⁸ We generally prefer managers who are less benchmark aware because it is very difficult for managers who track indices closely to perform with sufficient magnitude to compensate for fees and taxes. We utilize passive but then are truly different where we chose to be active

⁹ A valuation method used to estimate the value of an investment based on its expected future cash flows

¹⁰ Depending on discount and growth rate assumptions

¹¹ <https://www.rbcwealthmanagement.com/en-us/insights/the-great-narrowing-sp-500-concentration>

¹² <https://www.morningstar.com/business/insights/research/mind-the-gap>

¹³ <https://www.barrons.com/articles/ark-invest-stock-etf-cathie-wood-1047157e>

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