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Asset Management

The index trap: why passive allocation is the most active risk you can take

For Professional Investors Only | Marketing Communication

Kilian Niemarkt
Senior Client Portfolio Manager, Global Equities

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"Investors are taught that diversification, a cornerstone of sound investing, reduces risk and improves the quality of an investment return over the long term."

We look at whether benchmarks are fit for purpose for institutional investors, under current market conditions.

Key takeaways

- The current market environment has created a fragility that threatens the stability of investor portfolios reliant on index tracking.
- Any number of potential negative catalysts, such as AI valuation exhaustion as capex realities set in, the failure of debt-financed circular revenue schemes to mask underlying corporate stress, or the emergence of new tech, present a potential risk.
- The mitigation of these risks requires a shift in investors' mindset, from being renters of the market via passive vehicles to being owners of great businesses.

To many professional investors, a market index is regarded as a thermometer. It is viewed as an objective measurement tool designed to reflect the temperature of a specific market or economy. It can track the performance of a country, asset class or subset of an asset class. Investors rely on indices for asset allocation decisions but also to measure the return of a market, its characteristics and risks. In this traditional taxonomy, the index is the beta e.g. the passive baseline against which the active alpha of stock pickers is judged. The key assumption investors make about indices is that they are beta = 1 and alpha = 0. By definition, an index has maximum diversification as it holds all qualifying securities in a market, so it is fair to assume that idiosyncratic risk is minimal.

With low explicit costs and reduced susceptibility to idiosyncratic events, it's no surprise that investors began investing directly in indices, rather than using them solely as benchmarks.

Moreover, investors are taught that diversification, a cornerstone of sound investing, reduces risk and improves the quality of an investment return over the long term. There was a time when achieving that diversification required significant time and money due to research and transaction costs. Market capitalisation-weighted (market cap-weighted) indices changed this by offering a straightforward, cost-effective means of obtaining a diversified portfolio. By owning everything, investors avoided the challenge of picking winners and avoiding losers, while simultaneously capturing the capital growth of the broad asset class offered.

Although such an approach had the advantage of simplicity, that benefit was not delivered without cost. Over time, the drawbacks of index tracking have become increasingly visible, to the point where it appears that the risks of index-tracking strategies may now rival, or even exceed, those of traditional long only active investing.

The principles of market concentration

Stock level – the erosion of diversification

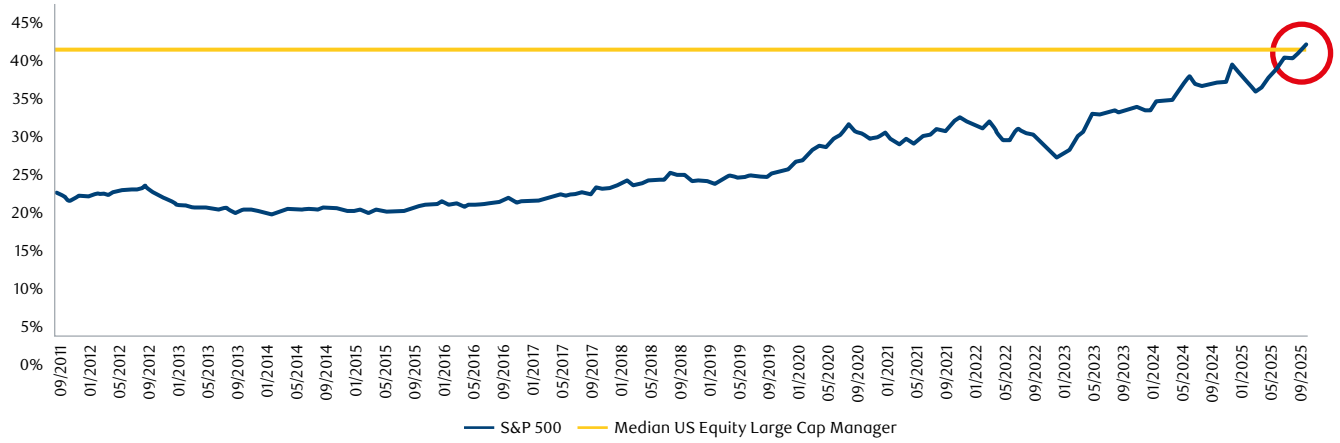
While equity market returns appear robust, a deeper analysis reveals that allocating assets to market cap-weighted indices is no longer a diversified beta pure play. It is, in fact, a highly concentrated, valuation-agnostic bet on a few specific narratives.

The top 10 holdings in the MSCI World Index accounted for almost 30% of its weighting, while the largest 10 names in the S&P 500 made up 41.6%, as of late October 2025. These concentration levels exceed those seen during the peak of the 2000-era dot-com bubble. In addition, almost 60% of the MSCI USA Index returns in 2025 were driven by its top 10 holdings, indicating one of the narrowest equity markets on record. The fundamental promise of index investing is diversification; by owning the entire market, an investor eliminates stock-specific risk, leaving only the returns driven by the market's systematic risks. However, the current composition of major global indices challenges this premise. Any active managers adopting such concentrated positioning would clearly be labelled as taking a high conviction bet.

To underline this, for the first time in October 2025, the S&P 500 Index surpassed the median allocation of active US Equity Large Cap managers to the largest 10 holdings; more than 40.9%, based on eVestment data. Passive allocations have essentially evolved to a higher conviction bet compared to the median active manager.

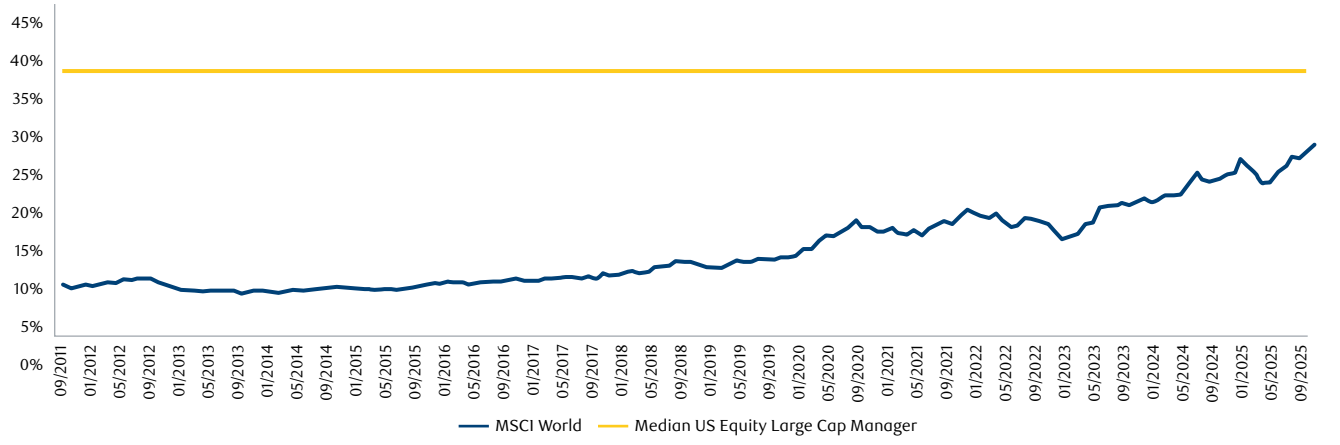
To quantify the extent of this diversification failure, the concept of effective membership can be applied. Since the S&P 500 is market cap-weighted, larger stocks carry a much greater weight than smaller ones. Some of the smaller stocks account for just over 0.01% of the index, thereby having minimal impact on index returns. By contrast, the largest stock, NVIDIA, had a weight of 7.4% at the end of 2025, equivalent to the total weight of the smallest 100 companies. One way to measure the concentration within an index is the Herfindahl-Hirschman Index (HHI), which is derived by summing the squared market shares of all firms in the index. The inverse of the HHI reveals the effective number of holdings.

Chart 1: Top holdings weight in S&P 500 versus active US managers



Source: RBC GAM, Bloomberg, eVestment, as at 30 September 2025.

Chart 2: Top holdings weight in MSCI World Index versus active global managers



Source: RBC GAM, Bloomberg, eVestment, as at 30 September 2025.

The implications of the data in Chart 3 are profound. The "market" is no longer a reflection of the broader economy. The effective membership of the S&P 500 has fallen to record lows. While the index consists of 500 companies, the mathematical reality is that its performance is driven by just 50 names. Furthermore, the combined weight of stocks with individual weightings of 3% or above is at an all-time high.

A prominent case study highlighting the peril of benchmark concentration is the former Canadian company Nortel Networks, which serves as a cautionary tale about the illusion of diversification in cap-weighted benchmarks. At its peak in 2000, Nortel was a global leader in fibre optic networking and accounted for over 35% of the total value of the Toronto Stock Exchange. Perceived by investors as the clear winner during the early internet hype, a combination of over-aggressive acquisitions, accounting scandals, and failure to adapt to shifts in the market for internet infrastructure, culminated in its bankruptcy in 2009. This wiped out billions in shareholder value and pension assets.

Another example from the same period is the American internet company AOL. In early 2000, AOL reached a peak market capitalisation of approximately USD224 billion and surged into the 10 largest companies of the S&P 500, joining other tech giants like Microsoft, Cisco and Intel. This rise was remarkable since the company was only added to the index in late 1998. In 2001, AOL completed a merger with Time Warner, which at the time was the largest merger in US history, with the deal initially valued at USD350 billion, creating the world's largest media company. However, shortly after the merger, the tech bubble burst, and AOL's inability to adapt to the rapid technological shift from dial-up internet to broadband led to the deal ultimately being regarded as a failure. Time Warner subsequently spun off AOL as an independent company in December 2009, by which point its market capitalisation had shrunk to approximately USD3.1 billion, a decline of over 97% from its peak.

Fast-forward to late 2025, and we are seeing a similar concentration profile in global benchmarks where the Magnificent 7 and the broader AI segment account for over one-third of the MSCI World Index. Just as Nortel and AOL were the must-own infrastructure plays of the dot-com boom, today's benchmarks are heavily geared towards a small group of AI-driven names.

The lesson for investors should be clear: high concentration at the top of the benchmark can turn a diversified index into a proxy bet on a single theme.

Sector exposure

Taking a closer look, we are currently seeing an over-concentration within the technology sector, with the AI-capex cycle dominating global indices. In September 2015, the technology sector was only the fourth largest sector in the MSCI World Index, accounting for just 10.1% of the index weight. One decade later, it has almost tripled to 27.3%. Despite the strong increase, this figure is optically conforming yet functionally misleading. Following the GICS reclassifications in 2018 and 2023, many of the world's largest tech-driven companies were moved into other sectors to prevent the technology sector from breaching concentration limits. Index heavyweights like Alphabet, Meta, Amazon and Tesla are not part of this sector.

> **"We are currently seeing an over-concentration within the technology sector, with the AI-capex cycle dominating global indice."**

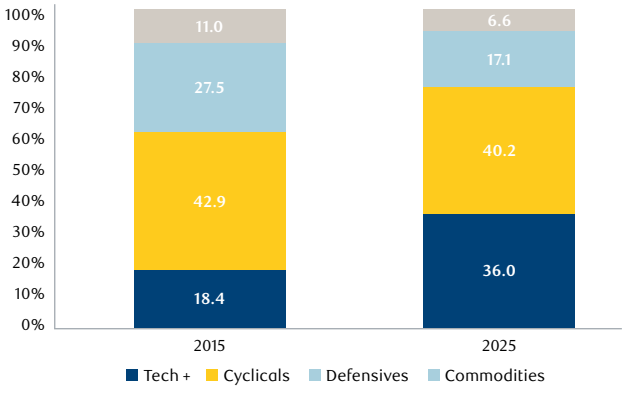
When dismantling the true economic drivers and aggregating them into broader sector groups, the impact is even more pronounced, where 'tech+' (information technology and communication services) now accounts for 36%, while commodities (basic materials and energy) have halved over the last 10 years. Defensive sectors like consumer staples have also nearly halved, now accounting for only 5.4%.

Chart 3: S&P 500 metrics

Metric (S&P 500)	Long-term average[1]	2000 dot-com peak	Current 31/12/2025
Top 10 weight	~20%	27%	41%
Effective membership	>100	79	46
Tech sector weight	~15%	33%	34%

Source: RBC GAM, S&P 500 Index, as at February 2026.
[1]Long-term average: 1975 to 2025, 2000 dot-com peak date: 10/03/2000.

Chart 4: MSCI World Index sector groups



Source: MSCI World Index, as at 30 September 2025.

Geographic exposure

Since many AI stocks are US domiciled, particularly in the critical hardware infrastructure, hyperscaler, and foundation models businesses, the weighting of the US in the MSCI World Index has grown to 72%, as at the end of 2025. At such a level, it is debatable whether investors in the MSCI World Index are getting a diversified exposure to global equity markets.

In addition, such a high US allocation does not fairly represent the actual economic value added by the US economy. The share of developed world GDP accounted for by the US is around 54%, significantly lower than the index weight. An equally-weighted version of the index, as opposed to market cap weighting, would be a much better representation of the developed world's economic output.

For institutional allocators, global diversification has long been a fundamental aspect of risk management. However, US exceptionalism in equity markets increases sensitivity to certain geographical risks. Firstly, there is jurisdictional overexposure to US policy volatility, including trade tariffs, regulatory shifts in Big Tech and the ongoing leadership transition at the Federal Reserve, coupled with debates around the independence of the central bank. Additionally, 2025 saw an increasingly strong dollar, where currency effects significantly eroded returns for non-US investors. For example, the S&P 500 delivered only a 3.9% total return for euro investors compared to 17.9% in US dollars. Lastly, increased geopolitical fragility is evident from the competition between the US and China, as well as varying strategic interests within NATO.

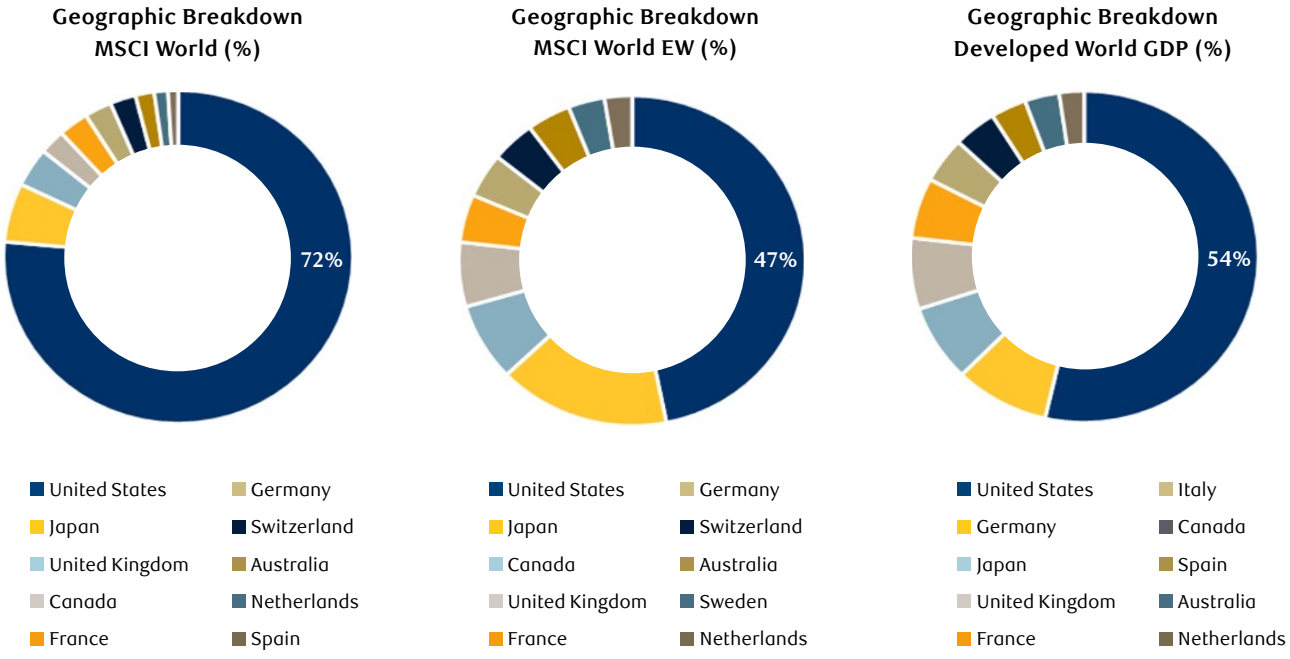
A shock in any of these areas could trigger a flight to quality, whereby portfolios overconcentrated in US tech names could potentially suffer severe drawdowns. A flight to safety can already be observed within precious metals, where, for example, gold has been climbing from one all-time high to the next, while equity markets have remained largely unaffected and continue to rise. Gold and equity markets have historically shown a low correlation, however, over the past year, the correlation has been highly positive, creating a significant anomaly, with both reaching a new all-time high.

Structural fragility and rising idiosyncratic risk

While passive investing is designed to eliminate company-specific risk through diversification, leaving the investor with systematic risk, the market environment of 2026 has introduced a paradox: the massive scale of index-tracking strategies has concentrated certain idiosyncratic risks. The premise behind passively investing in the MSCI World Index, which has over 1,300 companies is that, by owning all of them, the failure of any individual stock will have a negligible impact on the total wealth of an investor. However, in highly concentrated markets, this premise fails to deliver; large movements in individual index constituents can drive overall index performance and, consequently, investor outcomes. This can be further amplified by the circular revenue deals described previously.

"The failure of any individual stock will have a negligible impact on the total wealth of an investor."

Chart 5: Geographic breakdowns



Source: RBC GAM, Bloomberg, as at 31 December 2025.

The idiosyncratic risk within benchmarks has therefore increased significantly in recent years, after having been almost static in the previous decade. This is a risk that, in theory, shouldn't exist but arises because systematic risks are less able to fully explain all of the volatility within markets, leaving a residual. Since 2020, this idiosyncratic residual risk increased by almost 200bps in the MSCI World and S&P 500 indices. The first spike occurred during the Covid pandemic, with another noticeable spike after OpenAI released ChatGPT in November 2022. From that point forward, one can observe a gradual rise in idiosyncratic risk in both the MSCI World Index and S&P 500 indices.

"DeepSeek's technological advancements and efficiency claims sent shockwaves through the semiconductor industry."

Investors received a practical lesson in this new market risk environment in January 2025, when the China-based AI company DeepSeek, which was only founded in July 2023, challenged the thesis of US AI dominance. The company unveiled its DeepSeek V3 and R1 models, claiming that the final training run to develop its V3 model only took two months at a fraction of the cost of larger models. Furthermore, the company claimed to have only used deprecated NVIDIA chips. Third-party benchmark testing confirmed that DeepSeek's model outperformed the dominant models of the time, such as Llama 3.1, GPT-4o, and Claude Sonnet 3.5. DeepSeek's performance challenged the narrative that state-of-the-art AI necessitates billions of dollars in capex on cutting-edge hardware. A central element of the disruptive narrative revolved around its claimed technological efficiency, supposedly allowing it to achieve top-tier performance with significantly fewer resources.

DeepSeek's technological advancements and efficiency claims sent shockwaves through the semiconductor industry, prompting a reassessment of hardware requirements and future chip design priorities. NVIDIA lost USD600 billion in market cap in a single day, the largest single-day loss in history at that time, and dragged down the entire hardware sector. The S&P 500 Semiconductor and Equipment Industry Group went on to decline by -17.5% during the first quarter of 2025.

While the narrative shifted quickly from fears of demand destruction to the Jevons paradox (increasing efficiency of resources leads to more consumption of that resource), coupled with hyperscalers announcing that they would continue spending, it served as a valuable reminder to investors of how quickly market sentiment can shift from euphoria to panic, as though the AI gold rush was over.

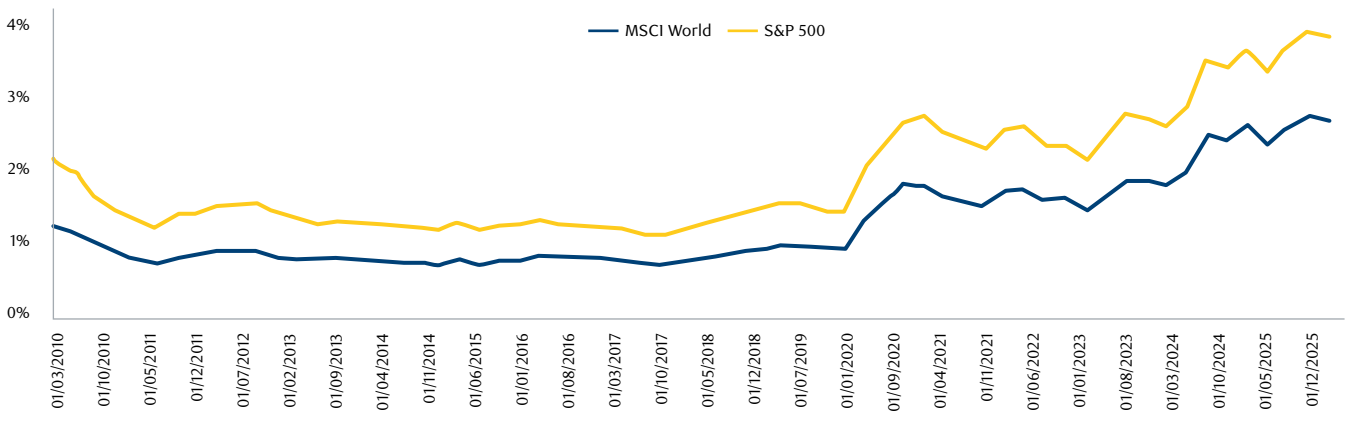
Valuations versus reality

By definition, an index has beta = 1. Active managers measure their factor exposures (such as value, growth, momentum and volatility) against an index. Therefore, factor concentrations may not be apparent as long as they are similar to the index.

Higher index concentration levels not only create bunching in large stock-specific risks, but they can also influence the composition of an index's factor exposures. These typically include an anti-value exposure. Because position sizes are based on a company's capitalisation, higher prices and higher valuations result in larger index weightings. There is an established corpus of academic research indicating a positive return to the value factor. Indices, by construction, will have a negative exposure to value.

In addition, indices are pro-momentum. Stocks with positive momentum tend to outperform those without, until such a time as momentum changes. In rising markets, this creates a positive dynamic that helps indices deliver stronger absolute performance. Indeed, this effect is reinforced as capital flows into the largest index participants when investors buy into rising markets and passive index-tracking strategies. However, this effect reverses and exacerbates negative absolute returns should market momentum switch.

Chart 6: Idiosyncratic risk of benchmarks



Source: RBC GAM, Bloomberg, as at 31 December 2025.

When using more absolute measures (rather than relative to an index), it becomes clear that the current market concentration has a distorting effect on index valuation levels, creating a two-tier market. As indices like the S&P 500 are capitalisation-weighted, the largest technology names pull the valuation of the entire index upwards. Towards the end of 2025, the S&P 500 reached a new all-time high valuation with a price-to-sales ratio of 3.4x. To demonstrate the disconnect, the S&P 500 equally weighted index is trading below its peak valuation, in line with its 10-year historical average, at 1.7x price-to-sales. Investors are essentially paying a premium for the index to access the growth of the top few firms.

Fundamentally, diversifying holdings across an entire index will reduce returns compared to what might be achieved from being more selective. For example, if an index combines cheap and expensive stocks as well as high-quality and low-quality stocks, an index tracker will inevitably have full exposure to the 'expensive/low-quality' segment of the market. Most investors would not expect such a segment to deliver returns greater than the rest of the market over the long term, suggesting that this element of diversification reduces overall returns.

Why do indices have these characteristics?

Once upon a time, Benjamin Graham famously remarked, "In the short term the market is a voting machine, but in the long run, it is a weighing machine." In the current environment, this quote seems highly relevant as it describes how stock prices can deviate from the intrinsic value of a company based on emotions, beliefs or certain opinions, but eventually, the company's value will align with its fundamentals.

The voting machine is currently in full swing, essentially acting as a popularity contest centered around the AI narrative. Investors are voting for the future dominance of these firms, driving up valuation multiples. The weighing machine asks the question, "do those earnings justify the weight?"

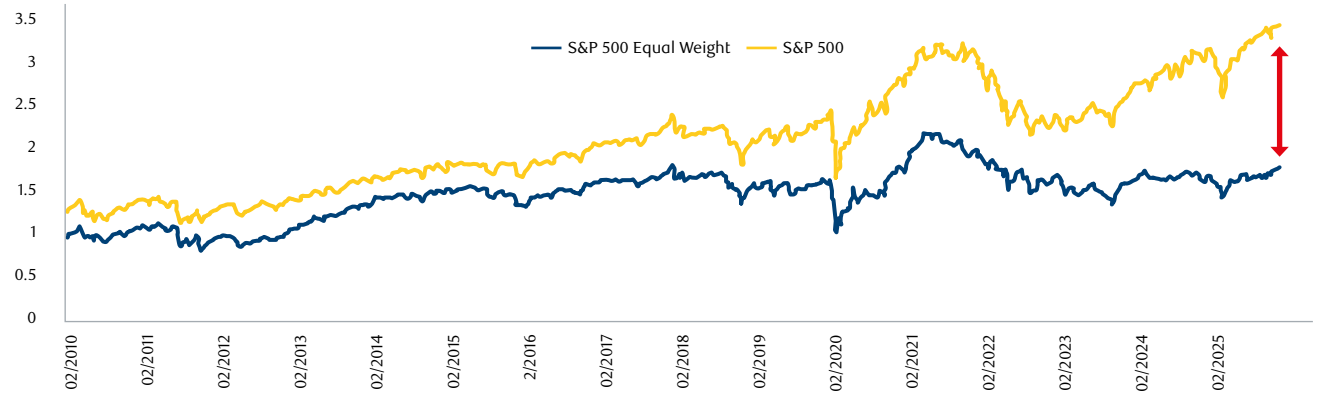
Market cap weighting is, by definition, a market-based weighting system. This makes it susceptible to being a momentum-driven allocation mechanism. It mandates that capital is disproportionately allocated to the largest, most successful and, therefore, often most highly valued companies. Rising prices attract more inflows, which drive prices even higher, creating a self-reinforcing feedback loop that inflates bubbles and deepens crashes once they burst.

Passive flows account for an increasing share of US equity volumes. In contrast, the participation rate of active long only managers has halved over the past 15 years to just 6.1% of total US equity volume. At the same time, a new cohort has entered the playing field: retail investors. Their participation has doubled since 2010 and now accounts for 20.5% of all US equity volumes, clearly surpassing professional active investors and amplifying short-term momentum-driven trading, as opposed to long-term fundamental views. We explored this topic in more detail in our paper, 'What is a share price worth', September 2025.

The gamification of trading via platforms like Robinhood or Reddit has had a significant impact in shaping this trend, shifting trading from a transactional utility to a dopamine-driven experience. These platforms act as liquidity funnels for the latest narrative-driven investment themes, including mega-cap technology stocks, as they actively promote the top risers and most traded names. Moreover, retail investors overwhelmingly prefer leveraged instruments, such as buying call options, particularly zero days to expiration (0DTE) or geared exchange-traded funds (ETFs). When a retail investor buys such an option, the trade is instantly sold to a market maker, who, in turn, hedges its risk to remain delta neutral by buying the actual underlying equity. This institutional hedging creates non-fundamental buying pressure on the actual stock and disproportionately benefits the most liquid names, such as the Magnificent 7.

"Retail investors overwhelmingly prefer leveraged instruments, such as buying call options."

Chart 7: Widening valuation gap between S&P 500 cap-weighted and equal-weighted indices (P/S ratio)



Source: RBC GAM, Bloomberg, as at 31 December 2025.

Since retail investors prefer 0DTE call options, which have the highest gamma sensitivity (a measure of how fast delta changes), a buying loop is created. The market maker is forced to buy even more shares which, as the stock keeps rising, encourages more retail traders to enter the trade, restarting the cycle. While the democratisation of equity markets through such platforms is positive, the gamification of trading is not.

Total option volumes have surpassed stock volumes for the first time in history in recent years and continue to grow strongly. According to CBOE, in 2025, average daily options volume reached a new all-time high, with over 59 million contracts per day – an increase of 22% compared to 2024 and a 260% increase compared to 2016.

Market makers will only sell options on the most liquid names that can be easily hedged. Since gamma squeezes drive prices up artificially, these companies receive a liquidity premium, trading at higher valuations simply because their option market is attractive. This pulls capital away from smaller companies in the index that do not benefit from such derivative-driven support, further widening the valuation gap.

> **"Market makers will only sell options on the most liquid names that can be easily hedged."**

The result is a market that is less efficient at price discovery and more prone to prolonged periods of mispricing, where asset values are determined by flows rather than fundamentals. This reduced elasticity of demand means that, when flow dynamics eventually reverse, the selling pressure is likely to be equally indiscriminate and severe. The danger is that if the voting machine, dominated by hype and passive flows, pushes prices to levels the weighing machine (future earnings and fundamentals) cannot support, prices will eventually collapse to meet the weight.

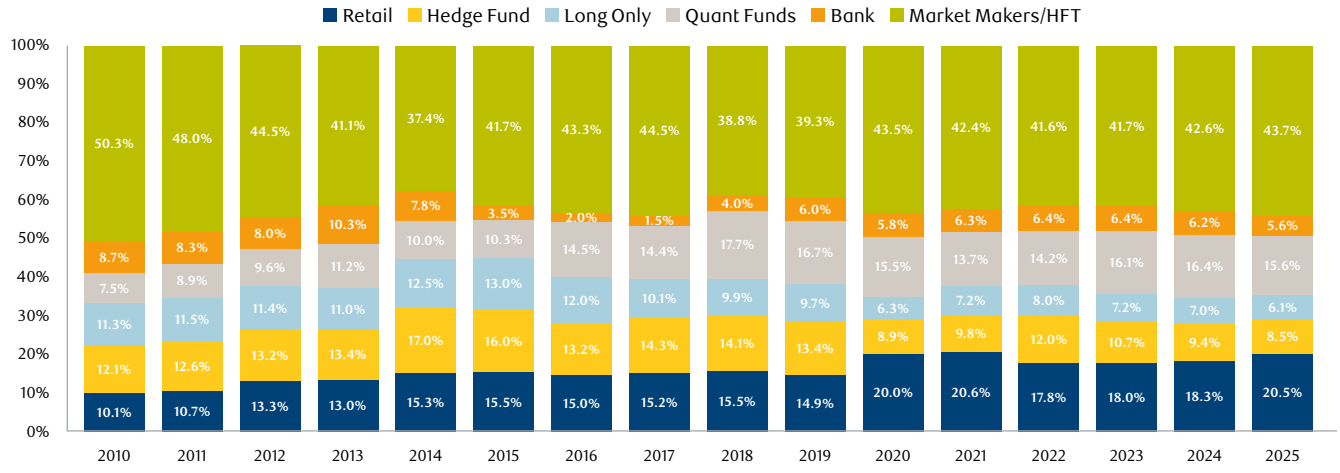
Are we in a bubble?

The primary narrative fuelling the current concentration in the market is the rally in generative AI stocks. While the transformative impact of AI is undeniable, the financial mechanics of the current investment cycle exhibit classic signs of a speculative bubble. However, this bubble differs from the one in 2000, which was characterised by internet businesses with no earnings. In contrast, today's AI leaders are immensely profitable. Instead, the bubble potential lies in the massive, front-loaded capex, based on future demand, and the growing disconnect between trillions of dollars of AI investment and the actual revenue being generated by software and services.

Another aspect of the rapid AI build-out is the depreciation of the underlying hardware. Cutting-edge GPU chips, like the NVIDIA Hopper or Blackwell series, have an estimated shelf life of three to five years before being rendered obsolete by the next-generation silicon. This creates a treadmill effect problem for hyperscalers like Amazon, Microsoft, or Meta, requiring continuous reinvestment of billions into chip architecture to maintain their competitive positions, even if revenue from previous investments has not yet fully materialised. This investment cycle is fuelled by intense competition between a small group of AI-firms, all striving to be the first to achieve 'artificial general intelligence', creating strong demand for chips capable of training the most sophisticated foundational models.

To further complicate the picture, the sector faces a circular revenue problem. For instance, a hyperscaler might invest in an AI start-up, which then uses that capital to purchase cloud computing services. Similarly, chip manufacturers provide funding to customers to buy hardware. Such transactions obscure the actual level of organic, external demand from end-users. The web of circular deals also poses a risk to financial markets and investors, as the fortunes of individual companies are tightly intertwined, meaning a failure at a single major AI node could trigger a systemic unravelling.

Chart 8: US equity volume by market participant (%)



Source: Bank of America, as at December 2025.

Historically, technology companies were primarily equity financed. However, companies are increasingly turning to the debt market to fund the capex needed in the global AI arms race; capex that has uncertain payback periods, adding increased sensitivity to interest rates and credit spreads. A debt-triggered correction could hit household wealth and pension funds, potentially causing a macroeconomic recession. The dot-com bubble was equity financed (primarily through public markets and venture capital) and was thus more contained when it reversed. In contrast, the AI investment cycle is funded not only by public and private equity but also by banks, bonds and private credit.

These concerns are corroborated by the December 2025 Bank of America Fund Manager survey, where an "AI bubble" was cited as the biggest growth tail risk by investors. Furthermore, a majority of surveyed investors believe that companies are overinvesting in AI capex.

Looking at this from a different perspective, academics have written about the small cap premium and why equal-weight benchmarks outperform capitalisation-weighted benchmarks over the long term. This phenomenon has also been justified by economists using a corporate lifecycle framework. Large and highly successful companies tend to eventually suffer from diseconomies of scale, while also attracting new competitors.

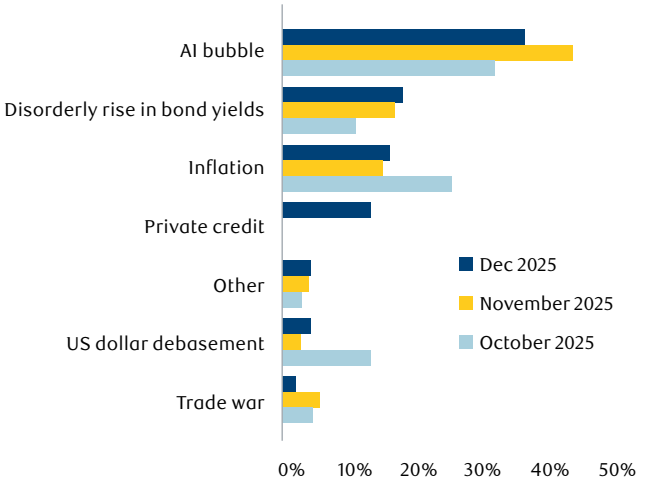
What does this mean for institutional investors?

The current historic levels of market concentration create several issues for institutional investors, not just from a volatility risk perspective but also in portfolio construction, as it is harder to achieve true diversification. An MSCI World portfolio as a global core allocation is now, in practice, heavily biased towards the US, mega caps and technology. While indices contain hundreds of stocks, effective diversification deteriorates due to correlation clustering within dominant sectors and factors. ***Investors stand at a juncture where the integrity of capitalisation-weighted indices is compromised.***

This environment forces a shift from simply buying the market to actively managing idiosyncratic risk exposures, since a concentrated index becomes more sensitive to interest rate shifts, tech sector earnings cycles and regulatory pressures on big technology names. In addition to idiosyncratic risk, factor risk must also be managed, as the increased exposure to mega cap tech stocks skews the index composition towards growth and momentum.

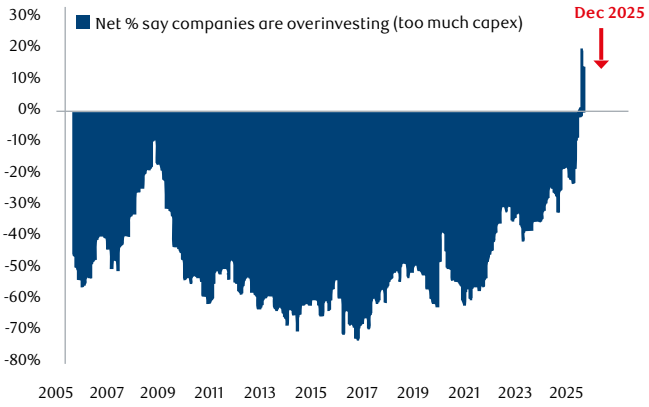
Lastly, there is a liquidity risk where the most liquid names could paradoxically become the source of a potential liquidity trap. In a concentrated market, ETFs hold large identical blocks of the top constituents. Liquidity is deep when markets are rising, but when the sentiment changes abruptly from hope to fear, triggering a sell-off, passive funds are forced to sell to meet redemptions and rebalance.

Chart 9: FMS investors see 'AI bubble' as biggest tail risk



Source: BofA Global Fund Manager survey.

Chart 10: FMS investors continue to believe that companies are overinvesting as concerns linger about the AI capex boom



Source: BofA Global Fund Manager survey.

Since passive funds own a large share of the free float of these stocks, there are fewer active buyers to take the other side of the trade during a sell-off, and the bids can disappear because the active price discovery mechanism is distorted. As a result, the price can fall dramatically, not due to fundamental reasons, but because the market cannot handle the simultaneous volume of passive divestment.

In the event of a bubble deflating, most market participants – high-frequency trading (HFT), hedge funds, and retail investors all assume that they can exit relatively quickly and sit out a bear market, watching from the sidelines and waiting for a buying opportunity. However, institutional investors, who have a long-term, through-the-cycle perspective often set out in their strategic asset allocation frameworks, face a different challenge. How do they navigate a bear market when the benchmark is so skewed towards the source of the bear market?

The bear market playbook

In the current market context of heavily skewed markets, active managers generally struggle to outperform. As long as momentum holds, index strategies seem to win. There is a similarity between today's equity market and the late stages of the Dot-com bubble in this regard. Then and now, the market has been dominated by a narrow group of large-cap technology stocks, while the rest of the market is largely overlooked.

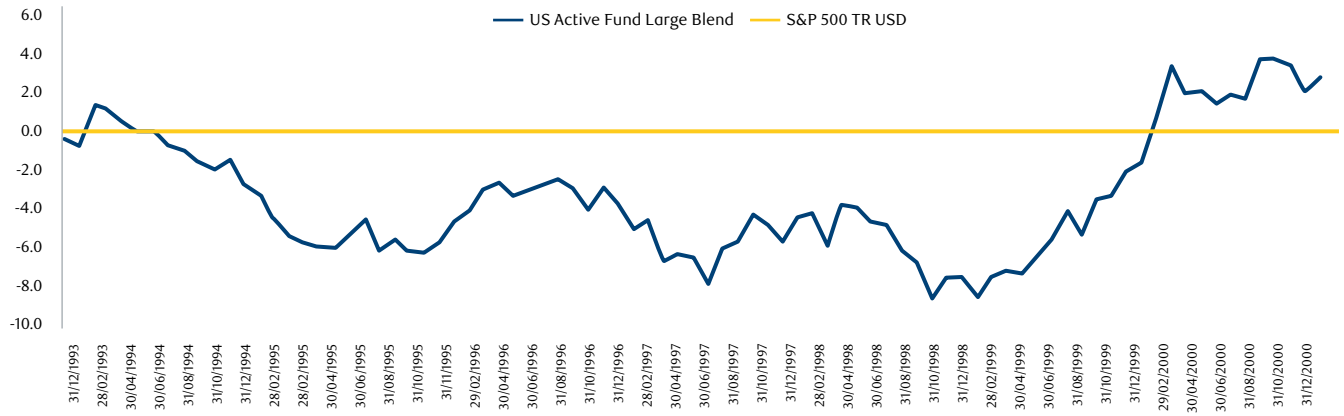
Active managers struggled to outperform the index during the build-up of the Dot-com bubble. With valuations moving from one record high to the next, managers had a hard time justifying allocating more capital to these often-unprofitable businesses. At the end of 1999, the largest 20 growth stocks were trading at a price-to-sales ratio of 10.8x and price-to-earnings (trailing) ratio of 68.0x. This led to a continuous decline of excess return generation compared to the S&P 500 index, which peaked in 1999 with -8% excess return for the average US manager. Looking at old equity research documents, by 1998 investors had even started to compare the internet hype with the 17th-century tulip mania. Calling a bubble is easy; making money from it is hard. It required two more years of patience until fundamentals started to drive share prices again. This was followed by a rapid recovery of alpha generation, ultimately leading to active managers outperforming during and after the bursting of the bubble.

When the Dot-com bubble burst, the S&P 500 and Nasdaq indices declined by -50% and -78% respectively. However, beyond these headline numbers, there was a significant dispersion. While mega-cap technology stocks decreased severely in value, active managers who chose to focus on fundamentals rather than faith managed to preserve wealth. Today's concentration may involve different stocks and themes, but the underlying mechanisms remain similar.

Active managers that care about valuation and diversification tend to underperform benchmarks in an inflating bubble but outperform them in a deflating one. During the inflation phase, absolute returns are good but relative returns are poor. Conversely, during the deflation stage, while relative returns may be good, absolute returns may not be. Can this be avoided?

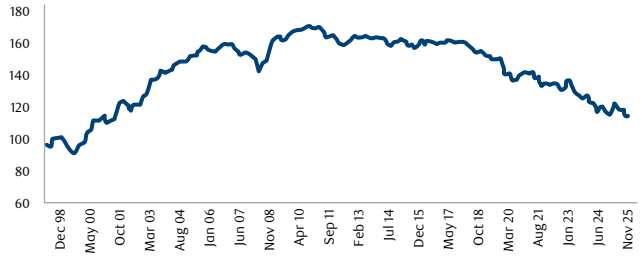
One of the simplest ways to exploit this dispersion is through equal-weight strategies. In a scenario where the top 10 stocks underperform or mean-revert, an equal-weight strategy will mathematically outperform the cap-weighted index. In fact, comparing the MSCI World Equal Weight Index with its market-cap version since inception, one can see that, over the long run, equal-weight strategies outperform cap-weighted strategies.

Chart 11: 1-year rolling excess return (%)



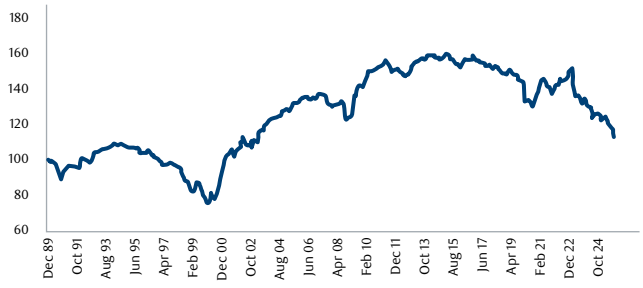
Source: RBC GAM, Morningstar, as at 31 December 2000.

Chart 12: Equally-weighted MSCI World Total Return Net Index vs MSCI World Total Return Net Index



Source: MSCI, as at November 2025.

Chart 13: Equally-weighted S&P 500 Index vs S&P 500 weighted Index



Source: MSCI, as at October 2024.

Summary

The theoretical underpinning of passive investing is based on the efficient market hypothesis and the benefits of broad diversification. However, the current market environment challenges the assumptions of efficient price discovery and diversified indices. Global equity markets at the beginning of 2026 are defined by a singular, overwhelming distortion, the concentration of capital in a handful of AI technology stocks, which is reinforced by the mechanical flows of passive investing.

While this dynamic has built wealth over the past decade, it has also created a fragility that threatens the stability of investor portfolios reliant on index tracking. Passive market cap-weighted strategies tend to outperform during prolonged bull markets, characterised by low volatility and abundant liquidity, benefitting from momentum-driven returns. However, this dynamic inverts during bear markets. The current market structure appears unusually fragile, leaving it exposed to any number of potential negative catalysts, such as AI valuation exhaustion as capex realities set in, the failure of debt-financed circular revenue schemes to mask underlying corporate stress, or the emergence of new semiconductor technology. The DeepSeek moment in early 2025 was a good reminder of how quickly market dynamics can shift from euphoria to fear.

The mitigation of these risks requires a shift in investors' mindsets, from being renters of the market via passive vehicles to being owners of great businesses. Passive is no longer a safe haven. When everyone is convinced that active management is dead, the conditions for regime change have already begun.

Investments carry risk. The value of your investment may go up or down, and you may not get back the full amount you invested. Past performance is not indicative of future results.

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