Ascentis
Asset Management

Advocating Active Management in a Passive Bubble:

Why Advisors Should Act Now

February 2026

Introduction

U.S. equity markets have been on a remarkable run. The S&P 500 has tripled since the 2009 lows, and the surge has accelerated in recent years thanks to enthusiasm for artificial-intelligence ("AI") and mega-cap technology companies. After such a prolonged bull market, many investors have gravitated toward index funds and exchange-traded funds (ETFs), believing that passive strategies are the safest and most cost-effective way to participate in equities. Passive funds now command more than half of U.S. equity assets, according to data from Charles Schwab, and their share continues to climb[1]. Yet the very characteristics that made passive investing attractive may now be creating a passive bubble. Equity valuations, by almost every metric, have climbed to record levels, and the market has become increasingly concentrated in a handful of companies. History shows that such conditions have often been followed by sharp corrections in which active managers regain the upper hand. This position paper argues that, given unprecedented valuations and concentration, investors and advisors should diversify away from passive index funds and embrace active management—including long/short and hedged equity strategies—as a tool for risk control and alpha generation.

The Case for Caution: Valuations at Historical Extremes

The first pillar of our argument is the extraordinary level of U.S. equity valuations. Valuation metrics quantify how expensive stocks are relative to fundamentals such as earnings, book value or the size of the economy. Today many of these gauges are near or beyond their historical peaks:

- Market capitalization-to-GDP (Buffett indicator): The total value of U.S. corporate equity reached roughly 232.4 % of nominal GDP by the second quarter of 2025, an all-time high that eclipses the 212 % peak reached during the 2000 dot-com bubble[2]. Fortune reports that the indicator has surged above 200 %, with the S&P 500's market capitalization now more than double the size of the U.S. economy[3]. The indicator, championed by Warren Buffett, suggests that equity prices have vastly outpaced economic output—a classic sign of overvaluation.

- CAPE ratio: Robert Shiller's cyclically adjusted price-earnings (CAPE) ratio smooths earnings over a decade to filter out business-cycle noise. As of October 22, 2025, the CAPE ratio stood at 39.51, the second-highest reading in history after the dot-com peak in 1999 and far above its long-term average of 17.65[4]. The CAPE is in the 98.7th percentile of historical valuations[5], meaning that only about 1 % of months since the late 1800s have seen stocks more expensive. High CAPE readings historically presage poor long-term returns; at today's levels, probability-weighted 10-year real returns may average 0 %–3 %, far below the long-term average of roughly 7 %[6].

- Price-to-sales ratio: Charlie Bilello observes that the S&P 500 trades at more than 3.3 times sales, the highest price-to-sales ratio on record[7]. Sales revenues are harder to manipulate than earnings, making this metric a robust gauge of overvaluation. The price-to-peak-earnings ratio has also climbed to 27.9, over 60 % above its historical median and the highest since 2000[7].

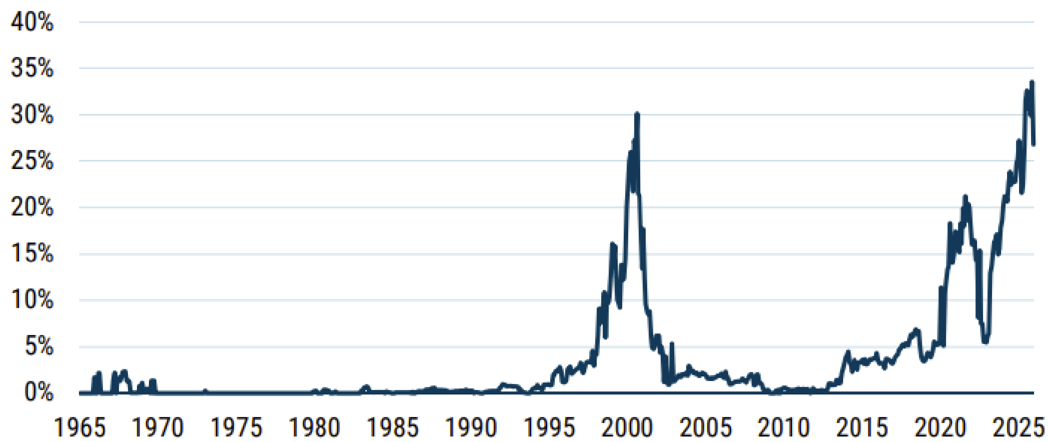
- Price-to-book and forward P/E: The S&P 500's price-to-book ratio has climbed to 5.3, exceeding the March 2000 dot-com peak of 5.1, while its 12-month forward price-earnings ratio is around 23, well above its 10-year average of 18.7[8][9]. Technology stocks trade at 30 times forward earnings—comparisons reminiscent of 1999[9]. A Reuters report warns that the technology sector's valuations are near dot-com levels, with parallels to past periods of "Nifty Fifty" exuberance[9].

- Q-ratio: The Q-ratio, which measures the market value of equities relative to the replacement cost of corporate assets, reached an all-time high of 2.09 in May 2025 and remained about 133 % above its historic average as of October 2025[10]. This implies that investors are paying more than twice the replacement cost of corporate assets—a strong sign of overvaluation.

Taken together, these metrics paint a picture of a market priced for perfection. Exceptional valuations may continue for some time if earnings or GDP growth accelerate. However, the historical record suggests that when valuations reach extremes, subsequent returns tend to disappoint. For example, the CAPE ratio explained roughly 25 % of the variation in subsequent 10-year real returns[5]. The negative correlation between high valuations and future returns means that investors who buy at peak valuations are taking on significant risk for modest expected reward.

EXHIBIT 6: PERCENTAGE OF U.S. STOCK MARKET TRADING AT OVER 10X PRICE / SALES

By market capitalization, 1965-2025



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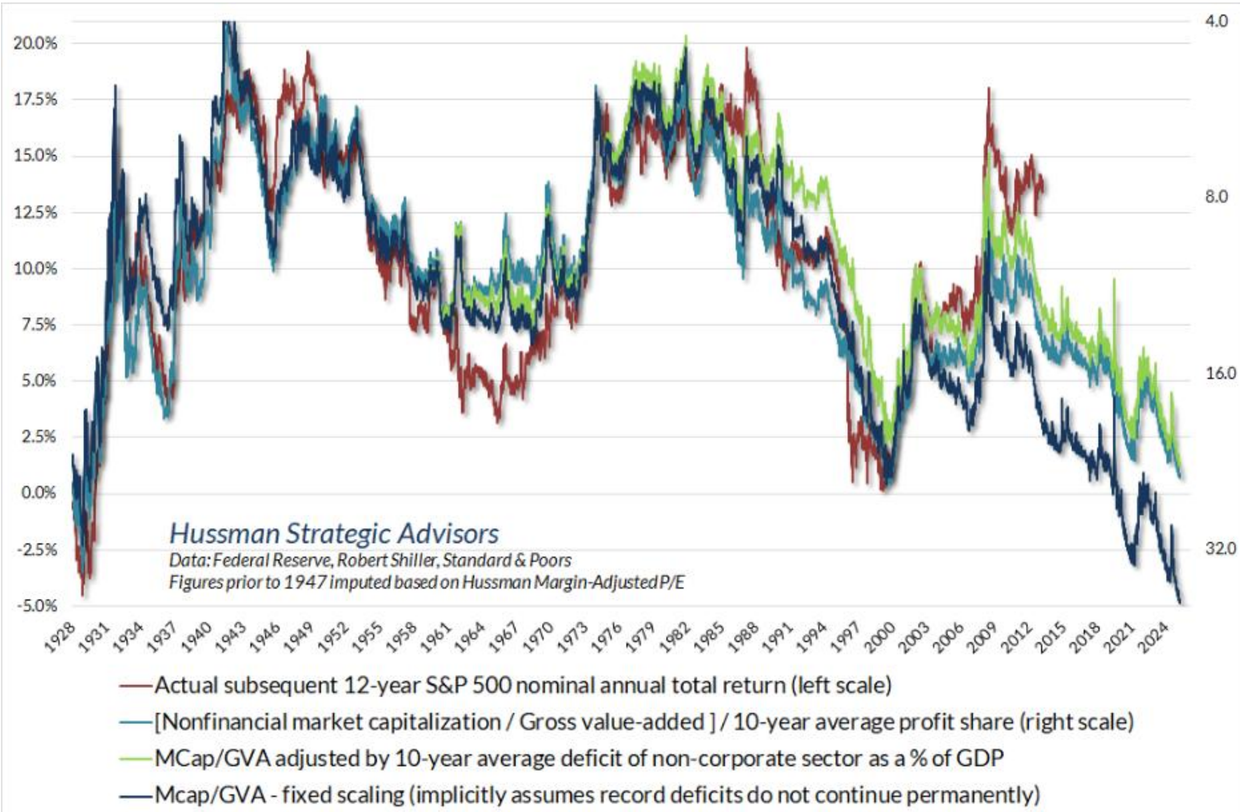
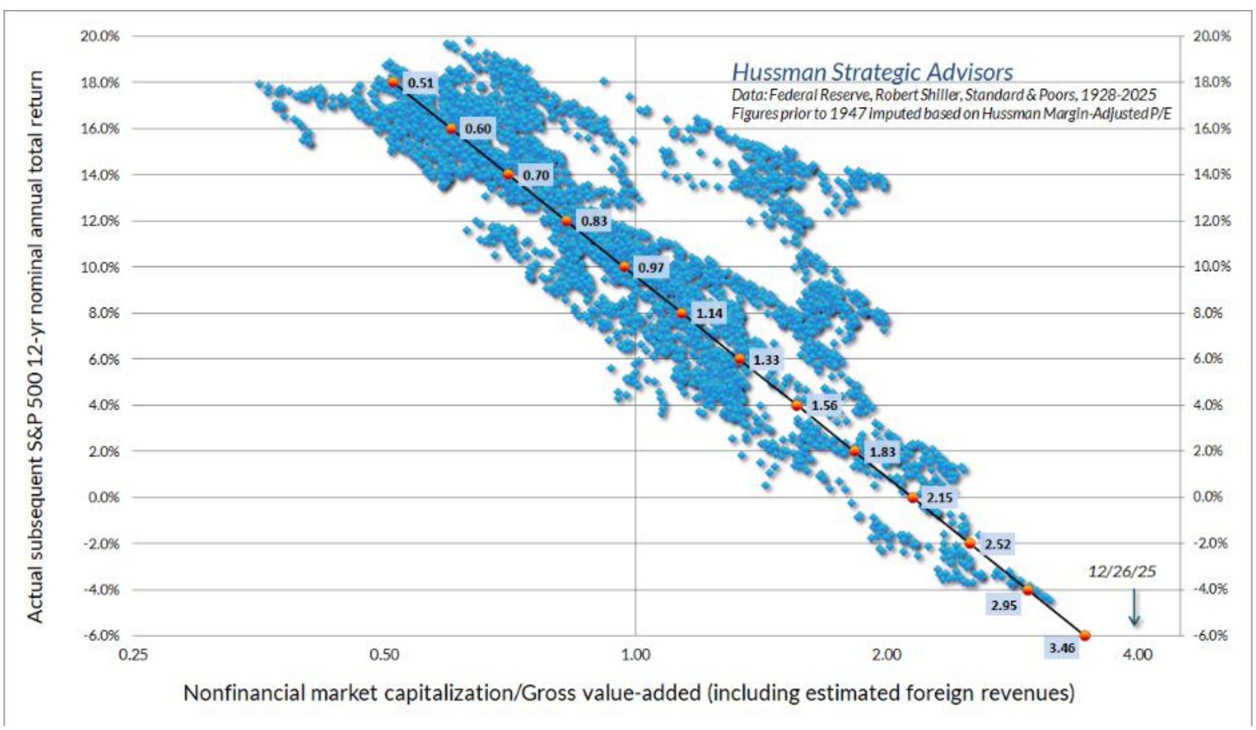

Hussman Strategic Advisors
Data: Federal Reserve, Robert Shiller, Standard & Poors
Figures prior to 1947 imputed based on Hussman Margin-Adjusted P/E
Actual subsequent 12-year S&P 500 nominal annual total return (left scale)
[Nonfinancial market capitalization / Gross value-added] / 10-year average profit share (right scale)
MCap/GVA adjusted by 10-year average deficit of non-corporate sector as a % of GDP
Mcap/GVA - fixed scaling (implicitly assumes record deficits do not continue permanently)


Hussman Strategic Advisors
Data: Federal Reserve, Robert Shiller, Standard & Poors, 1928-2025
Figures prior to 1947 imputed based on Hussman Margin-Adjusted P/E
Actual subsequent S&P 500 12-yr nominal annual total return
Nonfinancial market capitalization/Gross value-added (including estimated foreign revenues)
12/26/25

Extreme Concentration: A Market Dominated by a Few Giants

A second reason for caution is that U.S. equity returns are increasingly driven by a handful of mega-cap stocks. The so-called "Magnificent Seven"—Apple, Microsoft, Amazon, Alphabet, Nvidia, Tesla and Meta—have grown so large that they dominate broad benchmarks. Several studies show how concentrated the market has become:

1. Share of index capitalization: According to Charles Schwab, the largest 10 companies in the S&P 500 account for about 40 % of the index's market cap, and the top five represent around 27 %, exceeding the concentration during the dot-com bubble[1]. An Economic Times analysis puts the number even higher, estimating that the top 10 companies control 42 % of the S&P 500, almost double the level at the start of the decade[11]. These 10 companies collectively hold nearly $19 trillion in market value in a $45 trillion index[12].

2. Historical context: In 2000 the top 10 stocks comprised roughly 25 % of the S&P 500[13]. When the tech bubble burst, active managers—many of whom were underweight technology—outperformed by wide margins[14]. The current concentration is well above that 2000 level. In fact, the Economic Times notes that the S&P 500 has become a "10-stock show," with today's concentration higher than the dot-com era's 29 %[11].

3. Sector and style dominance: Nvidia, Microsoft and Apple alone account for nearly a quarter of the index[12]. The Osborne Partners report highlights that only one of the top 10 companies from 2000 (Microsoft) remains in the top ranks today; several of the once-dominant firms delivered negative returns over the subsequent 24 years[15]. This underscores how leadership changes over time and how concentrated portfolios can suffer when the favorites fall from grace.

4. Passive weighting in growth indices: The Russell 1000 Growth Index is now dominated by the same mega-caps, with the top seven representing about 40 % of the index. From 2000 to 2008, when the tech bubble deflated, the Russell 1000 Growth Index fell 57 % (an annual loss of 10 %), while the Russell 1000 Value Index declined only 9 %. There were moments when value outperformed growth by nearly 100 %[15].

High concentration increases risk in at least three ways. First, valuations of the largest constituents become stretched as investors chase a narrow group of winners, leaving the broader market undervalued. Second, index investors become unwittingly exposed to stock-specific risk—if one or two of the mega-caps falter, an S&P 500 index fund will decline markedly. Third, concentration reduces diversification across industries and factors, making portfolios more sensitive to economic or policy shocks affecting the dominant companies. Studies by Amundi show that after periods of high concentration, dispersion tends to rise and active managers often reclaim leadership[16].

The Passive Bubble: Crowd Behavior and Its Consequences

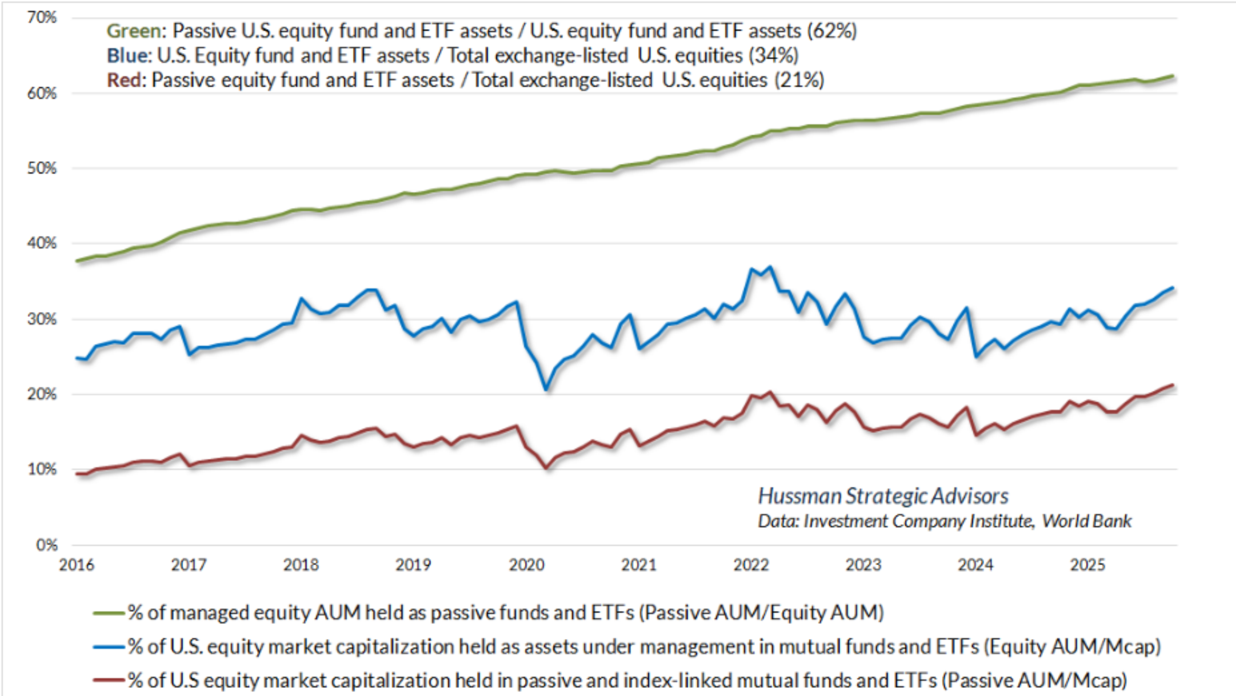
Passive investing has many virtues—low cost, transparency and tax efficiency. Yet the growth of passive vehicles has created a feedback loop that can inflate bubbles. When new money flows into index funds, it is allocated in proportion to existing market capitalizations. During bull markets this inflates the largest stocks further, regardless of valuation. Several indicators suggest that passive investing itself may be creating distortions:

1. Rising share of passive assets: Passive strategies (ETFs and index mutual funds) now represent more than 54 % of U.S. equity assets, according to Schwab[1]. Morgan Stanley notes that passive funds' market share reached 53 % by the end of 2024[17]. With more than half of investor dollars automatically tracking indexes, capital flows are dictated less by fundamental analysis and more by index weightings.

2. Boom–bust cycles around popular themes: The dot-com bubble and the recent "AI boom" illustrate how passive flows can exaggerate momentum. When valuations collapse, index funds remain fully invested in the hardest-hit stocks, while active managers can cut exposure. Morgan Stanley argues that heavy index concentration may become risky in a downturn, noting that when the top 10 stocks constituted 25 % of the index in 2000 and the bubble burst, active managers delivered significant alpha[13]. Amundi adds that after concentration peaks, more than 59 % of active U.S. large-cap managers outperformed from 2000–2005[16].

3. Valuation agnosticism: By design, passive vehicles do not discriminate between cheap and expensive stocks. When a small group of companies becomes extremely overvalued and dominates the index, passive investors are forced to own them. This may create a "passive bubble" in which index prices diverge from fundamentals. The CAPE, price-to-sales, price-to-book and Q-ratio metrics cited earlier all support the view that current valuations are unsustainable.

The upshot is that investors who rely solely on passive funds may be exposing themselves to concentrated risk at the wrong time. As valuations climb and dispersion increases, the relative advantage of active management tends to improve.


Green: Passive U.S. equity fund and ETF assets / U.S. equity fund and ETF assets (62%)
Blue: U.S. Equity fund and ETF assets / Total exchange-listed U.S. equities (34%)
Red: Passive equity fund and ETF assets / Total exchange-listed U.S. equities (21%)
70%
60%
50%
40%
30%
20%
10%
0%
2016
2017
2018
2019
2020
2021
2022
2023
2024
2025
Hussman Strategic Advisors
Data: Investment Company Institute, World Bank
% of managed equity AUM held as passive funds and ETFs (Passive AUM/Equity AUM)
% of U.S. equity market capitalization held as assets under management in mutual funds and ETFs (Equity AUM/Mcap)
% of U.S equity market capitalization held in passive and index-linked mutual funds and ETFs (Passive AUM/Mcap)

Evidence That Active Management Excels in High-Valuation Environments

Critics often argue that active managers rarely beat passive benchmarks after fees. Indeed, over long horizons, the majority of actively managed funds underperform after accounting for costs. However, performance is cyclical and tends to depend on market conditions. When valuations are low and the market is broad-based, passive investing often shines. In contrast, when valuations are high and dispersion widens, active managers have more opportunities to add value. Evidence supporting this view includes:

- Outperformance during market corrections: Hartford Funds examined 28 market corrections over the last 35 years. During these corrections, active managers beat passive strategies 22 times, with an average outperformance of 1.02 percentage points[14]. During the dot-com crash, active management outperformed passive by around 8 percentage points because active managers were underweight technology[18]. This highlights the ability of active managers to trim exposure to overheated sectors before a downturn.

- Improved success rates after concentration peaks: The Amundi blue paper notes that after the 2000 peak in index concentration, 59 % of active U.S. large-cap funds beat their benchmarks from 2000–2005[16]. This suggests that high concentration creates conditions for dispersion and rotation that active managers can exploit.

- Recent evidence of active success: Morgan Stanley reports that 60 % of U.S. large-cap managers outperformed the S&P 500 in the first quarter of 2025, and the firm believes active strategies are better suited to uncertain environments[17]. Forbes, summarizing Morningstar's Active/Passive Barometer, notes that 42 % of active funds beat their passive counterparts in 2024 and that active managers delivered particularly strong results in real estate and intermediate bond categories[19]. These figures may seem modest, but they underscore that meaningful numbers of active funds do add value when conditions align.

- Long-term reversal after speculative episodes: The Osborne Partners report shows that when the S&P 500 became highly concentrated in 2000, it took years for the index to recover. The Russell 1000 Growth Index lost 57 % from 2000–2008, while value stocks declined only 9 % and at one point outperformed by almost 100 %[15]. Active managers who were underweight technology or overweight value were able to mitigate the downturn.

The cyclical nature of active vs. passive performance suggests that we are entering a regime where active management is poised to outperform. Elevated valuations imply low forward returns for passive index investors, while increased dispersion offers active managers opportunities to differentiate winners from losers.

Harnessing Long/Short and Hedged Equity Strategies

Within the universe of active management, long-only strategies may not be sufficient to address the risks posed by extreme valuations and market concentration. Long/short equity and hedged equity strategies offer tools for generating alpha and managing downside risk in high-valuation regimes.

Why the Environment Favours Long/Short Equity

Long/short equity involves taking long positions in undervalued companies and short positions in overvalued or deteriorating companies. This allows managers to generate returns from both sides of the market and to reduce net market exposure. Several recent studies highlight why long/short strategies are well suited to today's environment:

1. Increased dispersion and pairwise correlations: Aberdeen's 2025 hedge fund outlook notes that lower correlations and wider dispersion across developed markets create a fertile environment for stock pickers. The report emphasizes that the current environment is as favorable for hedge funds as at any time in the past decade, and that Equity Long/Short and Equity Market Neutral strategies are expected to outperform historical returns[20][21]. Dispersion means that individual stocks can rise or fall independently, allowing skilled managers to add alpha through security selection.

2. High valuations and growth–value rotation: Cambridge Associates believes long/short strategies should perform better than typical in 2025 because U.S. growth stocks have become expensive and the "Magnificent 7" now make up over 40 % of the MSCI World Growth Index[22]. With growth enthusiasm moderating and value stocks trading at steep discounts, long/short managers can benefit from a rotation away from overpriced growth toward undervalued value stocks[23].

3. Improved cash yields and short rebates: Cambridge Associates' February 2025 paper emphasizes that higher cash yields and enhanced short-sale rebates improve the economics of equity long/short strategies[24]. During the zero-rate era, short selling yielded little because cash balances paid almost no interest; today higher short rebates provide incremental returns on the short side and help fund long positions. Elevated dispersion means that fundamental differences in earnings growth, balance-sheet quality and valuations are more likely to be reflected in stock prices.

4. Actual performance: Union Bancaire Privée (UBP) reports that equity long/short managers delivered returns of +7.2 % in the third quarter of 2025 and are expected to benefit from recovering stock dispersion in late 2025[25]. Hedge fund data provider HFR reported strong year-to-date returns for long/short equity managers, though not all categories have performed equally.

Hedged Equity as a Volatility-Damper

Hedged equity strategies aim to capture a portion of equity upside while providing downside protection through options or futures. Calamos Investments describes their hedged equity strategy as a “core long-equity portfolio with an actively managed option overlay” that seeks to generate downside protection and opportunistic alpha[26]. The strategy involves writing covered call options to harvest option premiums and buying protective puts to cap losses. This approach produces a more stable return profile than a traditional long-only equity allocation, sacrificing some upside in exchange for reduced drawdowns.

In high-valuation environments, hedged equity can be particularly valuable because the cost of protection may be offset by the income from writing calls. With options volatility elevated due to macro uncertainty, hedged equity managers can generate healthy option premiums. For investors who fear a market decline but still want exposure to equities, a hedged equity allocation can smooth returns and reduce behavioral mistakes.

Long/Short Direct Indexing and Tax-Loss Harvesting: A Hybrid Approach

Another emerging tool for advisors seeking to diversify away from passive indexes while adding tax alpha is long/short direct indexing. Traditional direct indexing replicates a benchmark by holding its constituent stocks in a separately managed account, enabling investors to harvest capital losses when individual positions decline and to customize exposures (for example, excluding certain sectors or applying factor tilts). BlackRock notes that direct-indexing strategies aim to replicate an index while generating capital losses that can offset gains elsewhere in an investor's portfolio[27]. Automation makes tax-loss harvesting a core feature of direct indexing, and SMAs allow customization that pooled funds cannot[28].

Long/short direct indexing extends this concept by adding a short overlay. Rather than simply owning the index constituents, the investor buys more than 100 % of the index (typically 130 % or 140 %) and sells short a portion (30 %–40 %) of the same or similar stocks. In a 140/40 structure, investors buy 140 % of an index in individual stocks and sell short an offsetting 40 %. This keeps net market exposure near 100 % while dramatically expanding the opportunity to harvest taxable losses across market cycles[29]. The Long Angle guide explains that long/short direct indexing maintains market-like returns yet offers a steadier stream of tax losses because short positions generate losses in rising markets and long positions generate losses in falling markets[30]. In fact, research cited by the guide suggests that traditional direct indexing might harvest around 40 % of initial investment losses over a decade, whereas long/short direct indexing can double that figure to roughly 100 %[31]. Because the strategy continues to generate harvestable losses even after many years (about 8 % per year even after a decade)[32], it may deliver higher after-tax returns and a more consistent tax benefit.

Long/short extensions can also help diversify concentrated stock positions tax-neutrally. A BlackRock note on long/short loss-harvesting strategies explains that investors holding an appreciated single stock can purchase additional securities with borrowed funds and create short positions that mirror a broad market index[33]. These long and short extensions are constructed to minimize tracking error, so that the combined position behaves like a diversified benchmark. As the long/short portfolio is rebalanced, losses are generated when the market price of the extension positions falls below their purchase price; these losses can then be used to offset the gains embedded in the concentrated stock[34]. The article emphasizes that the speed of diversification depends on leverage: in back-tested scenarios a more aggressive LS200 strategy (long and short positions equal to 100 % of equity) reduced an individual stock's active weight to 5 % within five years in 346 out of 380 scenarios[35].

Franklin Templeton views tax-aware long-short as a natural extension of custom indexing. In an executive summary, the firm states that the structure of long-short strategies enables potentially larger and more consistent tax benefits than long-only direct indexing and that such strategies can address multiple client objectives, including loss harvesting, re-energizing ossified portfolios, accelerating workdowns of concentrated positions and adding portable alpha without disturbing core holdings[36]. The article notes that removing the long-only constraint allows greater capital efficiency and a fuller expression of stock selection ideas, leading to higher after-tax return potential, a decreased incidence of tax lock and faster reduction of concentrated exposure[37].

While long/short direct indexing offers substantial tax advantages, it is not without risks. The Long Angle guide cautions that leverage and short positions can magnify both gains and losses, financing costs could rise, and wash-sale rules must be respected[38]. Franklin Templeton likewise stresses that managers require expertise in stock selection, risk management, portfolio construction and tax management to implement these strategies effectively[36]. Despite the complexity, long/short direct indexing provides a hybrid solution: it tracks a benchmark closely like a passive index, but the long/short overlay creates additional levers for generating tax alpha and customizing exposures. For high-net-worth investors and those with significant capital gains, it can be a powerful tool to manage taxes while maintaining market exposure.

Active Management Tools for a New Cycle

Beyond long/short and hedged equity, traditional long-only active strategies also offer tools to manage risk and seek alpha. Active managers can tilt portfolios toward undervalued sectors, avoid overhyped companies, and hold cash or defensive stocks when valuations are extreme. They can underweight the most expensive stocks in the index, seek exposure to smaller companies or international markets, and dynamically adjust sector allocations. Morgan Stanley argues that active management is particularly suited to uncertain times, noting that 60 % of large-cap managers outperformed in early 2025 and that active funds can navigate a narrow market dominated by a few names[17].

Advisors can implement active management through several vehicles:

1. Active mutual funds and ETFs: Many large asset managers offer actively managed ETFs with lower fees than traditional mutual funds. These products provide daily liquidity and transparency while allowing active managers to pick stocks selectively.

2. Separately managed accounts (SMAs): For clients with larger portfolios, SMAs offer customization and tax optimization. Advisors can tailor exposures by excluding certain companies or sectors and harvest tax losses to improve after-tax returns.

3. Hedge funds and alternative vehicles: Accredited investors may allocate to hedge funds or private funds employing long/short, market-neutral or multi-strategy approaches. The improved environment for hedge funds makes these vehicles attractive for those seeking diversification away from traditional equities.

4. Balanced portfolios: Combining active equity, fixed income and alternatives can provide a smoother ride. While the U.S. equity market looks expensive, segments of the bond market and international equities offer better valuations.

Managing Risks and Setting Expectations

While the case for active management is compelling, advisors must communicate realistic expectations to clients. Active strategies involve higher fees and the risk of underperforming benchmarks. Success requires careful manager selection, diversification across managers and styles, and a long-term perspective. It is unrealistic to expect every active fund to outperform every year; however, the data show that a significant proportion of active managers succeed when valuations are extreme and dispersion is high.

Investors should also understand that active management is not a panacea. Market timing is notoriously difficult, and valuations can remain elevated for long periods. A diversified approach that blends passive and active strategies may offer the best of both worlds. For example, investors might maintain low-cost core exposure through broad index funds while allocating a portion of their equity portfolio to active strategies or long/short managers. This creates a “barbell” structure that provides broad market participation and targeted alpha opportunities.

Conclusion: A Call to Diversify Now

The U.S. equity market is currently experiencing one of the most expensive and concentrated phases in its history. The market capitalization-to-GDP ratio, CAPE ratio, price-to-sales, price-to-book and Q-ratio all suggest valuations that are at or near historic extremes[2][4][7][8][10]. Simultaneously, index concentration in a handful of mega-cap stocks has reached unprecedented levels, with the top ten companies controlling around 40 % of the S&P 500[1][11]. Passive investing, while efficient in bull markets, may be amplifying these distortions and exposing investors to uncompensated risk. Historical experience shows that after periods of high valuation and concentration, active managers often outperform, particularly during market corrections[14][16].

In this environment, advisors and investors should act decisively. Reducing exposure to plain-vanilla index funds and incorporating active strategies can help manage downside risk and exploit opportunities created by dispersion. Long/short and hedged equity strategies, supported by favorable conditions—higher cash yields, elevated dispersion and improved short-sale rebates—offer compelling tools for generating alpha and smoothing returns[24][21]. While no strategy is infallible, the evidence suggests that the probability of success for active management has increased substantially.

For prudent investors, now is not the time to remain complacent or to assume that the winners of yesterday will continue to outperform indefinitely. By diversifying toward active management and embracing strategies designed for a high-valuation regime, advisors can position their clients to navigate the coming cycle with greater resilience and the potential for attractive risk-adjusted returns.

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Ascentis
Asset Management

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