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The changing structure of the market

Is the market up or down? How did you perform relative to the market? These are questions that most investors are all too familiar with. But what is 'the market'? That is an interesting line of inquiry, which few people seem to spend much time dwelling on. Yet, it is crucial to understand how the stock market has evolved over recent decades, as well as the numerous implications this has for investors.

Focusing on the U.S., the story of stock market indices begins in 1896 with the Dow Jones Industrial Average (DJIA), which simply averaged the stock price of just 12 major companies across key sectors (it was then expanded to 30 companies since 1928). Then, in 1957, the S&P 500 index was established, followed by the technology-focused NASDAQ composite in 1971. These were not only much broader in scope, but radically different because of their index construction methodology, which weights components by market capitalization. This means that the larger a company, the greater its weight and therefore impact on the index's performance. The introduction of market capitalization weighting, in conjunction with other developments, is undoubtedly one of the root causes of the changing structure of the stock market, as discussed in more detail below.

Another key development occurred in the 1970s, with the creation of the first index funds, which are mutual funds that track the performance of a specific index. This was followed by exchange-traded funds (ETFs) in the 1990s. It is hard to overstate the impact that these vehicles have had in making investing in the stock market more accessible, and at a massively lower cost – undeniably positive outcomes. Yet, as is often the case, this has also had a number of unforeseen consequences, which are more problematic in nature.

The combination of broad market indices with the ability to absorb an unlimited amount of capital, together with the growing accessibility of low-cost products, has unquestionably had a massive impact on investment flows in favor of so-called 'passive' investing. According to BCG's Global Asset Management Report (pg. 9), the market share of passive products has increased two-fold over the past decade, to nearly 40% of assets invested in mutual funds and ETFs globally (as of the end of 2024). Other sources such as Morningstar indicate that passive funds have already overtaken active ones globally in 2026, with the U.S. market leading the way at approximately 54%.

Further incentives in favor of passive investing were created by way of regulation[1]. One might also argue that as a result of these developments, many 'active' investment managers have gradually moved closer to their respective benchmark index, due to career risk and the difficulty of 'beating' this rapidly-morphing market. Lastly, one may point out to the generational change in perception towards investing, with a clear preference for easily-tradable, low-cost passive investment products.

[1] For example, the Employee Retirement Income Security Act of 1974, the Pension Protection Act of 2006, and the SECURE 2.0 Act of 2022 created strong incentives for retirement savings (representing some $51 trillion in assets as of mid-2026) to be invested in passive index funds and similar low-cost options – in terms of fiduciary risk, diversification requirements, pressure to minimize fees, as well as automatic enrolment mechanisms. Another key regulatory incentive relates to the substantial tax advantage that ETFs benefit from in the U.S., due to the in-kind redemption process and use of so-called 'heartbeat trades'. Last, one may also point out to the mandatory 'benchmarking' of mutual funds, introduced by the SEC in 1993, which incentivizes active investors to manage their fund's assets in relation to a benchmark index.

Why is any of this problematic, we hear you ask?

The central issue is rooted in the market capitalization weighting of most indices, which, together with the sheer magnitude of flows that have migrated to passive investment products, creates a very powerful self-reinforcing mechanism. Thus, the larger a company's weight in the index, the larger a fraction it gets of historically fast-growing flows, resulting in an even larger market capitalization. As many will recognize, this essentially amounts to a momentum strategy.

This phenomenon is readily observable by looking at market concentration levels, as we've discussed in past commentaries. As of today, the largest 10 companies (nearly all technology stocks) in the S&P 500 represent nearly 40% of the index, which is meaningfully above former peaks. Another way to look at market concentration is the combined weight of stocks that represent 3%+ of the index, which used to fluctuate between 0-10% for many decades, before breaking out to over 30% currently (pg. 8). Further evidence of the positive feedback loop we've described can be found in valuation levels, as well as the factors that have been driving market returns, with 'growth/momentum' clearly dominating relative to 'value' over recent decades.

The main problem that results from this changing market structure is that it hinders the central function of investing: the efficient allocation of capital and the competitive pricing of assets, taking into account fundamental considerations and risks. Over time, the gradual erosion of this vital function can have real economic impacts, as it affects companies' cost of capital and thus the economics of the projects they undertake. Social impacts such as wealth inequality also arise, as a result of stock-based compensation for example, as shown by the first-ever stock compensation package worth up to $1 trillion, approved in November 2025 by Tesla's shareholders (which is contingent on reaching certain market capitalization and operational milestones).

In addition to the aforementioned concentration, valuation, and fundamentals risks that arise from a market that is metamorphosing into a 'passive machine', we should highlight other risks that may prompt investment flows to reverse, which would be quite perilous for today's markets. One such risk is actually valuation itself, as it is not inconceivable that there could be an extreme valuation level at which flows suddenly reverse. Another cause for concern relates to demographics, and the sheer magnitude of retirement savings that has been invested in passive products. Should the net flows of pension plans turn negative as a result of retiring baby boomers or rising unemployment due to a recession, this would in turn reverse flows out of passive products. External shocks, for example related to the yen carry trade, could also prompt consequential changes in investment flows.

To sum up, the stock market has evolved meaningfully over recent decades, with the share of passive investments growing rapidly. The combination of market capitalization weighting and increasing investment flows has produced a powerful positive feedback loop, resulting in risks related to concentration and valuation levels, fundamentals, as well as a potential reversal in flows. What is one to do in the face of this reality? Well, to each his own, but it seems to us that if one's preference is to invest broadly and at the lowest possible cost, then avoid self-destructive behaviors and really invest passively in order to capture the full market return. The use of equal-weight funds/ETFs might also prove prudent in view of current risks, and by virtue of their long-term outperformance relative to their market cap weighted counterparts. For active investors, Oyat's chosen pathway rests squarely on investing in high-quality businesses, valuation discipline, adequate diversification, a focus on less competitive niches of the market, charging reasonable fees, and aligning interests by having 'skin in the game'.

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