TD Global Investment Solutions

Whitepaper 25 Minutes

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In Defense of Active Management

The last few years have not been kind to active managers. According to eVestment, only 44 percent of active managers in their Global All Cap Core equity universe outperformed the MSCI World Index in 2025[1]. That was an improvement from the previous two years; in both 2024 and 2023, just 29% of managers outperformed. For the cumulative three-year period ending December 31, 2025, the percentage of managers that outperformed was a now-familiar number, 29%, or just a little over 1 in 4 managers. And even though the MSCI World Growth Index outperformed MSCI World Index by 5.4% per year over this stretch, growth managers barely did any better at beating the MSCI World Index: 30% of the managers in that universe outperformed MSCI World Index during the most recent three years. Have active managers lost the ability to outperform? And if so, does that mean switching to passive investing today is a wise decision?

We will start with the first question: can active management still outperform? In answering that question, it is important to look at the subject from another angle: in the past, when have active managers outperformed, and when have they underperformed? And does the answer to that question tell us anything about what is likely to happen in the future?

[1] Source: eVestment. As of December 31, 2025

Think about what has been going on over the last few years as active managers have failed to keep pace with the index: the index has been growing increasingly concentrated. At the end of 2025, the ten largest stocks in the MSCI World Index made up 28.5% of the weight in the index. Three years earlier, at the start of the period we were just discussing, that figure was 16.3%. That tells you that the stocks that were already large three years ago kept getting even larger relative to other stocks – that is, they outperformed. The numbers are staggering.

These stocks were already large three years ago. Six of the current top ten were in the top ten at that time; the "smallest" of the current top ten at the end of 2022 was was an American multinational designer, developer, manufacturer, and global supplier of a wide range of semiconductor and infrastructure software products, with a market cap of $234 billion, making it the 26th largest stock in the index at that time[2]. Yet they all outperformed the overall cap-weighted index over the subsequent three years, some of them by astonishing margins, further increasing their already large weights within the index.

Managers who did not overweight these stocks in their portfolio were at a disadvantage in trying to outperform the index. But many managers do not like to concentrate their portfolios that way. At some point, keeping active risk (i.e., relative to the benchmark) low by holding increasingly larger positions in a small handful of stocks raises the absolute risk of the portfolio – you're just not diversified enough. (At this point, you may be thinking, "well, absolute risk shouldn't matter to the manager; modern portfolio theory tells us that the cap-weighted index is the optimal portfolio. So, the manager should only focus on active risk relative to that optimal portfolio." Hold that thought.)

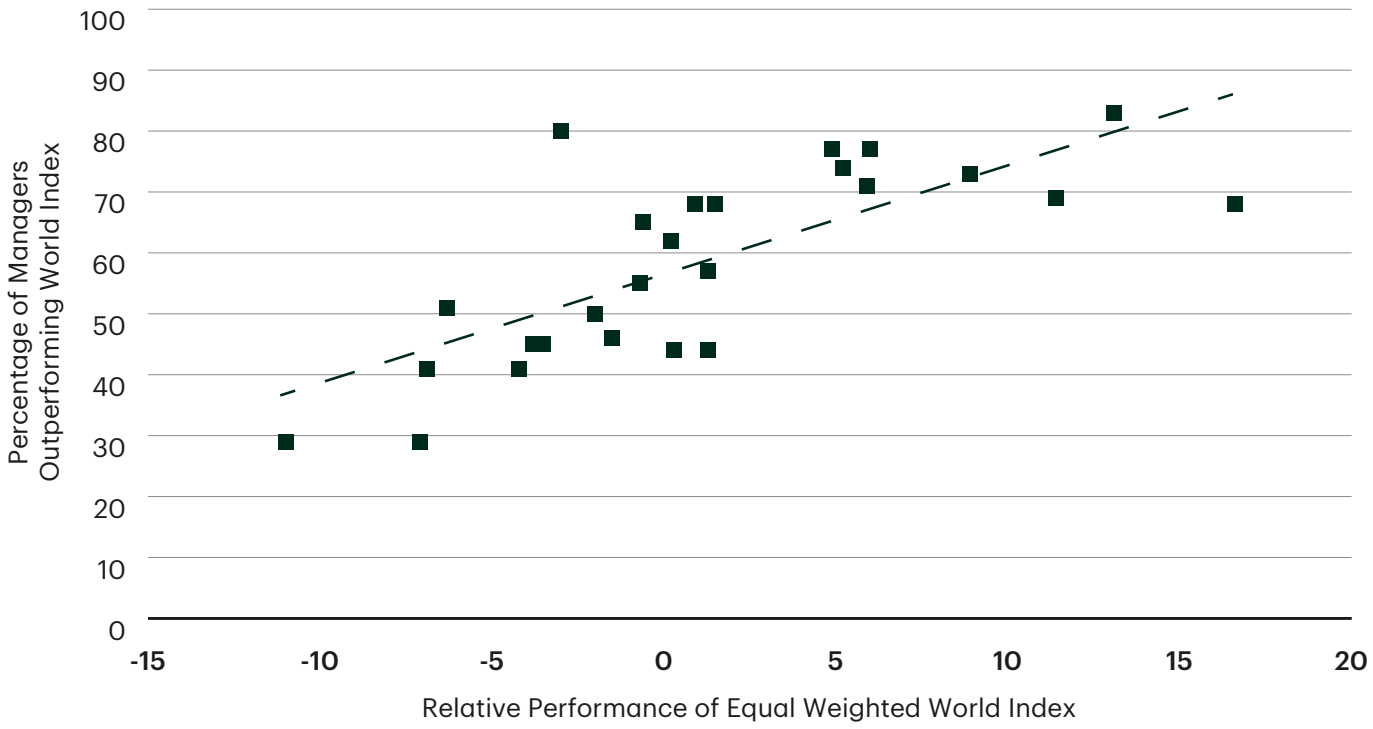
The point is, most managers' portfolios look more like an equal weighted version of the benchmark than they do a cap-weighted version of it. Not only do they tend to underweight the largest stocks relative to what their weights would be if they cap-weighted their holdings, they overweight the smaller stocks. This is a subtle point, and it's helpful to expand on it. It might seem like if a manager holds the largest of their stocks at close to their index weights, then they are following a cap-weighted approach. But that's not the right way to think about it. An American technology company for example, was 5.5% of the MSCI World Index at the end of 2025. But that does not mean holding it at 5.5% in your portfolio makes your portfolio look more "cap-weighted." In the context of a portfolio of, say, 40 names, cap-weighting means looking at each stock's capitalization relative not to the index, but to the other 39 stocks in the portfolio. Ultimately, the weights in the portfolio must add to 100%. If you only hold 40 stocks and you tried to hold each one at its index weight the math would not work – you would fall far short of 100%. Suppose you choose to hold the American technology company, and for the other 39 stocks in your portfolio you hold the rest of the 40 largest stocks in the index. For that portfolio of stocks to be "cap-weighted" – i.e., each one held in proportion to its percentage of the total market cap of the 40 stocks — the technology company's weight would not be 5.5%, it would be 13.2%! But of course, nobody just holds the top 40 stocks. Managers hold plenty of stocks that are much smaller than the 40 largest stocks. So, if they were cap-weighting their portfolios, it might well be that a single stock would be 30% of the portfolio, while some other stocks would be below 1%. No actively managed portfolios that we have ever seen look like this. They come much closer to an equal weighting scheme.

Managers

[2] Source: FactSet. As of December 31, 2025

And that's the key to understanding when active managers tend to do well and when they tend to do poorly relative to the cap-weighted benchmark. **Figure 1** plots the percentage of active managers in the Core Global Equity universe who outperformed the MSCI World Index in each individual calendar year from 2000 to 2025 (on the y-axis) against the relative performance of an equal-weighted version of MSCI World Index against the cap-weighted version (on the x-axis).

Figure 1: Active Manager Outperformance versus Relative Performance of Equal Weighted Index



Source: FactSet; Bloomberg Finance L.P. As of 12/31/2025

The relationship is quite strong. More managers tend to outperform when the equal-weighted index outperforms the cap-weighted index (which means that smaller stocks performed better on average than larger stocks), and fewer managers tend to outperform when the equal-weighted index underperforms (meaning large cap stocks outperformed). Here's one way to see how strong the relationship has been: there have been 14 calendar years over this time period in which the equal-weighted index outperformed, and a majority of active managers outperformed the cap-weighted index in 12 of those 14 years. But in the 12 years in which the equal-weighted index underperformed, a majority of active managers outperformed only 4 times.

So to answer our first question – can active managers still outperform? – we would say that yes, they can, but we should understand that it is more likely to happen when an equal-weighted version of the index outperforms the cap-weighted version. And now is the time to come back to that thought that we asked you to hold – that the cap-weighted index, according to modern portfolio theory (MPT), is the optimal portfolio. If that's true, why should we care about an equal-weighted index, or the fact that managers are more likely to outperform when the equal-weighted index outperforms? Isn't this a meaningless point?

We do not think so. We have written a few times over the years on what we think are the flaws in the MPT argument that the cap-weighted market portfolio is the optimal portfolio. We won't lay out our criticism in lengthy detail here but will simply summarize it as follows: MPT asks you to accept certain assumptions, the most important one being that volatility of returns is the appropriate definition of an asset's "risk." If you accept that assumption, then there is indeed, conceptually, a portfolio that is "optimal" in the sense that this portfolio, when combined with a risk-free

asset (defined as Treasury bills) in varying amounts, will provide the highest expected return for any level of "risk." At that point, the conclusion that the optimal portfolio is the cap-weighted market portfolio is not a mathematical proof, it's simply a logical deduction: if we all accept the premises of MPT, then we would all agree this portfolio is the optimal portfolio, and we would all seek to hold it. But the only portfolio that we can all hold simultaneously is a miniature replica of the overall market, i.e., an index fund. Viewed from the other direction, if we all hold the same portfolio, then the market portfolio, which is just the sum of all our individual portfolios, will look the same as every individual's portfolio.

The problem with this view comes when you challenge the assumption that volatility of returns is all you need to capture an asset's riskiness. MPT assumes that we can all agree on the riskiness of a given asset; volatility, after all, is an objective number. But behavioral economics has taught us that people will subjectively react to that objective number in different ways. In one person, the pleasure of a 10% gain might be exactly offset by the pain of a 10% loss. In another person, the pleasure of a 10% gain might be the inverse equivalent of the pain of only a 7% loss. These two people can look at a stock and agree on its volatility, but that doesn't mean they will agree on how "risky" the stock is. It's not clear that they would ever agree on what the "optimal" portfolio is.

So MPT's conclusion that a cap-weighted market portfolio is optimal is not as ironclad in theory as some believe. But even when you use the MPT framework to evaluate the equal-weighted version of MSCI World Index against the cap-weighted version, it's not clear that the cap-weighted version is superior in practice either. We have data on the equal-weighted MSCI World Index back to December 31, 1998. Based on the monthly returns to the equal and cap-weighted versions of MSCI World Index over the 27 years through the end of 2025, the equal-weighted index had a Sharpe ratio of 0.12 (average monthly excess return over Treasury bills of 0.56%, with a standard deviation of 4.70%), while the cap-weighted index delivered a Sharpe ratio of 0.11 (average monthly excess return 0.49%, standard deviation 4.41%).

In short, the theory behind indexing to the cap-weighted market portfolio is flawed, and the results over the last quarter century show that the cap-weighted index has not been superior to an equal-weighted approach in practice. So, the fact that managers look more like the equal-weighted index should not be viewed as a negative.

But suppose you are unconvinced by this discussion and think that indexing looks attractive after the last three years of active managers underperforming. In that case, our second question – is switching to passive investing today a wise decision? – is worth discussion as well.

Earlier we talked about the sharp rise in the concentration within the MSCI World Index over the last three years; the top ten stocks went from making up 16.3% of the index at the end of 2022 to 28.5% at the end of 2025. If you look back even farther, the change has been bigger still: Ten years ago, at the end of 2015, the top ten stocks made up just 10.5% of the index.

Every single one of these ten stocks outperformed the overall index over the last ten years, by an average of 20% per year. That's not really all that surprising – that's how they got to be such large weights in the index. (It's not necessarily always the case, though, that all of the top ten stocks have outperformed over the trailing decade. Ten years ago, on December 31, 2015, an American multinational conglomerate founded in 1892 was still one of the ten largest stocks in the index, despite having underperformed over the previous ten years. It's just that it had started out from such a high ranking at the end of 2005 – it was the second largest stock in the index at that time – that even though it underperformed over the next decade it stayed within the top ten. In subsequent years it performed poorly enough to drop from the top ten.)

Volatility

If you choose to switch today from an actively managed portfolio that looks more equal weighted to a passively managed index fund, you will most likely be adding to your positions in all these stocks, after a decade of them all outperforming by wide margins. There is nothing bad about that. But it is probably wise to keep in mind previous instances in market history where stocks, or entire markets, that had outperformed massively and seen their index weights rise sharply, subsequently underperformed just as dramatically.

To cite one well-known example that some investors today may be less familiar with: over the twenty years ending in 1989, the MSCI Japan Index outperformed MSCI World Index by over 10% per year on an annualized basis. The outperformance reached extremes in what, with the benefit of hindsight, has come to be called the Japanese real estate bubble of the late 1980s. In the last four years of that 20-year period, Japan outperformed the MSCI World Index by over 16% per year. The result was that Japan's weight in the index, which had been in single digits in 1970, was over 40% by the end of 1989. Most active managers balked at the high valuations in Japan in those years and underweighted Japan in their portfolios, which made most of them underperform. But choosing to switch from active to passive at the end of 1989 would not have worked out well. Over the subsequent ten years, Japan underperformed MSCI World Index by over 12% per year as that real estate bubble imploded and the economy stagnated. The underperformance continued even over the next ten years after that, and Japan's weight in the index eventually returned to single digits. The persistent Japan underweight by active managers added a lot of value in the 1990s.

The dot-com bubble of the late 1990s provides another example of the risks of buying into a cap-weighted index after a group of stocks has seen massive outperformance and the index has become more concentrated. We will use the S&P 500 Index for this example because we have a longer history for the equal weighted version of the index than we do for MSCI World Index. In the five years through the end of 1999, which saw the height of the dot-com frenzy, the cap-weighted S&P 500 Index outperformed the equal-weighted index by over 10% per year as concentration within the index rose to what were then record levels (subsequently surpassed in the last couple of years). When that bubble burst, the numbers pretty much reversed. Over the subsequent five years through the end of 2004, the equal weighted S&P 500 Index outperformed the cap-weighted index by 8.7% per year. Thanks to the effects of compounding, the equal-weighted index came out slightly ahead (i.e., 9 basis points per year) over the two periods combined. Once again, buying into a cap-weighted index at a time of high concentration levels would not have worked out well relative to an equal-weighted approach over the subsequent years.

Summary

Active managers have tended to lag their benchmarks over the last few years. Historically, this has been common when cap-weighted indices outperformed equal-weighted indices. We believe that cap-weighted indices, contrary to what modern portfolio theory teaches, are not necessarily the optimal approach, and data shows they have not necessarily been superior in practice. Investors should understand the context of recent active manager underperformance and be wary of switching to a passive approach that mimics a cap-weighted index at a time of high concentration in the index. ■

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Additional Disclosure

On September 10, 2025, the Chicago Mercantile Exchange ("CME") made findings involving The Toronto-Dominion Bank ("TD") related to a transaction effected on the Chicago Board of Trade ("CBOT") in June 2023. The CME determined that the transaction was executed in order to transfer a futures position between accounts with common beneficial ownership in violation of CBOT Rules 534 and 538.C. Without admitting or denying any violations or factual findings, TD consented to the entry of findings by the CME and paid a penalty of $25,000. None of the conduct regarding this matter involved Epoch Investment Partners, Inc. or its employees. A copy of the CME findings can be found here: https://www.cmegroup.com/content/dam/cmegroup/notices/disciplinary/2025/09/cbot-24-1744-bc-toronto-dominion-bank-nda-posting.pdf