

Looking out at what markets are signaling

Risks Hiding in Plain Sight

How the dominance of passive investing is reshaping market risk

Key Takeaways

- **Passive dominance is reshaping risk.** Measuring risk as tracking error creates a false sense of safety while underlying vulnerabilities quietly build.
- **Market behavior is increasingly driven by flows, not fundamentals.** Capital is allocated mechanically based on size, reinforcing a feedback loop that concentrates exposure and weakens price discovery.
- **Diversification is weakening when it's needed most.** Rising correlations and crowded positioning are turning passive portfolios into a single trade - heightening exposure to abrupt, systemic shocks when flows reverse.

The greatest risks in markets are often the ones that don't look like risks at all. Passive investing - now controlling well over 50% of US equity fund assets and more than \$20 trillion globally, up nearly 20x since 2000 - has fundamentally altered how investors define risk. What used to mean the potential loss of capital has quietly been replaced by something far more benign: tracking error. In today's market, the real danger is no longer being wrong - it's being different. As long as you own the index, you are considered "safe," even if the index itself is increasingly concentrated, expensive, and detached from underlying fundamentals.

But markets do not eliminate risk - they simply transform it. Passive investing does not allocate capital based on value, cash flows, or economic reality. It allocates based on market capitalization. As Mike Green, Chief Strategist at Simplify Asset Management, describes it, the system runs on a single rule: if money comes in, buy; if money goes out, sell. At small scale, this might be harmless. At today's scale, it is determinative. Flows drive the market. Stocks that rise become larger index weights, which attract more passive inflows, which pushes prices higher still. This reflexive loop concentrates capital into a narrow group of mega-cap companies and suppresses the incentives for active investors to challenge valuations. Price discovery weakens, and markets drift further from fundamentals.

The consequences are already visible. Rising passive ownership is associated with greater co-movement across stocks, diminished diversification, and increased sensitivity to liquidity shocks and volatility. Assets that appear diversified on paper increasingly behave as a single trade in practice. This is not risk reduction - it is risk compression. And compressed risk has a tendency to re-emerge suddenly and violently. The market appears stable precisely because flows are persistent and one-directional. But that stability is conditional, not structural.

What makes the current moment particularly dangerous is where this concentration is occurring. Passive flows are overwhelmingly directed into the same handful of mega-cap technology companies driving index performance. These firms are now committing hundreds of billions of dollars to AI infrastructure relative to their capital-light history, while facing a world of rising geopolitical fragmentation, deglobalization, regulatory scrutiny, and the specter of being disrupted by AI themselves. In other words, the largest and most crowded positions in global portfolios are also those undergoing the most uncertain economic transition in decades. Yet passive capital continues to flow into them automatically, indifferent to valuation or changing fundamentals.



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The illusion of safety comes from benchmarking. Investors believe they are minimizing risk by hugging the index but in reality, they are simply outsourcing the management of risk to the index itself. Tracking error is not risk - it is a career constraint. Real risk is the permanent loss of capital. And when markets are dominated by fundamental-indifferent flows, concentrated positioning, and synchronized behavior, that risk does not disappear - it accumulates.

Passive investing is not inherently flawed. But its dominance creates a system where everyone owns the same assets, for the same reasons, at the same time. And when that is true, the exit is no longer an individual decision - it becomes a collective one. That is the risk hiding in plain sight.

A handwritten signature in black ink, appearing to read "Travis Prentice".

Travis Prentice
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