

When Risk Controls Distort Opportunity

Rethinking Tracking Error in Equity Portfolio Construction

Equity markets have become increasingly concentrated over the past decade, with a small number of mega-cap stocks driving a disproportionate share of index returns. In response, many active managers have adopted tighter tracking error constraints and more benchmark-aware portfolio construction.

While this approach reduces relative volatility versus the index, it introduces structural biases that appear to be commonplace across active managers. We believe these observations are an important consideration when identifying active manager skill and propose an alternative approach to current market behavior.

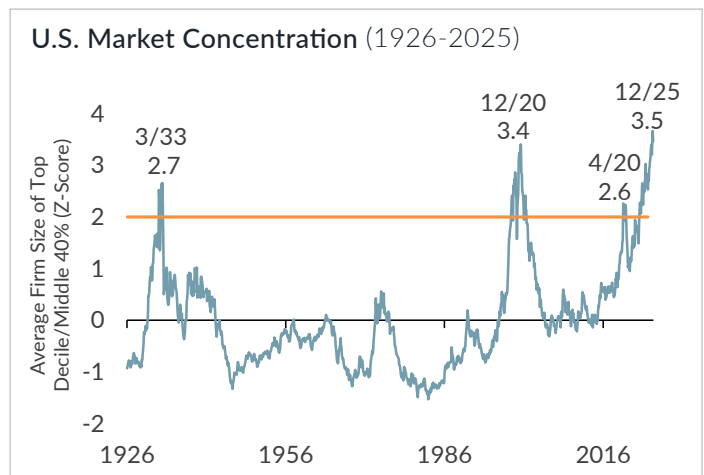
While tracking error sensitivity reduces relative volatility versus the index, it may limit potential returns and increase overall portfolio risk:

- Tracking error-constrained portfolios systematically dilute alpha potential by embedding benchmark exposure irrespective of investment merit
- The cost of benchmark alignment increases with market dispersion, shifting performance outcomes away from stock selection and toward index approximation
- Effective active managers will prioritize durable investment attributes and absolute risk considerations over deviations from a benchmark

Fear of Being Left Behind

Over much of the past decade, equity markets have been defined by historically narrow leadership, with a small cohort of mega-cap companies contributing as much as 34% of index returns. A narrow group of mega-cap stocks has been reshaping both benchmark composition and the behavior of active managers. As investor patience has waned, many actively managed portfolios have gravitated toward lower tracking error frameworks emphasizing benchmark awareness and tighter alignment with index weights. As reported by eVestment, the average large cap growth manager now has an active share of 53% compared to 64% five years ago.

At one level, this evolution is understandable. In an environment defined by concentration and momentum-driven leadership, straying too far from the cap-weighted benchmark introduces meaningful relative risk even though



Source: Glenmede Investment Management, Ken French data library, Dartmouth.edu
Market Concentration is defined as average firm size in the top decile divided by average firm size across the middle 40% of the CRISP database.
Data as of 12/31/2025

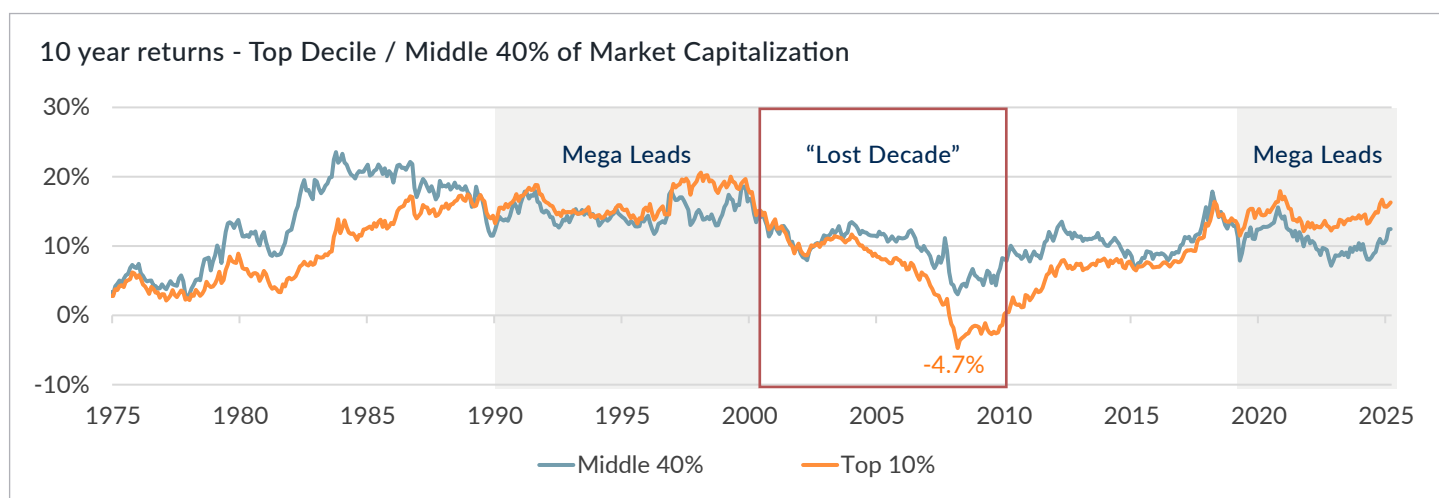
market capitalization has historically shown limited efficacy as a driver of excess returns. In attempting to manage that risk, many portfolios have adopted constraint-driven frameworks that ultimately undermine their objective of pursuing excess returns.

Tracking Error & the Size Paradox

Tracking error is a measure of deviation from a benchmark—not an indicator of investment quality or forward return potential. When embedded as a constraint, it influences both holdings and position sizing. High-conviction ideas with lower weights are scaled down while low-conviction holdings are maintained to manage relative risk. Position sizing reflects benchmark weight based on market capitalization rather than investment merit.

Decades of research within the Fama-French factor model, however, have consistently shown that size has weak and inconsistent efficacy as a driver of excess return. Despite a drawdown of -2.75% per year over the past decade, the Fama-French size factor, which promotes small cap companies over large ones, would have returned 1.61% annualized over the history of the 5-Factor model since 1963. This indicates that large cap companies have actually underperformed in the long run.

Following past concentration peaks, large-cap segments have underperformed over extended periods, reinforcing the risks of benchmark-aligned positioning. Notably, the period following the late-1990s concentration peak offers a clear case study. After the dot-com bubble, the largest segment of the market underperformed, driving what is often referred to as the “lost decade for U.S. equities”.



Source: Glenmede Investment Management, FactSet, Ken French data library, Dartmouth.edu

Data as of 2/28/2026

Despite their dominant performance at the peak, the top decile of companies by market cap is the only segment that would have produced negative returns over the 10-year holding period, as leadership broadened and more attractively valued segments of the market outperformed. Aligning portfolios more closely with the index, particularly at extreme levels of concentrated markets, has historically been a poor proxy for forward return potential. This reinforces the risks embedded in tracking error–constrained approaches, by owning larger index positions.

The result is a subtle but important shift in decision-making. Instead of asking whether a stock represents an attractive investment based on its underlying attributes, managers are increasingly forced to consider whether they can afford to exclude a position in their portfolio.

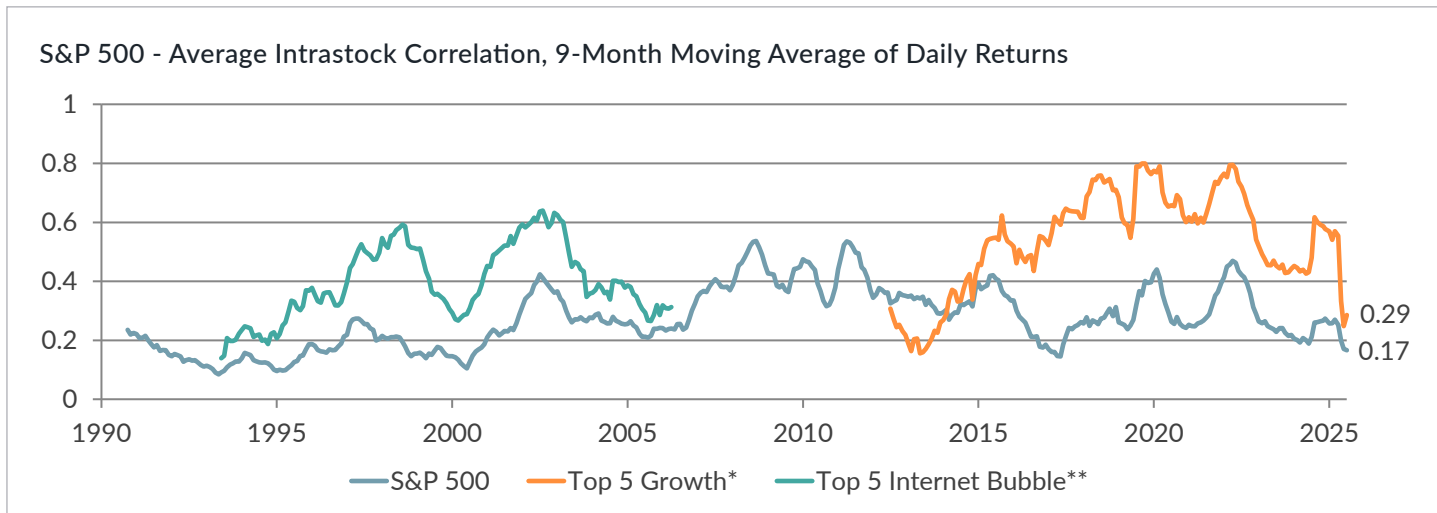
If size is not a reliable return driver, why are portfolios increasingly being constructed to resemble it?

A Turning Point in Market Structure

Recent market data reinforces that the period of narrow, synchronized leadership may be shifting. Correlations among the largest companies in the S&P 500 have declined meaningfully, with the average intrastock correlation of the 5 largest companies falling to approximately 0.28, its lowest level since 2017.

This marks a clear departure from the highly correlated environment that defined much of the past decade, potentially signaling a shift toward a more variable market environment suggesting that returns are becoming less driven by uniform capital flows and more dependent on company-specific fundamentals.

Historically, similar breakdowns in correlation have coincided with periods of broader market participation and increased dispersion of returns. In these environments, leadership tends to expand beyond a narrow set of companies, and performance becomes more differentiated across sectors, styles, and geographies.



Source: Glenmede Investment Management, FactSet

Data as of 3/31/2026

*Top 5 Growth includes MSFT, AAPL, GOOG, NVDA, and AMZN

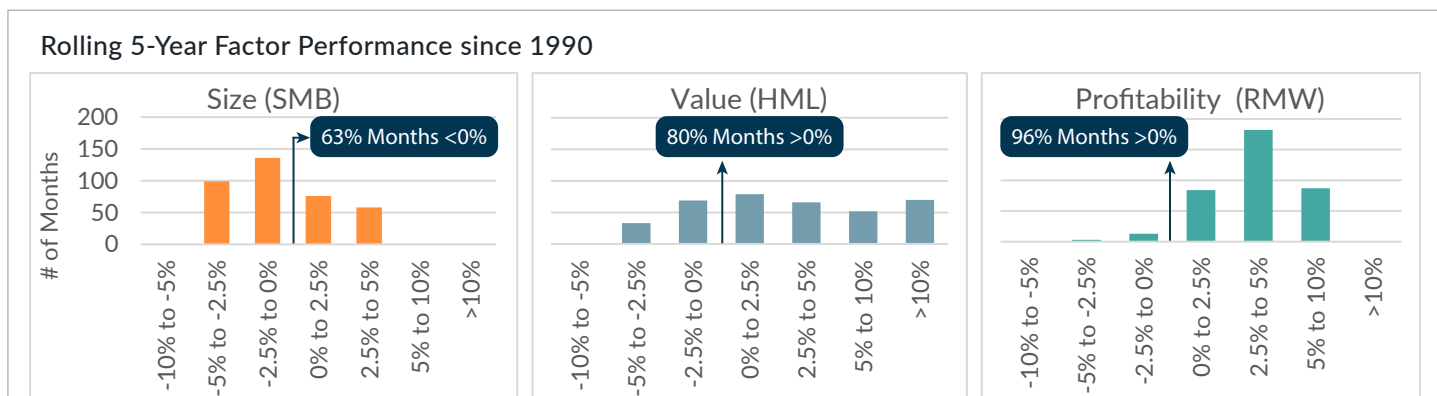
**Internet Bubble Top 5 Includes MSFT, INTC, CSCO, WMT, and GE

The implication is clear: Active managers' ability to express differentiated views becomes increasingly important as market structure shifts toward greater dispersion. Rising dispersion should present greater alpha opportunities for active managers that thoughtfully consider absolute portfolio risk, not only relative risk. Benchmark-constrained portfolios may be structurally disadvantaged in this environment if relative risk principally drives investment decisions.

A Broader Pattern Across Asset Classes

Although this dynamic is most pronounced in U.S. large cap growth, it extends across developed market equities as well. Rather than displaying concentration in individual securities, it often appears as thematic concentration, where a relatively narrow group of themes drive performance.

Long-term factor data confirms that developed market equities (ex. USA), see market cap as a factor exhibiting a structurally unfavorable distribution profile. Return distributions are negatively skewed, with negative average and median outcomes as well as a low frequency of months with positive rolling five-year returns. This suggests that allocating incremental capital based on the market cap factor has not been rewarded over time.



Source: Glenmede Investment Management, Ken French data library, Dartmouth.edu

Data as of 3/31/2026

Despite this, recent market conditions have favored large-cap leadership across equity markets.

A familiar tension exists where short-term leadership reinforces positioning toward an attribute that lacks durable long-term efficacy. When embedded within benchmark-aware frameworks, this dynamic can further entrench exposure to segments of the market that may not offer an attractive forward-looking return profile.

Performance is driven by differentiation, not closet indexing. Markets with greater variability in return present greater opportunities for alpha. As equity markets broaden, so will the opportunities they present for active managers. Going forward, we believe there will be a greater cost associated with looking more like your benchmark than actively allocating based on strong investment attributes.

Glenmede Disciplined Equity: Reframing Risk from Relative to Absolute

We believe a more effective approach to evaluate portfolio risk is by analyzing the probability of loss, downside magnitude, and investment durability. Rather than minimizing deviations from the index, we focus on a portfolio construction process that seeks to maximize exposure to durable investment attributes at a stock level, including valuations, fundamentals, earnings dynamics, and market behavior.

Within this framework, stock selection can be a primary driver of performance outcomes in which buy and sell disciplines operate together. Portfolio risk management is based on the constant assessment of the probabilities and magnitude of capital losses, rather than tracking error. Position sizing reflects idiosyncratic risk, while diversification is achieved through broad sector exposures and independent sources of return.

All returns are in U.S. dollars, include dividends and capital gains, and are not continuously compounded. The market factor is the return on a region's value-weight market portfolio minus the U.S. one month T-bill rate. The daily T-bill return is the simple daily rate that, over the number of trading days compounds to 1-month T-bill rate.

The Fama/French 5 factors (2x3) are constructed using the 6 value-weight portfolios formed on size and book-to-market, the 6 value-weight portfolios formed on size and operating profitability, and the 6 value-weight portfolios formed on size and investment.

To construct the SMB, HML, RMW, and CMA factors, we sort stocks in a region into two market cap and three respective book-to-market equity (B/M), operating profitability (OP), and investment (INV) groups at the end of each June. Big stocks are those in the top 90% of June market cap for the region, and small stocks are those in the bottom 10%. The B/M, OP, and INV breakpoints for a region are the 30th and 70th percentiles of respective ratios for the big stocks of the region.

SMB (Small Minus Big) is the average return on the nine small stock portfolios minus the average return on the nine big stock portfolios. HML (High Minus Low) is the average return on the two value portfolios minus the average return on the two growth portfolios. RMW (Robust Minus Weak) is the average return on the two robust operating profitability portfolios minus the average return on the two weak operating profitability portfolios.

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