Passive investing, mega-cap issuance, and the rise of structural volatility

An industry at an inflection point

For over two decades, the rise of passive investing has been underpinned by a belief in its simplicity and efficiency. Market capitalisation weighted indices have been regarded as neutral aggregators of information, reflecting the collective judgement of markets with minimal friction.

That assumption is now being tested.

The scale and speed of capital formation at the upper end of equity markets is beginning to challenge the structure of index investing itself. Alphabet's decision in early June 2026 to raise approximately 80 to 90 billion US dollars through a combination of public offerings, private placements, and at-the-market issuance programmes is a clear example of this shift.

While the strategic rationale, primarily funding the expansion of artificial intelligence infrastructure, is well understood, the broader implications for market structure are less widely appreciated. This is not simply a question of dilution. It reflects the interaction between the mechanical replication requirements of passive capital and the volatility that can arise from that process.

"The scale and speed of capital formation at the upper end of equity markets is beginning to challenge the structure of index investing itself."

From price discovery to flow enforcement

In theory, market capitalisation weighted indices operate as self-adjusting systems. Prices move, weights change, and capital follows. In practice, the growing dominance of passive investing is beginning to reverse this relationship. Flows are increasingly shaping price formation, rather than simply reflecting it. Active investors retain discretion over whether to participate. Passive investors do not, they are required to buy.

The CFA Institute Research Foundation recently published a report estimating [YF1.1]that "S&P index-tracking strategies now own roughly 25% of the market cap of all members of the index. It is also worth noting that these effects extend beyond US benchmarks. Global equity indices and sector allocations, including MSCI and FTSE, respond in a similar way, creating multiple layers of rebalancing across markets.

This divergence is important. It demonstrates that market outcomes are increasingly influenced by index construction rather than underlying fundamentals. Indices with higher exposure to issuing companies experience greater adjustment, while those without are comparatively insulated.

To accommodate new issuance, passive funds must increase exposure to the issuing company by reducing exposure elsewhere. The purchase of new shares is therefore funded by selling other constituents. As the scale of issuance increases, so too does the intensity of this internal redistribution.

These adjustments tend to occur over compressed timeframes, often around index rebalancing events. The consequence is that price insensitive demand meets limited liquidity, generating market impact that extends well beyond the issuing company itself.

Concentration as a multiplier

These dynamics are further amplified by the degree of concentration within modern indices. The Magnificent Seven account for a significant proportion of both the Nasdaq 100 and the S&P 500, along with global and sector indices.

This combination of high index weight and incremental supply creates a powerful structural effect.

When a company of this scale alters its capital structure, passive portfolios must adjust accordingly. This results in selling pressure in other constituents that is unrelated to fundamentals, reinforcing the idea that indices are becoming transmission mechanisms for concentrated shocks.

The derivatives layer as a multiplier of volatility

The implications extend well beyond cash equities into the derivatives ecosystem.

Exposure linked to benchmarks runs into the tens of trillions across futures, options, swaps, and structured products. Even small changes in index composition can trigger significant hedging flows, which are typically pro-cyclical.

When combined with passive rebalancing, this creates a system in which flows reinforce one another, amplifying market movements beyond the underlying fundamentals.

Tracking error as a structural feature

Passive investing has historically been associated with minimal tracking error. That assumption is increasingly difficult to maintain.

As the frequency and scale of rebalancing increases, tracking error becomes structural rather than incidental, particularly in concentrated indices where changes in a single constituent require meaningful adjustments across the entire portfolio.

The next phase: Mega cap initial public offerings

If recent issuance represents the first phase of this evolution, the next may prove even more significant.

Several private companies, including SpaceX, OpenAI, and Anthropic, are expected to enter public markets at significant valuations approaching or exceeding one trillion US dollars. Combined, these listings could introduce 5 to 7 trillion US dollars of market capitalisation within a relatively short period. However, the investable impact is likely to build more gradually, as initial free float is limited and expands over time.

At the time of writing, SpaceX has reached a market capitalisation of circa 2–3 trillion US dollars following its recent IPO, while also announcing an acquisition using its own shares as consideration. This provides a clear illustration of the dynamics we are highlighting in this piece.

The IPO initially involved c. 555–630 million shares outstanding, with only a limited free float available for trading.

Following the announcement of Cursor, structured as a $60 billion all-stock transaction, a material number of additional shares will be issued (currently estimated at c. 270m to 400m), with the final amount dependent on the share price at completion, expected in Q3.

As a result, index weightings and associated rebalances are likely to adjust quickly and repeatedly as both the share count and free float evolve, driven by ongoing deal activity and the unwinding of lock-ups. This, in turn, leads to flows coming through in relatively rapid succession as indices incorporate updated share counts and recalibrate to a larger equity base. It is also worth acknowledging that Amazon holds a stake of c.20% of Anthropic, with a further c.15% stake held by Google, while Microsoft maintains a c.27% economic interest in OpenAI. The result is a rather compromised set of index dynamics, where constituents are materially exposed to one another before a new entrant has even arrived.

In this instance, when Anthropic and OpenAI ultimately enter the index, passive funds will find themselves selling down holdings in companies whose valuations already reflect their exposure to Anthropic, simply to fund a direct allocation to Anthropic itself. It is, in effect, a circular exercise in ownership that rather undermines the notion of clean, independent index representation.

These are not conventional listings. They will enter markets as immediate large-scale constituents, requiring rapid allocation from passive capital.

In the S&P 500, float adjusted methodology may limit initial weightings. By contrast, the Nasdaq 100, with its faster inclusion framework, could see more rapid incorporation of large new constituents. However, initial weights are still expected to be constrained by limited free float and index methodology.

These effects extend beyond US indices. Global portfolios allocate heavily to US equities, creating a secondary layer of rebalancing across global benchmarks. Current indices rules look like the following for these mega cap IPOs:

Nasdaq:	15 days post-IPO
MSCI:	10 days post-IPO
Russell:	5 days post-IPO
S&P 500:	12 months post-IPO (under review)

Free float constraints and the feedback loop

The most significant risk arises not only from size, but from limited tradable supply.

Where free float is constrained, passive demand can overwhelm available supply. This creates a self-reinforcing feedback loop:

- Prices rise
- Index weights increase
- Passive funds are required to buy more

In strong markets, particularly those driven by enthusiasm around artificial intelligence, price appreciation can outpace increases in float, intensifying this dynamic.

Rebalancing at scale

The inclusion of these companies will require tens of billions of dollars of compulsory buying, matched by equivalent selling elsewhere.

This is not new capital entering the market. It is a redistribution of capital within the system, conducted over compressed timeframes, increasing the likelihood of short-term volatility.

Indexing is often perceived as low cost due to minimal fees and turnover, but rebalancing introduces meaningful hidden costs. Stocks added to indices typically rally ahead of inclusion and underperform thereafter, while deletions fall before removal and often rebound. This creates a persistent performance drag that is not reflected in expense ratios. S&P estimates these effects reduced S&P 500 returns by around 25 bps per year between 1989 and 2017. While modest, such costs are material in an industry where even 1 bp can influence flows. With the growing dominance of mega caps and their increasing index weightings, these implementation costs are likely to become more pronounced.

A market driven by its own architecture

Taken together, these developments point to a shift in market behaviour.

Markets are becoming:

- Highly interconnected
- Increasingly reflexive
- Sensitive to structural imbalances

Volatility is no longer purely a response to external events. It is generated internally, through the interaction of flows, hedging, and index mechanics.

Conclusion: Rethinking passive investing

The traditional perception of passive investing as stable and low friction is becoming less persuasive.

As mega cap issuance grows and new entrants arrive at unprecedented scale, passive investors are becoming active participants in market dynamics, driven by the need to rebalance at speed and size.

The key question is whether current index frameworks remain appropriate in a market where corporate actions by a small number of companies can influence the entire system.

Passive investing is no longer purely passive. It has become a central component of the market's structure, and one that may increasingly amplify volatility rather than mitigate it.

apexgroup.com

Contact us | Disclaimer

8609_220726