



UNDERSTANDING INDEX RECONSTITUTION IN AN ERA OF MEGA-CAP IPOs

Do You Know What's in Your ETF?

The annual Russell index reconstitution rarely makes headlines outside of investment circles.

But what exactly is index reconstitution?

Think of it as a periodic update that allows index providers to reassess which stocks belong in an index and how much of an allocation each stock should receive.

This year's reshuffling, however, offers an important reminder that indexes evolve with markets. And the changes can have meaningful implications for investors in related exchange-traded funds (ETFs) and mutual funds.

The numbers alone are striking. The Russell 3000, which represents the broad U.S. equity market, grew from \$58.4 trillion to \$75.6 trillion in market value over the past year. The 10 largest companies now account for more than \$26 trillion of that total. This highlights how concentrated the market has become in a handful of massive companies.

But the most important takeaway is what the data reveals about a larger shift beneath the surface of the market.

Indexes Frequently Change

Some investors think of index funds as stable, diversified holdings. In many ways, they are, often holding hundreds if not thousands of stocks, depending on the benchmark they seek to track. But indexes are rules-based structures that must adapt as companies grow, shrink, merge, spin off or go public.

This year's Russell reconstitution produced some significant changes. Several stocks that had become significant holdings in the Russell 1000 Value Index moved into the Russell 1000 Growth Index. Other companies graduated from the small-cap Russell 2000 into the large-cap Russell 1000 after experiencing large gains in market capitalization.

None of this is inherently good or bad. In fact, reconstitution is working as intended. The process helps indexes accurately reflect the markets they track. But it also highlights an important reality: Buying an index fund today does not guarantee you'll own the same portfolio a year from now.

The Next Wave Is Coming

If index changes seem significant today, the next six to 12 months could bring even larger shifts.

Consider SpaceX, whose recent IPO placed it among the largest publicly traded companies in the world. Future offerings from companies such as Anthropic, OpenAI and other AI-related firms could follow a similar path. These aren't startup IPOs of the past. These businesses could enter public markets with valuations measured in hundreds of billions—or even trillions—of dollars.

Historically, companies spent years growing into major index constituents. Today, they may enter public markets already large enough to command meaningful positions in broad-market benchmarks.

That matters because indexes, and the ETFs and funds that track them, don't decide whether the valuation is attractive or whether the timing is right. Their job is to own what the benchmark tells them to own, so they must buy or sell stocks in proportion when the index changes.

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The Float Effect

There's another layer to the story that receives less attention.

When many large companies first go public, only a portion of their shares are available for trading. Founders, employees and early investors often hold significant blocks of restricted stock.

As more shares enter the public market, a company's "float" increases and earns a larger weighting in major indexes. As that happens, index funds may need to buy more shares to keep pace with benchmark changes.

In other words, a company can become a larger holding in an ETF even if an investor never purchases another share of the fund.

Passive Investing Meets Market Concentration

Passive investing ranks among the most successful innovations in modern finance. Low costs, tax efficiency and broad diversification have created significant benefits for investors.

We believe those advantages are not going away.

But the composition of indexes matters more when market leadership becomes increasingly concentrated. As of this year's Russell reconstitution, the 10 largest companies represented over one-third of the entire value of the Russell 3000.

Now consider what happens if several of the world's largest private companies join public markets over the next year. Some will earn significant index weightings. Others may debut at valuations that immediately place them among the market's largest stocks.

Investors who buy an index fund will own those companies whether or not they've evaluated the business, considered the valuation or developed a view on the investment opportunity. This is a key difference between index investing and active investing with a portfolio manager who is considering those factors before adding a stock to their portfolio.

Again, that's not a criticism of indexing. It simply recognizes that investors need to understand what they own as indexes grow more concentrated and dynamic.

Looking Ahead

Markets evolve over time. New industries emerge. Leadership changes. Private companies become public giants.

Index providers adjust their benchmarks right alongside those market changes.

For investors (and wealth managers), the takeaway is straightforward: Understand the index behind your ETF or fund. As new IPOs enter the public markets and benchmark compositions shift, that knowledge may become increasingly valuable.

If you'd like to discuss how index construction, concentration risk or emerging IPOs fit into your portfolio, your advisory team is here to help.

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