S&P500 Concentration risk and the case for factor diversification

The Magnificent Seven now account for more than 35% of the S&P 500. For advisers, this transforms what clients see as passive, diversified exposure into a concentrated bet on mega-cap technology stocks. Factor diversification offers a structural response, without requiring market timing.

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You know the conversation. A client, or an investment committee member, asks why you don't put everything in the S&P 500. It's beaten most alternatives for years. The numbers are hard to argue with.

But that question misses something. The S&P 500 they're asking about isn't the index of ten years ago. The Magnificent Seven — Apple, Microsoft, Nvidia, Amazon, Alphabet, Meta, and Tesla — contributed more than half the index's gains in 2023 and 2024, according to Bespoke Investment Group data reported by CNBC. JP Morgan analysis shows the return gap between these seven stocks and the remaining 493 has widened sharply: 44% versus 5% since January 2023.

You're not alone if clients are asking why diversified portfolios have lagged. But the better question is: what are the risks of that concentration, and what's the evidence for alternatives?

The new shape of concentration risk

Concentration in the S&P 500 has reached levels not seen since the early 1970s. The top ten stocks now represent around 40% of the index. A decade ago, the figure was closer to 20%.

If a client came to you with a business where seven customers accounted for 35% of revenue, you'd flag the risk immediately. The same logic applies to portfolios.

"You are concentrating risk in a relatively small number of names, which is at a historic high," says Garrett Quigley, Co-Chief Investment Officer at Global Systematic Investors. "This is an unusually extreme level of concentration, and historically such extremes have tended to be unsustainable."

It's a problem that extends beyond US borders. MSCI World, often positioned as globally diversified, now has its top ten holdings at around 21%, according to Complementa data. Global diversification increasingly means owning the same mega-caps through a different wrapper.

How did we get here?

Two forces drive concentration in cap-weighted indices, and both are mechanical rather than fundamental.

First, cap-weighting amplifies winners automatically. When a stock's price rises, its market capitalisation grows, and its weight in the index increases. No decision required. The index owns more of whatever has already gone up.

Second, passive flows reinforce the effect. Morningstar estimates around £700 billion flows into passive US equity funds each year, with passive strategies now holding about 53% of US fund assets. Every pound entering these funds buys more of the largest stocks, pushing prices higher and increasing concentration.

"Your allocation to that investment is driven by a market cap that's been pushed up by rising prices," Quigley explains. "So you end up with a high allocation regardless of what you think about valuation."

Japan offers the cautionary tale. At its bubble peak in 1989, Japanese equities represented roughly 45% of MSCI World. Today that figure sits around 5.5%. The Nikkei 225 took 34 years to recover its previous high. Advisers who remember the certainty with which investors viewed Japanese stocks in the late 1980s will recognise the pattern.

What academic evidence tells us

Factor investing isn't a tactical response to current market conditions. It's built on decades of peer-reviewed research documenting persistent return premiums.

Data from the Kenneth French Data Library at Dartmouth College, covering 1926 to 2023, shows annualised premiums of around 2.3% for size (small minus large, 3.4% for value (high book-to-market minus low, and 3.1% for profitability (robust minus weak. These aren't theoretical constructs. They're observable patterns across nearly a century of market data.

Research from Dimensional Fund Advisors shows no significant differences in expected factor premiums across US, developed ex-US, and emerging markets.

Quigley puts it directly: "That higher-priced stocks tend to deliver lower long-run returns is one of the strongest empirical findings in finance. As a strategic position, I think you are better off being underweight mega-cap growth stocks in the long run."

The logic is straightforward. Buying more of stocks that have already appreciated in price means paying more for each pound of earnings. Higher starting valuations typically mean lower subsequent returns. Factor strategies that tilt away from the largest, most expensive stocks take advantage of this pattern in returns.

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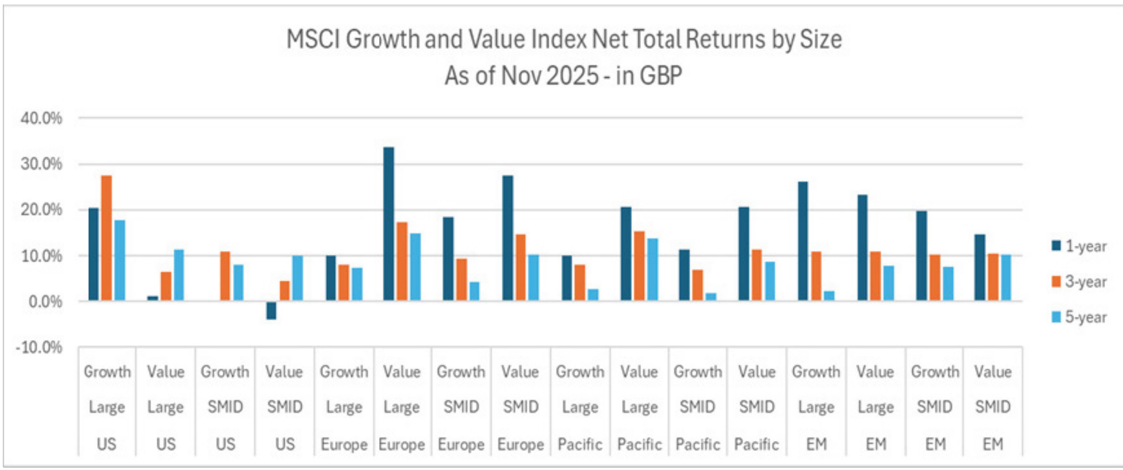

What factors are working now

Factor performance varies significantly by region and market segment. “Outside of the US, value has performed better then many investors may reaiise,” Quigley observes. “Over the last five years, in Europe, Pacific (inc. Japan) and Emerging Markets, value has outperformed growth in both large cap and in small and mid-cap segments.”

“Even in the US, in small- and mid-cap, value has beaten growth. Globally, the recent dominance of growth is really a US large cap phenomenon. In fact, over the last year, large value stocks everywhere outside North America have outperformed US large growth stocks in sterling terms.”

In the US, concentration appears to be receding. Market breadth data supports this. Capital Group analysis shows that by June 2025, 51% of S&P 500 stocks were outperforming the median Magnificent Seven stock. In June 2023, that figure was 1%.

Small-cap valuations look attractive. As of September 2025, small-caps traded close to a 25-year low relative to large-caps on an enterprise value to earnings basis, according to Royce Investment Partners.

International developed and emerging markets show similar patterns. Valuations outside the US sit well below US levels on most metrics. For advisers building globally diversified portfolios, the opportunity set extends far beyond the Magnificent Seven.

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Reducing concentration without abondoning mega-caps

Factor diversification doesn’t mean selling out of large-cap US equities entirely. It means reducing reliance on a few dominant names while maintaining equity exposure.

The concentration data makes a case for looking beyond large-cap benchmarks. Total market indices include mid and small-cap exposure that pure S&P 500 tracking miss-es. Adding dedicated small-cap allocations increases exposure to the size premium while reducing concentration.

Value tilts offer another lever. But implementation matters. Naive value strategies can load up on distressed companies heading toward bankruptcy — the so-called value traps.

"At GSI, we aim to underweight less profitable stocks within the value universe," Quigley explains. "Such stocks tend to have lower returns despite their value-like characteristics."

GSI's Global Aware Focused Value Fund shows the approach in practice. Since its inception in June 2021 to the end of November 2025, the fund delivered 10.04% annualised returns versus 9.77% for the MSCI World IMI Value Index Net Total Return — after fees. The strategy incorporates clients' ESG preferences but does not treat ESG ratings as a source of expected excess return. Returns are expected to be driven by the factor exposures. Geographic diversification rounds out the approach. The fund invests across developed markets, focusing on value stocks in each region.

Addressing the timing objection

But if concentration has rewarded investors so handsomely, why diversify at all?

Consider the dot-com parallel. Valuations looked stretched by 1997. The market ran for three more years before peaking in March 2000. Investors who diversified "too early" underperformed for several years. Those who stayed concentrated lost decades of returns when the bubble burst.

"You just don't know where the end of the cycle will be," Quigley acknowledges. "No one knows where we are in the current cycle. There's really no reliable way of timing these things."

Factor diversification works regardless of whether the concentration trend continues or reverses. If mega-caps keep outperforming, a diversified portfolio still participates — at reduced weight. If concentration reverses, "you're better positioned if you're more diversified with higher exposure to mid and small-cap," as Quigley notes.

Quigley rejects the "everything bubble" narrative. "There are still many parts of global markets that aren't overvalued," he points out. Factor strategies can target those areas systematically, without needing a view on when mega-cap dominance will end.

The asymmetry favours diversification. The upside of staying concentrated is continued outperformance in an already extended trend. The downside is severe underperformance when that trend reverses.

Making the case with confidence

Return to that investment committee conversation. When asked why you don't allocate everything to the S&P 500, you have an answer.

The index has changed. What looks like diversified passive exposure is a concentrated bet on ten companies representing 42% of the portfolio. Any business analyst would flag that as a risk.

Factor diversification offers a structural solution. Size, value, and profitability premiums have persisted across decades of data and multiple market cycles. Implementing them systematically reduces concentration risk while maintaining full equity exposure.

Cap-weighted indices reward yesterdays winners, not tomorrow's returns.

Factor diversification gives Advisors a structural way to reduce concentration risk without trying to time the end of a cycle.

"The timing is unknowable, but the positioning is defensible. Whether mega-cap dominance continues or reverses, a factor-diversified portfolio is built for multiple scenarios.

"The case for doing that seems pretty strong to me currently," Quigley concludes.

Harry Markowitz famously called diversification the only free lunch in finance. When concentration reaches historic extremes, that lunch looks more valuable than ever.

Resources

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