

THE ILLUSION OF DIVERSIFICATION

Why concentrated markets demand active judgement and valuation discipline.

Introduction

After one of the strongest bull markets in U.S. history, it may be tempting to conclude that passive index investing is all an investor needs. The S&P 500—lifted by a narrow group of mega-cap technology companies—has delivered impressive headline results. Yet beneath the surface, significant risks are building—risks that passive investing, by design, struggles to address. These include extreme concentration in a few stocks, the ever-changing nature of market leadership, unsustainable valuation gaps, and structural inefficiencies emerging in an index-centric market. Disciplined active management offers the flexibility to mitigate these risks and capture opportunities that broad indexes often overlook. We assert that in today’s environment, high-conviction, valuation-disciplined active management is more vital than ever for U.S. large-cap equity investors.

For institutional investors charged with fiduciary oversight, the rising concentration of market returns poses unique portfolio and governance risks that passive structures cannot mitigate.

Concentration & the Evolution of Market Leadership

The S&P 500, long viewed as a proxy for broad diversification, is increasingly dominated by a handful of companies. The top ten stocks now account for nearly 40% of the index by weight—unseen in modern history. In 2023-2025¹, the “Magnificent Seven” tech giants alone grew to a combined market capitalization rivaling the size of entire national stock markets (**Figure 1**).

¹ As of October 31, 2025.

Key Takeaways



The S&P 500 Index has become heavily concentrated in a handful of mega-cap tech stocks, potentially leaving passive investors overexposed to a narrow slice of the market.



Passive indexing may magnify valuation and governance risks by automatically allocating more capital to yesterday’s winners, regardless of fundamentals or changing leadership.

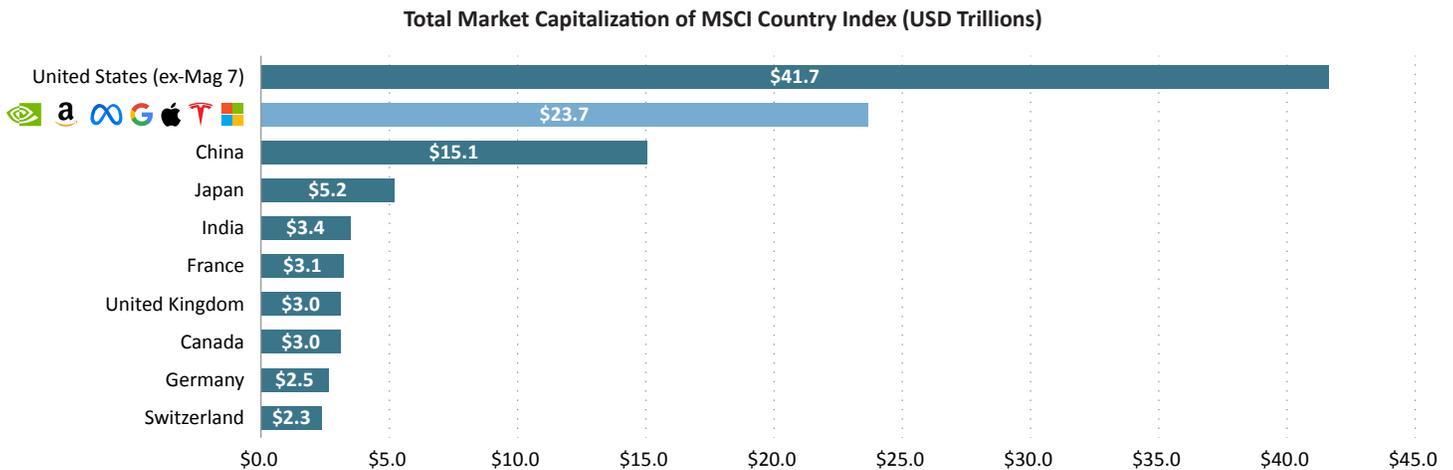


Disciplined active management can better serve investors by applying valuation, quality, and balance-sheet analysis to identify overlooked opportunities and manage downside risk.



Behavioral discipline and patience are critical, as short-term performance chasing often undermines the long-term benefits of active strategies.

Figure 1 The “Magnificent 7” represents the second largest “country” in the world



Source: FactSet, MSCI; As of September 30, 2025.

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For passive investors, this means portfolios that appear diversified are in reality making a concentrated bet on a very small group of companies. While several of these mega-cap businesses remain strong franchises, their growing weight in major indices introduces valuation and concentration risks that passive investors cannot manage. If those few market darlings stumble, a passive portfolio has no mechanism to reduce exposure.

History offers a sobering reminder that market leadership is rarely permanent. AT&T, IBM, General Electric, and ExxonMobil were all once among the largest U.S. companies, yet each eventually gave way to new innovators. Passive investing has no mechanism to adapt to such turnover—by construction, index funds continue holding and even buying more of companies whose fundamentals may be starting to weaken or mature (**Figure 2**).

Figure 2 Despite new paradigms, the largest companies rarely persist

Largest companies by market cap in the world at the beginning of the year

1980	1990	2000	2010	2020	2025*
IBM	NTT	Microsoft	ExxonMobil	Saudi Aramco	NVIDIA
AT&T	Industrial Bank of Japan	General Electric	Apple	Apple	Microsoft
Exxon	Sumitomo Bank	Qualcomm	PetroChina	Microsoft	Apple
Standard Oil	Fuji Bank	Cisco Systems	Microsoft	Alphabet	Alphabet
Shell	Dai-ichi Kangyo Bank	Walmart	BP	Amazon	Amazon
General Motors	Mitsubishi Bank	AT&T	HSBC	Meta	Meta
Mobil Oil	Toyota	ExxonMobil	Petrobras	Alibaba	Saudi Aramco
General Electric	Exxon	NTT Docomo	China Construction Bank	Berkshire Hathaway	Broadcom
Eastman Kodak	IBM	Shell	Berkshire Hathaway	Tencent	Tesla
Atlantic Richfield	General Electric	Lucent	Shell	J.P. Morgan Chase	Taiwan Semiconductor

Source: FactSet, Based on the MSCI ACWI Index.

Underperformance refers to the companies shown relative to the top ten companies in the ACWI Index by market capitalization. This information should not be considered a recommendation to purchase or sell any particular security. Recommendations made in the last 12 months are available upon request. Please see important disclosures at the end of this document.

Companies in red fell out of the top ten by the next decade (meaning: they underperformed).

*2025 is as of September 30, 2025.

Active management, by contrast, allows investors to maintain position-size discipline, selling when market enthusiasm exceeds fundamentals, and redeploying capital toward businesses that can be better positioned for the future. A disciplined active approach requires continuous evaluation of company fundamentals: competitive advantages, management behavior, balance-sheet strength, and the potential catalysts that can unlock value over time. This focus helps differentiate between temporary market leaders and those capable of sustaining long-term value creation.

When leadership inevitably changes, a passive portfolio remains tethered to the past, while a disciplined active portfolio can focus on companies whose fundamentals and valuations support durable value creation. In essence, active management can add value by anticipating change, whereas passive strategies only reflect the past and present.

Artificial Intelligence: Promise, Pressure, and Parallels

The recent artificial intelligence (AI) boom offers a timely example of how market narratives can magnify both opportunity and risk—particularly for passive investors heavily exposed to a narrow group of beneficiaries. AI has become the defining investment story of 2025, driving trillions of dollars of market capitalization gains for a few key players in semiconductors, cloud computing, and AI platforms.

The hype and capital inflows are enormous—driven by the belief that rapid AI adoption will soon translate into explosive earnings growth. Industry leaders have announced record-scale capital expenditure plans, yet broad, profitable monetization beyond narrow use cases remains uncertain. History urges caution: The dot-com and telecom buildouts of the late 1990s were similarly fueled by transformational dreams, but many of those investments failed to deliver returns commensurate with expectations.

The AI buildout is also straining power grids and utility infrastructure—systems stretched too thin tend to fail at the core, not the margins. If capacity growth cannot keep pace, lofty projections for AI-driven economic expansion could prove difficult to sustain, at least in the near term.

For investors, the AI surge presents a paradox: The companies most associated with AI carry the highest expectations

and valuations, while more mundane “picks-and-shovels” beneficiaries—such as infrastructure, industrial, and service providers—may offer steadier long-term returns at far more reasonable prices. Passive strategies are forced to own the obvious winners at any valuation, whereas active managers can differentiate between sustainable opportunity and speculation—participating selectively where fundamentals justify it and allocating capital toward overlooked businesses positioned to benefit indirectly from AI adoption.

The AI boom thus exemplifies a broader reality. Valuation extremes are once again shaping market dynamics, and the illusion of safety in size has rarely been more pronounced.

Valuation and the Illusion of Safety

Market-cap-weighted indices inherently allocate more capital to stocks that have already gone up the most. This creates an illusion of safety in size—investors take comfort in owning the biggest companies, even if their prices have far outrun fundamental value.

Today the valuation gap between growth and value stocks sits near multi-decade extremes. A concentrated group of large-cap companies commanding premium valuations are priced as though years of extraordinary profitability are assured, while many steady, cash-generative businesses outside the spotlight trade at significant discounts. The recent surge in AI-related investment has intensified this divide: Hundreds of billions of dollars are being spent each year on data centers, semiconductors, and supporting infrastructure, yet broad, profitable monetization beyond a few specialized use cases remains uncertain. Such mismatches between capital investment and realized earnings are often a hallmark of overheated markets.

Index funds, by design, will pour more money into these heavily weighted stocks simply because they are large, while overlooking many fundamentally sound but less popular businesses with smaller weights. This momentum-by-construction dynamic can be dangerous; it was similarly the case in 1999, when the largest technology companies traded at extreme valuations while many quality businesses were left behind.

Valuation discipline is essential but cannot be applied in isolation. Long-term investors must first assess business quality, durable competitive advantages, financial strength, and capital allocation priorities. Valuation serves as a framework for understanding

risk and potential reward, not as a short-term signal. By pairing this discipline with ongoing assessment of catalyst strategic, operational, or structural factors that can unlock value over time—we seek to differentiate between businesses capable of compounding value and those whose market prices rest on less sustainable assumptions.

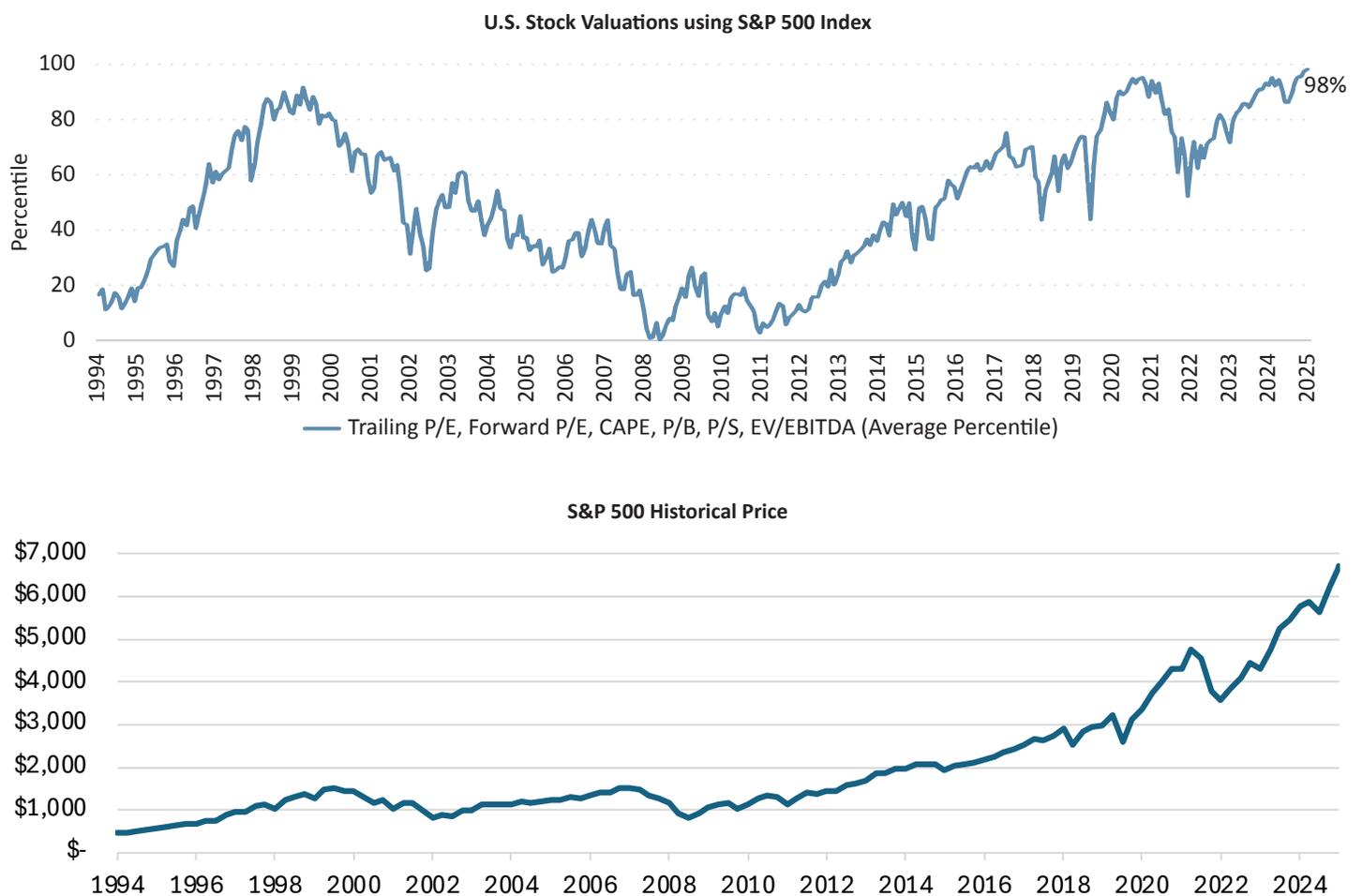
Active managers with a disciplined eye on valuation can exploit these inefficiencies by leaning into undervalued, fundamentally solid companies and trimming or avoiding overhyped names. This approach is not about predicting short-term swings but about ensuring that each investment’s value proposition remains sound and supported by underlying fundamentals.

In today’s market, we believe many durable businesses outside the index heavyweights offer better risk/reward profiles. Only through active management can capital flow toward these opportunities, supporting genuine value creation rather than market momentum.

Markets Have Grown Less Efficient

Adding to these challenges, evidence suggests that markets themselves have become somewhat less efficient in recent years. The rise of passive investing—now well over half of U.S. equity assets—means ever more dollars are allocated without regard to individual company fundamentals. This can lead to

Figure 3 As the S&P 500 has hit an all-time high, valuations have reached a 30-year peak



Source: Bloomberg

price distortions. We observe that valuation spreads between expensive and cheap stocks have widened dramatically at times, and mispricings have become more severe and longer-lasting. In a fully efficient market, such gaps would be quickly arbitrated away. But when a large fraction of trading is just indexing or quantitative strategies indifferent to valuation, who is left to correct mispricings? Fewer active stock pickers in the market can actually create more opportunities for the remaining active managers. In other words, for active investors, market inefficiency is not a frustration; it is a source of opportunity. If a good business's stock is languishing due to a temporary narrative or because it's not in a popular index, an active manager can buy it and wait for the value to be realized. Passive holders cannot exploit such situations; they are the ones inadvertently *creating* them.

The Power of Patience vs. Chasing Recent Performance

Investors are only human, and a well-documented behavioral pitfall is the tendency to chase what has been working and flee what has not. In the context of active management, this often means hiring managers after they've had a hot streak, and firing managers after they've had a slump. Unfortunately, this can lead to a classic "buy high, sell low" outcome.

Research by Amit Goyal and Sunil Wahal on institutional plan sponsors illustrates this point vividly.² In a large study of over 3,400 hiring and firing decisions by pension plans and other

institutions, they found that plan sponsors typically hired new investment managers right after those managers had delivered very strong returns and conversely fired existing managers after periods of weak returns.

However, the subsequent performance did not justify these moves. On average, the newly hired managers did not continue outperforming—their post-hire excess returns were either negative or minimal compared with pre-hiring performance. The fired managers, once terminated, often saw their performance mean-revert such that their returns after firing were as good as the replacements. In fact, Goyal and Wahal found that if the plan sponsors had simply stayed with the fired managers, they would have achieved outcomes no worse (and sometimes better) than those delivered by the new hires.

In short, chasing recent winners and cutting losers added no value—and often detracted value after considering transaction costs. This pattern highlights a structural behavioral problem: Even sophisticated institutions are prone to abandoning long-term strategies at precisely the wrong time.

Academic and industry research reinforces this point. A Vanguard study found that even top-performing active managers—those who ultimately beat the market over full cycles—spent between 40% and 60% of all one-year periods underperforming the index. On average, such managers experienced a continuous downturn relative to their benchmarks lasting two years or more once per decade. Nearly all saw at least one 20% or larger drawdown relative to their benchmarks during their careers.

Figure 4 Gross excess return of U.S. equity managers before and after being hired²

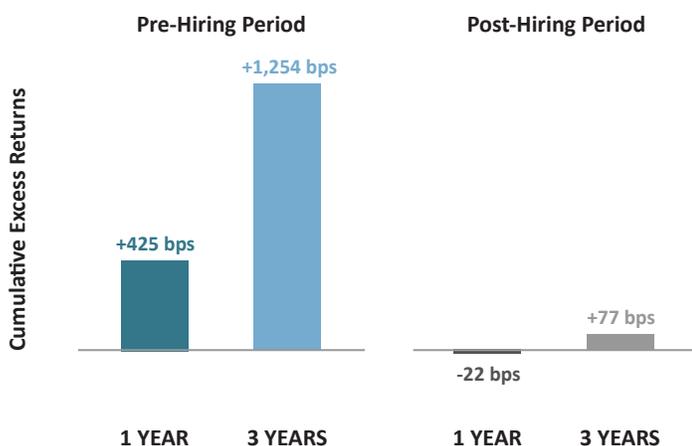
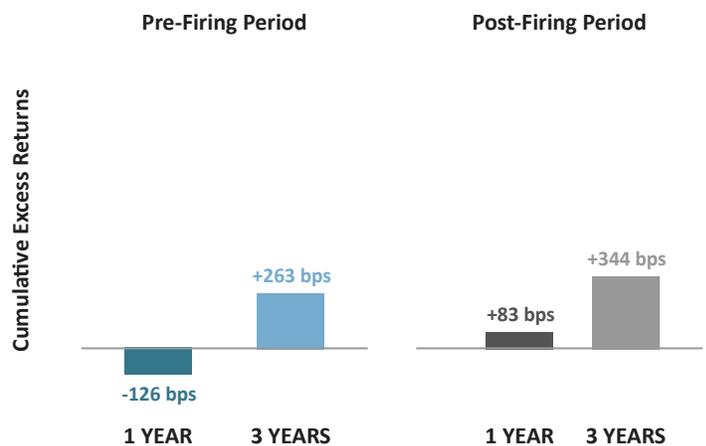


Figure 5 Gross excess return of U.S. equity managers before and after being fired²



² Source: Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors," *Journal of Finance*, August 2008. Manager performance tracked between 1994-2003. Excess returns calculated versus managers' respective benchmarks.

In other words, patience—not prediction—is often the deciding factor in whether investors actually capture the alpha their managers generate.³

Avoiding this performance-chasing cycle requires strong governance and conviction. Institutions should focus less on one- or three-year results and more on whether a manager continues to adhere to their stated process and investment discipline. Evaluating consistency of philosophy, team stability, and portfolio fundamentals is far more predictive of long-term success than reacting to short-term fluctuations, in the Vanguard study authors' view.

Patience, paired with sound due diligence, is often the key differentiator between long-term success and reactive decision-making. For fiduciaries, this discipline is not merely behavioral—it is a governance imperative. The ability to remain invested through periods of temporary underperformance may determine whether an institution benefits from active management's potential alpha or simply funds it for others.

Lessons from the “Superinvestors” of Graham-and-Doddsville

While statistical studies highlight the challenges of active management, history also provides compelling evidence that disciplined approaches can outperform over time. One of the clearest demonstrations came from Warren Buffett's 1984 essay *The Superinvestors of Graham-and-Doddsville*, which profiled nine investment managers—all trained in the principles of value investing—who consistently achieved exceptional long-term results.

Though their portfolios differed, each shared a common foundation: investing in businesses trading below intrinsic value, maintaining a margin of safety, and thinking like long-term owners rather than traders. Their performance, sustained across decades and market cycles, was far beyond what chance could explain. Buffett's conclusion was simple: persistent outperformance is not luck—it is the outcome of skill, discipline, and adherence to a sound philosophy.

The lesson for investors remains as relevant today as it was then. Active management grounded in fundamental research, patience, and conviction can produce meaningful long-term

results. What we find unites the most successful practitioners—past and present—is not prediction or market timing, but the consistent application of a thoughtful, repeatable process that focuses on quality, valuation, and long-term value creation.

Active Share: Why Truly Active Managers Can Win

One practical way to identify an active manager's level of conviction and differentiation from the benchmark is by examining their Active Share. Active Share is a metric that measures the percentage of portfolio holdings (by weight) that differ from the benchmark index. A high Active Share means the fund looks very different from the index (via stock selection), whereas a low Active Share indicates the fund largely overlaps with the index (often called a “closet index” because such a fund charges active fees but essentially hugs the benchmark).

Research has shown that Active Share can be a useful predictor of performance. Portfolios with very low Active Share have tended to underperform net of fees (not surprising, since they are basically index funds charging higher fees), whereas funds with high Active Share—i.e., truly active, concentrated portfolios—have shown better odds of outperforming.

Academic research by Martijn Cremers (University of Notre Dame) and Antti Petajisto, who first introduced the concept of Active Share, found that funds with very low Active Share tend to underperform after fees, while truly active, high-conviction funds have better odds of outperformance over time.

In one study covering 1990–2015, the lowest-active-share equity funds lagged their benchmarks by an average of about 1.4% per year, while the highest-active-share funds slightly outperformed by ~0.7% per year. The spread between the top and bottom Active Share groups was roughly +2.1% per year in favor of the high Active Share funds. Importantly, there was no evidence that high Active Share funds as a group underperformed their benchmarks over time—in other words, truly active managers did at least as well as the index on average (often better), whereas closet indexers reliably did worse once fees were accounted for.⁴

For institutional allocators, Active Share provides a practical framework to assess whether active managers are genuinely differentiated or merely charging active fees for passive

³ Source: Chris Tidmore and Andrew Hon, “Patience with active performance cyclicality: It's harder than you think,” *Vanguard*, October 2020

⁴ Source: Martijn Cremers, Jon Fulkerson, Timothy Riley, “Active Share and the Predictability of the Performance of Separate Accounts,” *Financial Analyst Journal*, October 2021.

exposure. It's worth noting that simply being different from the index is not a guarantee of success—it matters why a manager is different. This is where factors like skill, investment process, and risk management come in.⁵

Subsequent studies have reinforced that the most successful active managers tend to be those with both high Active Share and patient investment styles (low turnover). One study found that “patient managers with high Active Share have been quite successful” over time. Published in the *Financial Analysts Journal*, the authors extended this concept to institutional separate accounts. It found that among separately managed portfolios, those with high Active Share exhibited performance persistence, and in fact the top performers with high Active Share went on to deliver significant alpha in subsequent periods.⁶

What does this mean for investors? When selecting active managers, avoid low-active-share funds (which are unlikely to overcome their fees or the index by much). Instead, look for managers with the courage of their convictions—portfolios that look different, backed by a clear investment rationale. Those differences should stem from a disciplined, repeatable process rather than style drift or short-term bets. The evidence indicates that high-active-share, high-conviction managers are the ones most likely to deliver excess returns in the future. These are typically managers who think and act very differently from the index, often with a value and/or quality bias, and who have the patience to hold positions until the market recognizes their value.

Conclusion: Looking Ahead for Long-Term Investors

The dominance of mega-cap growth stocks in recent years has led many to believe that passive indexing is the only sensible choice—after all, why not just own the index that has been hard to beat? However, we believe this is a dangerous oversimplification. The conditions that prevailed in the last decade—a handful of companies leading an uninterrupted bull market—may not persist into the next. Markets are ever-changing: leadership turns over, valuations eventually matter, and investor sentiment swings create cycles of boom and bust.

As we head into 2026 and beyond, several structural risks loom

for passive investors: extreme concentration, the potential unwinding of crowded trades (such as an overcrowded AI trade if merely remarkable results disappoint), and a market increasingly prone to inefficiencies due to widespread indexing. Passive strategies, by their nature, offer little to no defense against these risks – they will ride the market up, but also ride it all the way down.

Active management, on the other hand, offers tools to navigate what lies ahead. A concentrated yet diversified active portfolio can provide true risk diversification—not by the number of holdings, but by avoiding over-exposure to the most overvalued and vulnerable areas. A disciplined quality-first, intrinsic value approach can protect capital when frothy segments of the market eventually come back to earth. Crucially, active management can incorporate *normalized* fundamentals—balance sheet strength, margin structure, free cash flow, etc.—whereas an index only reflects yesterday's winners.

To be clear, not every active manager will outperform, and success requires selecting skilled managers with the right approach and sticking with them. As discussed, investors must be prepared for stretches of underperformance and avoid the pitfalls of performance chasing. But for those willing to take the long view, the rewards can be significant and compound in their favor. In our view, the case for active management in U.S. large caps is stronger now than it has been in years; markets are less forgiving of complacency, and the gap between the index's structure and investors' true objectives (like capital preservation or consistent income) is widening.

Successful active management is not about trading frequently or predicting short-term market moves—it is about discipline: evaluating businesses carefully and investing in those whose quality, valuation, and long-term fundamentals support sustainable value creation. Effective active strategies differ meaningfully from broad market indices because they reflect conviction rather than replication.

For fiduciaries overseeing long-term pools of capital, the objective is not merely to track an index but to allocate capital prudently on behalf of beneficiaries. Maintaining an active perspective is not a luxury—it is an obligation to invest with discernment and foresight.

⁵ Source: Martijn Cremers, “Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity,” *Financial Analyst Journal*, December 2016.

⁶ Source: Martijn Cremers, Jon Fulkerson, Timothy Rille, “Active Share and the Predictability of the Performance of Separate Accounts,” *Financial Analyst Journal*, October 2021.

In practice, the goal for most clients is not simply to own the market at all times; it is to achieve specific financial objectives (be it retirement funding, endowment growth, or capital preservation) with the highest probability of success. That requires not only capturing upside in good times but also protecting on the downside and positioning for share gains through the cycle. Active management, applied with discipline, provides the human judgment, flexibility, and foresight that are especially valuable when the future may not resemble the recent past.

The forward-looking case for active managers who are high-conviction, valuation-conscious, and patient is compelling: These managers can build portfolios that look very different from the index and exploit its shortcomings, while aligning with the timeless fundamentals of investing. In a world where passive funds blindly follow the herd, the active contrarian with a steady hand may well have the last laugh. Institutional investors benefit from maintaining such insight and adaptability as they navigate the next chapter in the markets.

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