

COMMENTARY 21

AI boom turns S&P 500 into a dangerous bet



ROGER MONTGOMERY

The broad-based S&P 500 index has been the ultimate symbol of quality stockmarket diversification for decades. So effective was the index's diversification that if energy stocks waned, consumer staples cushioned the blow. If financials faltered, industrial giants picked up the slack.

That, and the fact some 80 per cent of corporate profits were reinvested rather than paid out as dividends, as they are here in Australia, meant the S&P 500 has consistently trounced its poor Aussie cousin.

It's also worth noting that 45.4 per cent of the ASX 200 is comprised of financial companies such as the big banks while nearly 17 per cent is in materials, which includes BHP and Rio Tinto. This compares to 16.1 per cent and 3.5 per cent respectively for the S&P 500.

But the world's most widely followed equity benchmark has morphed into something unrecognisable. No longer is it an economic cross-section but instead a highly concentrated, thematic bet on AI.

Independent market structure data reveals the S&P 500's top 10 constituents – led by Nvidia, Apple, Microsoft, Alphabet, Amazon and Meta – now command between 35 per cent and 38 per cent of the total index weight. Nvidia alone now carries a market capitalisation weighting of roughly 7 per cent, an allocation that effectively outweighs the bottom 100 companies of the entire index combined.

More concerning for investors is the underlying thematic exposure. Direct semiconductor listings now account for nearly a fifth of the S&P 500's total capitalisation and when we widen the lens to include "AI-narrative" equities – hyperscalers, cloud infrastructure providers, AI-adjacent consumer tech and software platforms – up to 60 per cent of the index's total valuation is currently driven by the artificial intelligence thesis.

That's just super dangerous because what you've been sold as being a "balanced" equity exposure has effectively become a wager on a single technological epoch. And given nearly \$US1 trillion (\$1.43 trillion) of foreign flows have been hurled into US equities in just the past 12 months alone, the reversal will have devastating consequences for global consumer confidence and economic growth.

Meanwhile, as capital crowds into the momentum-driven AI narrative, conservative "quality" factor investing has been pushed to the margins.

The six-month relative return of the S&P 500 Quality Index has plunged to -11.5 per cent against the broader market. This is the steepest underperformance for "quality" as a factor since April 1999 – a year before the absolute height of the dotcom bubble.

In fact so extreme is the divergence between market momentum and corporate fundamentals, it has rarely been observed in modern financial

history. Over the past 12 months, the US All-Cap Momentum factor has surged significantly, while a corresponding basket of Quality equities – defined by low net debt, stable free cashflow, and high returns on equity (ROE) – has severely lagged, creating a historic 30-percentage-point performance spread.

And this hurts personally – I wrote the book on identifying quality companies, and that book may as well be a paperweight right now.

Alpine Macro's quantitative research reveals the gravity of this anomaly: the price-to-earnings ratio between US Momentum stocks and Minimum Volatility stocks has risen to five standard deviations above its long-term average. In statistical terms, a five-sigma event should occur roughly once every 4776 to 13,932 years, and today's exceeds the highest divergence levels seen during March 2000, June 2008 and February 2021.

For the second half of 2026, investors need to question not whether AI will ultimately transform global productivity – most agree it will. Rather, the dilemma is whether a prudently managed portfolio can allow a single theme to dictate up to 60 per cent of the equity risk.

Fortunately, as I write this column, investors who have made money off this anomaly have the option of locking it in, banking the gains and diversifying away, even outside the stockmarket.

At the same time, the current disparity offers a rare, structural mispricing. Quality companies are currently trading at their most attractive relative valuations in a quarter-century, precisely because they lack exposure to the AI narrative.

Historically, five-sigma factor expansions inevitably mean-revert. This means AI will slump at least relative to quality. Of course, AI could take quality with it – all boats sink when the tide runs out – but AI will hurt much more.

The shift, however, could also trigger a multi-year cycle of quality outperformance. Just keep in mind rebalancing toward quality in a portfolio today is less about timing a sudden market rotation and more about fundamental risk management.

Vanguard's long-running Advisor's Alpha study notes the "behaviour gap" – the performance lost by average investors chasing the latest hot narrative and abandoning disciplined asset allocation – costs portfolio returns an estimated 1.5 per cent annually. And I reckon the cost of waiting this time around could cost a lot more than 1.5 per cent.

The S&P 500 has officially become structurally indistinguishable from a tech fund. Meanwhile, the unglamorous, cash-generating firms with high rates of return on equity and little or no debt – the companies Warren Buffett advised investors to own for the past 50 years or more – have been left behind. They are no longer just value plays.

In today's concentrated market environment, quality is the ultimate opportunity for genuine diversification, although Buffett's record \$US400bn cash pile says waiting may not hurt.

Roger Montgomery is founder and CIO of Montgomery Investment Management.