Assessing Concentration Risk in the S&P 500 and Nasdaq 100 Indexes

Through the first half of 2023, the stock market has embarked on an admirable rebound from a 2022 that left most of us cursing under our breaths. Year to date, the S&P 500 and Nasdaq 100 are up approximately 16% and 38% respectively (5). Certainly nothing to scoff at for either index, but nevertheless, there's a clear disconnect between the two. It's easy to sit and wonder: why not abandon the S&P 500 in favor of the turbo powered Nasdaq? The answer, of course, is not so simple.

The first difference of note is the number of companies that they each hold; they're aptly named with the S&P holding 500 and the Nasdaq 100. Both indexes are market cap weighted, meaning that the larger the company is, the bigger its weight will be within the index (1)(2). By virtue of having fewer total holdings, the Nasdaq is a much top-heavier index. For every dollar invested in the S&P 500, 22 cents go to the top 5 companies; with the Nasdaq, that number jumps to 43 cents (3)(4).

The second difference between the two indexes is their composition. While both are market cap weighted, they aren't choosing their companies from the same pool. The S&P 500 includes the 500 largest companies trading on either the New York Stock Exchange (NYSE), the Chicago Board Options Exchange (CBOE), or the Nasdaq Exchange; albeit with a few entry requirements outside of size. The Nasdaq 100 on the other hand, includes only the largest 100 companies that trade on the Nasdaq Exchange, while completely excluding any companies belonging to the financial sector (1)(2). Understandably, this creates quite a difference in the makeup of the two indexes. Most notably, 51% of the Nasdaq is invested in the Technology sector, with the S&P allocating only 29%. The differences get even more stark when you look at the style of company in each index. The Nasdaq allocating 70% to growth companies, with only 8% to value; while the S&P allocates 41% to growth companies, and 23% to value. The remainder going to companies considered to be a blend between the two (5).

Circling back to our question about abandoning the S&P 500, the answer ultimately comes down to concentration risk. By investing in the Nasdaq, you're placing a lot of faith in those top 5 companies, and a lot of faith in the technology sector. To a certain extent, this is also true with the S&P 500, but the picture it paints matches the total US stock market far better than the Nasdaq does. Right now, maybe the technology sector looks strong, and maybe those top 5 companies are looking mighty infallible; but as with all good things, nothing lasts forever. Being so highly concentrated in one sector, or individual holding, opens you up to the unnecessary risk of that sector or company falling on hard times. Looking back to the technology bubble of the early 2000's, or the financial crisis of 2008 shows us that no sector is immune to a significant downturn, and attempting to see that coming and time your exit is what many people in this industry refer to as a "fools' game."

In the end, the question shouldn't be the S&P 500 versus the Nasdaq 100, but rather one about diversifying away the risks involved in investing in any one index.

Written by Justin Hamlin, CFP®, AEP ® and Ben Bulchik

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1: https://www.investopedia.com/terms/n/nasdaq100.asp

2: https://www.investopedia.com/articles/investing/090414/sp-500-index-you-need-know.asp

3: https://www.slickcharts.com/nasdaq100

4: https://www.slickcharts.com/sp500

5: Kwanti Analytics / Morningstar Historical Price Data