

Q2 2026

ETF/index outlook: diversify and thrive



It should be noted that diversification is no guarantee against a loss in a declining market.



Delivering diversification¹

Concentrated equity market leadership. Heightened geopolitical risk. Bond/equity correlation uncertainty.

It's no great surprise that diversification is top of the wish list for many risk-aware investors today. This is particularly true following the onset of the conflict in the Middle East, which has increased market volatility. Instead, the question is how to achieve it.

In this publication, we offer three different perspectives on diversification, each combining detailed insights with practical solutions investors may wish to consider using today:

1. Why dividend income strategies may help increase sector diversification
2. The role of equal weight in overcoming equity market concentration risk
3. Why turning a factor investing lens on thematic strategies could reveal untapped diversification potential

What connects all of these ideas is the need for thoughtful implementation via strategies that aim to overcome real-world investor challenges.

I hope you find these articles useful and thought provoking.



David Barron,
Global Head of Index and ETFs



The role of dividends in a diversified strategy

By targeting dividend income, we believe investors can increase their allocation to sectors overlooked by market-cap indices.

Elisa Piscopiello, Senior Index and ETF Analyst

Key takeaways:

- Dividend payments can help investors reduce exposure to stock market volatility, and modern strategies can target regular, stable income for predictability and liquidity management
- A dividend income strategy can increase sector diversification, increasing exposure to cheaper parts of the market
- A quality-focused and equal weighting approach can help avoid dividend traps



For many investors, diversification² means gaining exposure to assets across a range of sectors and geographies. But true diversification isn't 2D – it spans many dimensions, and can be targeted in many ways.

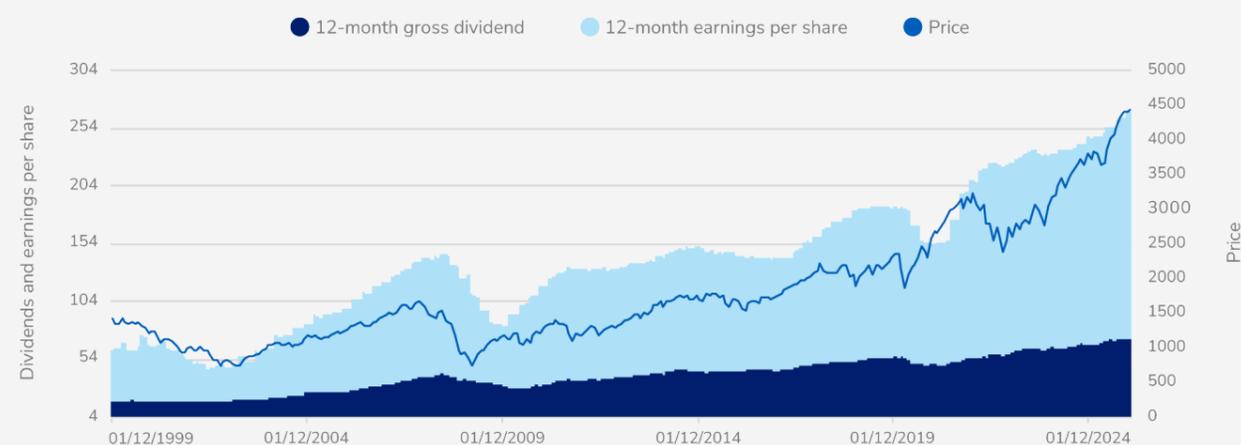
Income type is a good example of a potentially overlooked diversifier. Rather than relying only on capital growth, we believe investors may do well to consider the income

component of returns, which has historically provided greater stability than capital growth.

We believe an income-focused approach can be particularly useful for investors who aim to achieve more stable income through market cycles.

Dividend income strategies now exist that aim to target a smooth, monthly income distribution, providing better liquidity management and predictability.

Dividends and earnings of the MSCI World Index

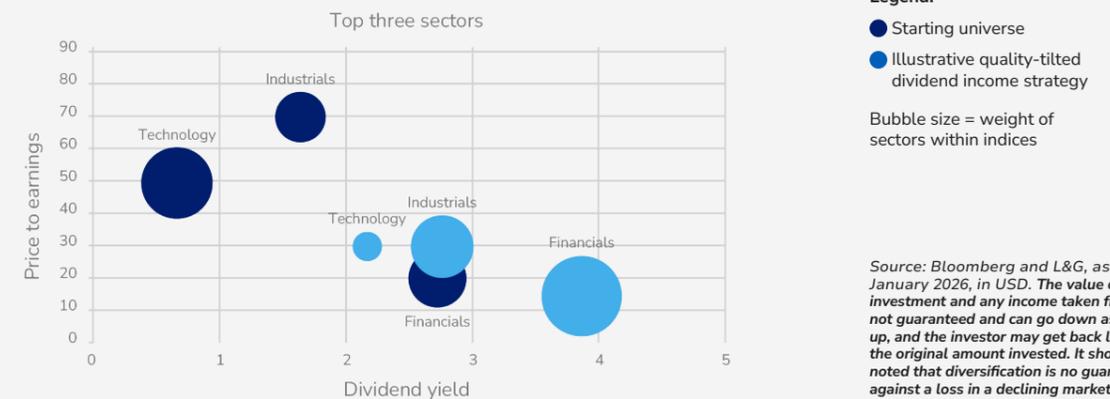


Price and earnings have historically been at least two times more volatile than dividends:

	Annualised standard deviation
12-month gross dividend per share	6%
12-month earnings per share	17%
Price	15%

Source (table and chart overleaf): L&G, Bloomberg, monthly observations from 31 December 1999 to 31 December 2025. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.

Targeting sector breadth, higher income and cheaper valuations



Legend:
 ● Starting universe
 ● Illustrative quality-tilted dividend income strategy
 Bubble size = weight of sectors within indices

Source: Bloomberg and L&G, as of 30 January 2026, in USD. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested. It should be noted that diversification is no guarantee against a loss in a declining market.

There are several important takeaways from the chart above:

- 1. Wider sector breadth:** The bubble sizes represent the weight of sectors within the indices. The illustrative quality-tilted dividend income strategy displays lower exposure to IT, and higher exposure to financials and industrials
- 2. Higher income:** The horizontal axis displays 12m dividend yield, as a weighted average based on the underlying sectors. Within each sector, the illustrative quality-tilted dividend income strategy offer exposure to higher-income stocks
- 3. Cheaper valuations:** The vertical axis displays price to earnings, as a weighted average based on the underlying stocks. Within each sector, the illustrative quality-tilted dividend income strategy offer exposure to cheaper stocks

Dividends as a value-hunting tool

At a time when multiples are high pretty much everywhere, we believe dividends can provide access to better-valued segments of the market.

This is because dividends tend to come from companies that have overcome their highest-growth phase. They are still investing in growth but have spare cashflows to return to shareholders, instead of investing everything in growth opportunities. Healthcare, industrials and consumer services are examples of important dividend sectors that don't have the 'growth' multiples associated with technology.

The chart above shows an illustrative quality-tilted dividend income strategy versus a standard market cap weighted index. By targeting sources of dividend income, this strategy overweightes cheaper parts of the market, potentially providing both value and diversification.

What about dividend traps?

No discussion of dividend strategy would be complete without mentioning dividend traps. At the start of this article we made the case that diversification is multi-dimensional. We believe it's exactly the same with dividend strategy: a well-constructed strategy must look beyond the headline yield and consider income sustainability.

For this reason, we think it's important to include a screen based on quality. This screen may be particularly valuable within an emerging market sleeve, simply because these markets exhibit more quality dispersion.

While no single, agreed definition of 'quality' exists, what's crucial is to create a definition that can be scaled across many sectors and regions, and to develop a consistent framework and to screen stocks systematically.

Equal weighting: spreading the load

Another important aspect of dividend income strategy construction is the weighting scheme. While it may feel intuitive to weight based on the level of dividend paid, this may expose an investor to sector and stock concentrations that hamper diversification.

Adopting an equal-weighting approach ensures that performance is driven by many different components of the portfolio instead of a few key holdings.

By focusing on quality and mitigating concentration risks, investors can aim to tap the vital source of returns provided by dividends while also aiming to enhance overall diversification.

How equal weighting can tackle concentration risk

By selecting an equal-weight version of a major equity index, investors can reduce concentration risk and access diversified³ sectors, in our view.

Aude Martin, Head of Pooled Index Investment Specialists at L&G Asset Management

Equity concentration risk is on the rise. With the top 10 constituents of the S&P 500 accounting for almost 40% of the total index weighting,⁴ investors have found themselves exposed to severe drawdowns during periods of market stress.

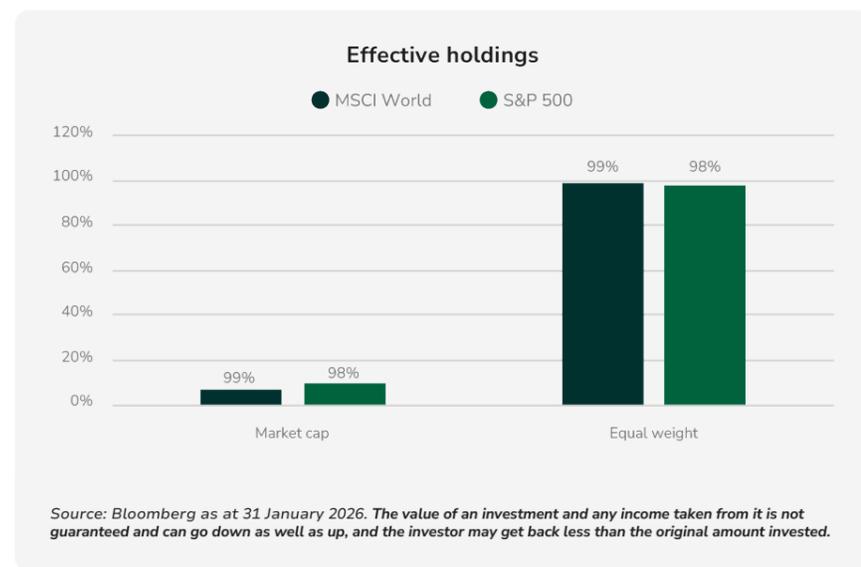
The fact that the majority of those top 10 operate in one sector – information technology – further amplifies the risk.

Same holdings, better diversification

In our view, one important way of diversifying to mitigate this risk is to use an equal-weighted investment strategy. This allows investors to access the same

underlying pool of constituents as they would find in a market-cap-weighted index, but in a way that provides a much broader spread of exposures.

Below we show how this plays out with the MSCI World and S&P 500. In both examples, the effective number of holdings⁵ in the market-cap-weighted versions is comfortably below 10% of the total. In practice, this means that the 500 top US companies ostensibly represented by the S&P 500 is effectively reduced to about 35 companies.



Key takeaways:

- Market-cap-weighted equity indices have shown a rising concentration risk, with most of the weight concentrated in a single sector
- Equal weighting improves diversification in terms of effective holdings representation, geographical spread and sector representation
- In November, equal-weighted indices bounced back quicker than market-cap-weighted indices amid the selloff

In the case of a 'global' index such as the MSCI World, it's important to note that market-cap weighting often results in a heavy skew towards the US, with very modest exposure to other regions. Equal weighting improves regional diversification, as shown in the map chart below.

As well as enhancing diversification in terms of the number of companies an index effectively represents and geographical spread, equal weighting can also increase sectoral diversification. In a large company regional index such as the S&P 100, it's worth adding that this doesn't alter the liquidity profile of the portfolio.

Again using the market-cap weighted MSCI World and S&P 500 as examples, the technology sector currently accounts for over a third of both. In the equal-weight versions, exposure to this sector is rebased in line with healthcare, industrials and financials in the range of 11% to 16%, providing a balanced exposure of cyclical and defensive sectors.

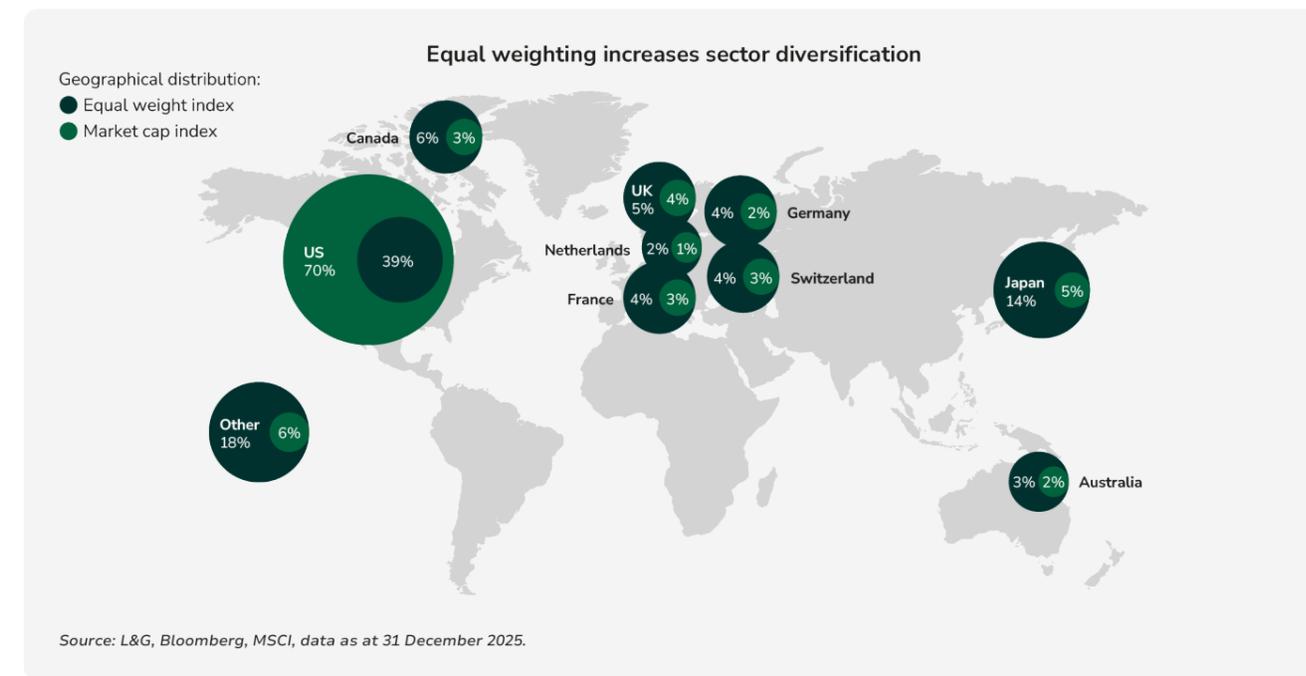
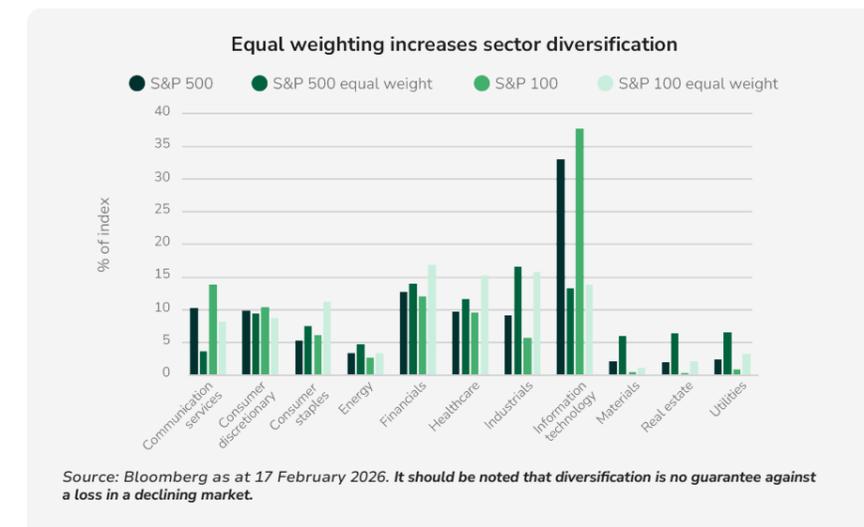
Increasing the representation of sectors outside technology also results in cheaper valuations in aggregate across the portfolio.

In the market-cap weighted S&P 500 the price-to-earnings ratio is 26x, which falls to 21x for the equal-weight version. For the S&P 500, the comparison is 28x for the market-cap version and 21x for the equal-weight version⁶.

Equal weight outperforms in recent downturn

In November, we saw market-cap weighted US equity indices sell off heavily amid concerns over the future profits of software companies given advances in AI. Thanks to their greater diversification and reduced single-sector exposure, equal weight portfolios recovered better in this period.

For investors who wish to consider accessing the dynamism and return potential of the US equity market without being beholden to the daily ups and downs of the AI narrative, we believe equal weight is a compelling option.



³It should be noted that diversification is no guarantee against a loss in a declining market. ⁴Source: Bloomberg, the weight of the top 10 holdings of the S&P 500 stood at 38% as at 31 January 2026.

⁵Effective number of holdings' is a concentration measure in the form of the reciprocal of the Herfindahl-Hirschman Index. Effective number of holdings = 1/HHI or 1/sum(squared stock weights). ⁶Source: Bloomberg as at 17 February, Bloomberg estimate P/E ratio. It should be noted that diversification is no guarantee against a loss in a declining market.

Understanding the factor exposures of thematic indices

Ahead of a major research paper to be released later this year, we analyse the factor exposures of thematic indices – and what this means for investors seeking diversification.

Shichen Zhao, ETF Thematic Research Analyst and Karan Bhanot, ETF Investment Strategist

Thematic investing targets long-term megatrends shaping the future. It focuses on themes rather than traditional sectors, seeking exposure to companies driving or benefiting from change while avoiding those at risk of disruption.

Because themes cut across sectors and geographies, they can provide access to companies not widely held in traditional equity portfolios, especially mid- and small-cap companies. This provides exposures with naturally low overlap with market-cap indices.

As a result, systematic thematic strategies can serve as core building blocks, offering diversified, complementary exposure alongside existing equity holdings.

A snapshot of factor exposure across thematic equity

We are examining how thematic investing interacts with factor investing. This research draws on L&G's in-house factor scores and our suite of thematic indices.

L&G's factor strategies adopt a modern, refined approach built on definitions that reflect the realities of today's market economy. While our style factor definitions remain firmly grounded in academic research, we have incorporated additional features that capture our own investment insights.

You can learn more about our [factor framework](#) on our factor

webpage, and we have written extensively about factors including [Quality](#), [Low Volatility](#) and [Value](#).

According to the research paper [Factor Exposures of Thematic Indices](#), thematic indices typically show strong negative exposure to the profitability and value factors. This suggests that they tend to hold growth-oriented stocks that prioritise investment today in anticipation of future profitability.⁸

While innovative, technology-driven themes tend to exhibit a clearer tilt towards the growth and momentum factors currently, themes linked to essential services typically align more closely with quality and value characteristics, given their stable earnings profiles, defensive business models, and consistent cash flow generation.

See our thematic indices below.

Our thematic indices can be divided into two buckets:



Essential service themes: Clean Water, Global Brands, eCommerce, Cyber Security.

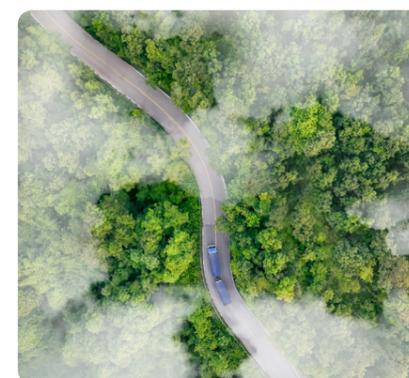


Innovative/technology driven themes: Robotics, AI, Clean Energy, Battery, Metaverse, Healthcare Technology, Hydrogen.

Benchmarks: MSCI World, MSCI Tech.

Key takeaways:

- Thematic investing can offer a diversified,⁷ complementary exposure to market cap weighted equity holdings
- Our research finds innovation-led themes tilt towards growth and momentum, while essential services lean more towards quality, value and low volatility
- The varied factor profile of different thematic strategies may provide an additional source of diversification



We classify themes as essential services when they provide non-discretionary, habitual services or platforms that households and businesses rely on day to day, the everyday service layer when viewed through an economic lens.

On the Growth vs Momentum chart below, plotting Momentum (Y) against Growth (X) shows innovation-led themes (blue) cluster towards the upper-right quadrant, signalling a clear growth-momentum tilt consistent with faster-growing companies and stronger investor inflows. Essential services themes (green) lean towards lower-left quadrant.⁹

On the Value (X) vs Quality (Y) map, essential services themes (green) cluster toward higher Quality – often consistent with steadier fundamentals and a more defensive profile. Innovation-led themes (blue) tend to lean slightly away from Quality.

The radar chart summarises the average factor 'shape' of the two buckets across five factors: Value, Quality, Growth, Momentum and Low Volatility.

Because each factor naturally sits on a different scale, we normalise the scores, so the chart highlights relative emphasis rather than absolute levels.

In simple terms, the innovation-led bucket (blue) shows a stronger tilt to Growth and Momentum, while the essential services bucket (green) leans more toward Quality, Value and Low Volatility, a profile typically associated with steadier fundamentals and a more defensive return pattern.

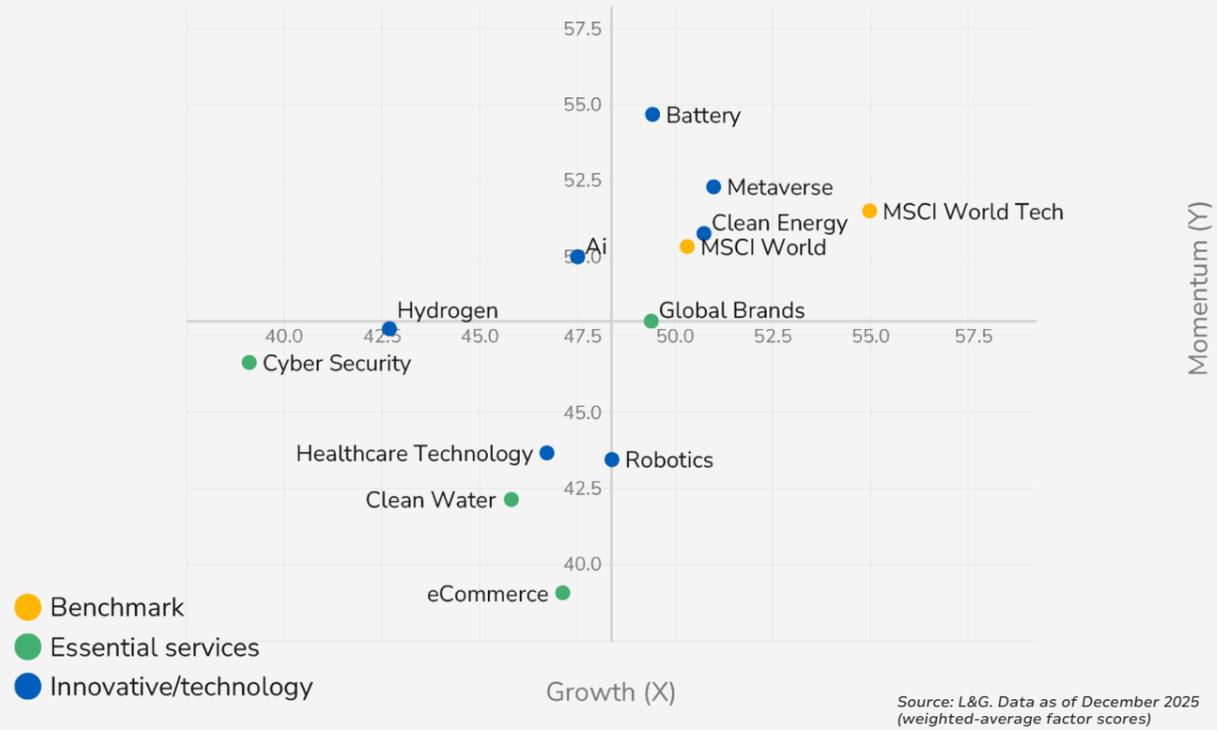
Taken together, these charts show that thematic exposure is not a homogenous narrative: each theme carries distinct, measurable factor tilts that position it differently along the Growth/Momentum and Quality/Value spectrums.

The variability in factor profiles across themes introduces an additional source of diversification, potentially allowing investors to access differentiated return drivers relative to conventional market capitalisation weighted strategies.

We will explore the link between themes and factors in more detail in a full research report later this year.



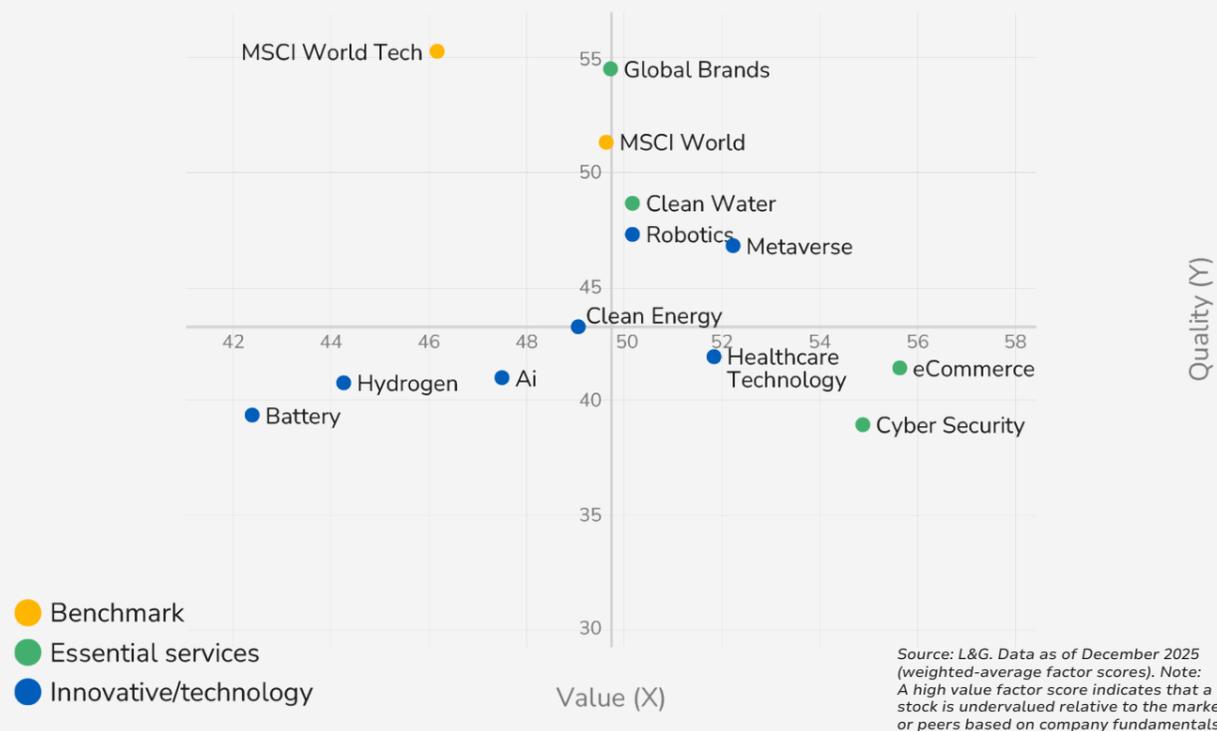
Growth vs Momentum (coloured by bucket)



Radar of bucket averages (normalised quality)



Value vs Quality (coloured by bucket)





Key risks

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