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# Building Resilient Long-Term Equity Portfolios

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## Key Takeaways

- Market-cap indices now embed significant concentration, and implicit industry and style factor exposures, rather than representing neutral market exposure.
- True diversification arises from balancing underlying return drivers, not simply increasing the number of holdings.
- Multifactor portfolios historically delivered improved risk-adjusted returns and more stable performance across regimes.
- Small caps provide distinct economic and factor diversification, yet remain underrepresented in cap-weighted portfolios.
- A resilient equity framework should combine market participation, factor exposure, and breadth across segments.

## Abstract

For most of the past decade, equity investing has appeared deceptively simple. Strong performance from a handful of US large-cap growth stocks has delivered stellar returns for market-cap weighted strategies that have a significant allocation to the US. However, this outcome has led to rising market concentration and has been driven by a specific set of conditions that may not persist. That playbook worked exceptionally well. But it worked for very specific reasons. And that raises the core question: What if those conditions don't persist?

Market-cap indices increasingly embed implicit exposures to a narrow set of stocks, sectors, and factors. Portfolios built around a single view of the world can perform exceptionally well when that view is correct, but they can also suffer sharply when conditions change. Interestingly, stripping the "Magnificent 7" (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, and Tesla) from the S&P 500 has quietly outperformed the full index so far in 2026[1]. S&P 500 has delivered approximately 8% YTD, while excluding the Magnificent 7 has delivered 12.20%[2]. This is why we believe resilient portfolio construction should focus on balancing multiple sources of return that can compound across different market environments.

This paper addresses this challenge, and using the US market as a case study, we show that portfolios constructed to diversify across underlying return drivers have historically delivered improved risk-adjusted returns, lower volatility, and more stable performance across market regimes. The evidence suggests that resilient long-term equity portfolios should move beyond traditional notions of diversification and instead be designed explicitly around balanced exposure to persistent sources of return, combined with broad participation across market segments.

We propose a framework for designing forward-looking equity portfolios that balance market participation with systematic allocation across factors and capitalisation tiers.

[1] Source: L&G calculations based on index data from S&P and BITA as at June 2026.
[2] Source: L&G calculations based on index data from S&P and BITA as at June 2026.

# 1. Concentration has become the strategy

Today's equity markets have been shaped by three structural forces:

- Strong performance of passive, market-cap weighted strategies
- Dominance of a small number of mega-cap stocks
- Reinforcing feedback loops from passive inflows and benchmark-relative allocation

Together, these dynamics have shaped a widely held perception that market-cap weighting represents a neutral and efficient default. However, this assumption has become increasingly fragile. Market-cap indices today embed elevated valuations, implicit factor tilts (notably towards growth and momentum) and concentration risk.

This matters because the rise of passive investing has changed how capital is allocated across equity markets. As a growing share of flows is deployed mechanically through market-cap weighted indices, capital is increasingly directed pro rata towards the largest benchmark constituents, regardless of valuation or fundamentals. This can weaken price discovery and reduce the arbitrage pressure that has historically helped close valuation gaps, reinforcing the dominance of already-large companies.

As a result, investors face a fundamental trade-off. Underweighting dominant stocks introduces exclusion risk, while maintaining full exposure increases concentration risk. This tension is often framed as a choice between active and passive investing, but that framing misses a more important point.

Market-cap indices are no longer neutral—they are structurally concentrated expressions of a narrow set of return drivers.

This raises a key question: how should portfolios be constructed to remain robust over the long term? We believe diversification holds the key.

# 2. Rethinking equity portfolio construction

## 2.1. Diversification across return drivers

A large body of academic literature documents the existence of systematic patterns in equity returns commonly referred to as factors. These include, most prominently, Value, Quality, Momentum and Low Volatility.

These factors have demonstrated persistent return premia across time, geographies, and asset classes, supported by both risk-based and behavioural explanations. While the debate between these explanations continues, the empirical evidence is clear: Factor premia have proven persistent, economically meaningful, and difficult to arbitrage away at scale.

In this context, diversification should not be understood as the number of securities held, but as the breadth of independent return drivers within a portfolio. The goal is to not to take big, concentrated bets, rather to compound reliable diverse source of outperformance over time.

Multifactor portfolios are designed explicitly with this objective. By systematically combining exposures to Value, Quality, Momentum and Low Volatility, they seek to reduce dependence on any single factor or on a handful of stocks, improve balance across economic environments and ultimately capture multiple, partially independent sources of return.



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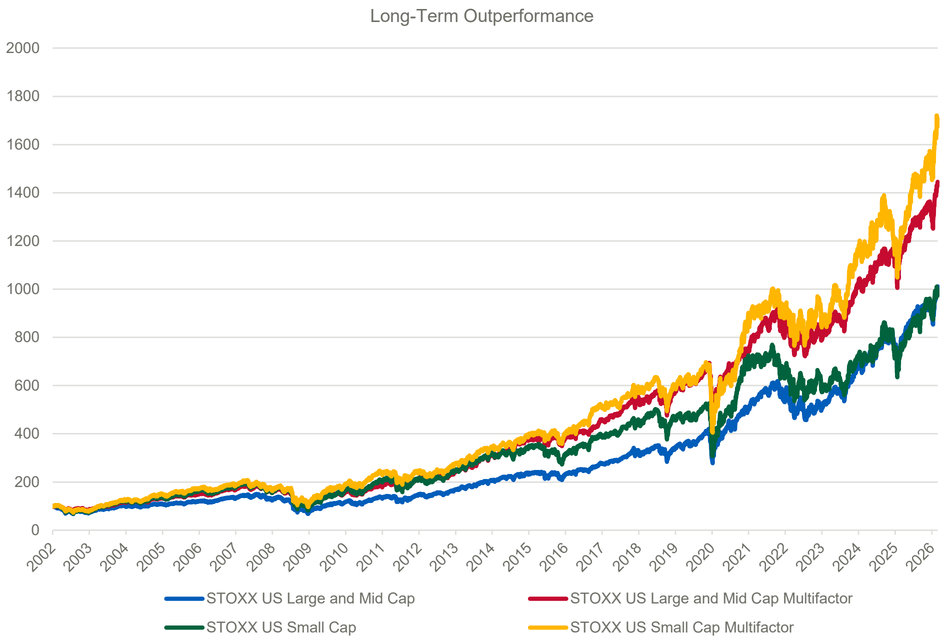
## 2.2. A US Case Study in Multifactor Portfolio Construction

To assess the effectiveness of multifactor investing, we use the US equity market as a case study. The US is the world's largest equity market, represents a substantial share of both institutional and retail portfolios, and has delivered exceptionally strong returns over recent decades. It therefore provides a relevant and demanding setting in which to evaluate whether a systematic multifactor approach can improve portfolio outcomes across both large- and small-cap universes. Appendix 1 provides further detail on the construction of the portfolios used in the analysis.

**Exhibit 1. Multifactor portfolios delivered stronger risk-adjusted returns over the long term**




Source: L&G, STOXX. Benchmark is STOXX US Universal and STOXX US Universal Small Cap. Quarterly backtest from March 2002 to March 2026. All stats calculated with USD Gross Returns. ***For illustrative purposes only. Past performance is not a guide to the future.***

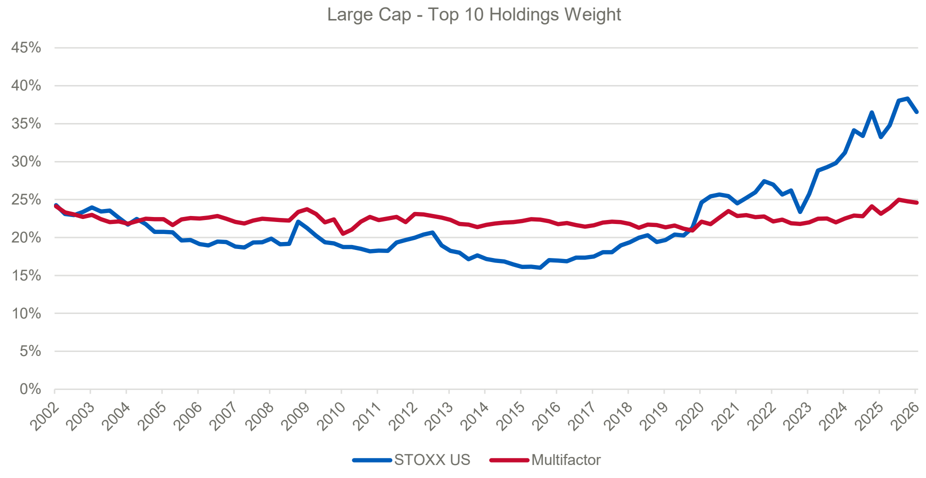
### Exhibit 2. Improved portfolio efficiency

| | US Large Cap | | US Small Cap | |
|---|---|---|---|---|
| | **Benchmark** | **Multifactor** | **Benchmark** | **Multifactor** |
| **Annualized Active Return (%)** | | 1.59 | | 2.41 |
| **Annualized Active Risk (%)** | | 4.09 | | 4.48 |
| **Information Ratio** | | 0.39 | | 0.54 |
| **Annualized Return (%)** | 9.66 | 11.25 | 9.55 | 11.96 |
| **Annualized Risk (%)** | 18.85 | 17.83 | 21.87 | 20.54 |
| **Sharpe Ratio** | 0.51 | 0.63 | 0.44 | 0.58 |
| **Market beta** | | 0.92 | | 0.92 |
| **Max Drawdown (%)** | -55.07 | -51.11 | -58.85 | -53.76 |

Source: L&G, STOXX. Data as at March 2026.

The results indicate that multifactor portfolios delivered higher cumulative returns relative to their respective benchmarks across both large- and small-cap universes over the long term. The improvement was achieved with lower volatility, resulting in stronger risk-adjusted outcomes. This suggests that diversification across return drivers could enhance long-term portfolio efficiency, and that improved outcomes are not driven by mega-cap dominance or a single prevailing style (e.g. momentum).

### Exhibit 3. Multifactor portfolios reduce concentration in dominant stocks



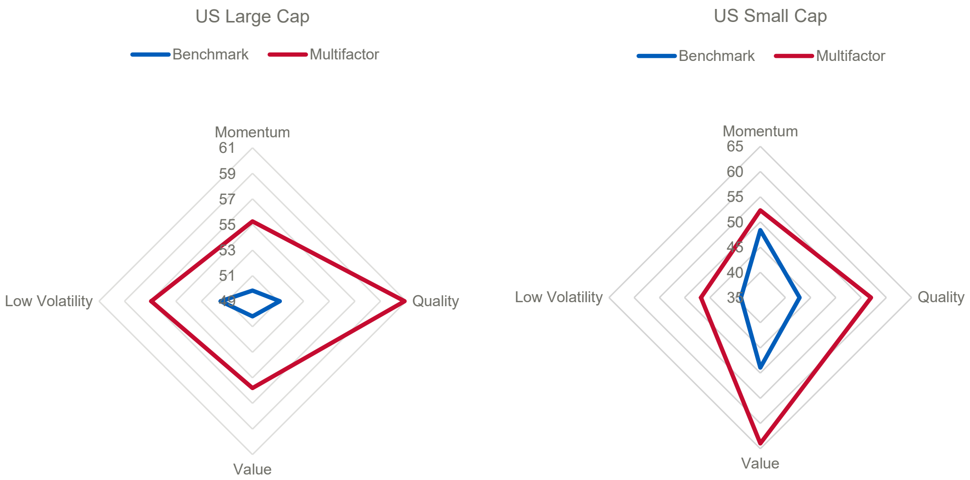

**Source**: L&G, STOXX. Blue line shows the total weight of the top 10 benchmark holdings, and red line shows the total weight of the top 10 holdings of the Multifactor portfolio. The top 10 holdings of the Multifactor portfolio are not necessarily the same as the top 10 holdings of the benchmark. Data as at March 2026.





The reduction in exposure to the largest benchmark constituents demonstrates that multifactor portfolios can maintain broad market participation without being dominated by mega-cap stocks.

### Exhibit 4. Balanced exposure across multiple return drivers




Source: L&G, STOXX. Data as at March 2026.

By construction, multifactor portfolios achieve a more balanced exposure across rewarded drivers, rather than relying on a single dominant style.

## 2.3. Key observations

The empirical analysis presented in the previous section points to a few key insights, focusing on the structural implications for the importance of broad market participation and the role of factor premia in shaping long-term investment outcomes:

1. **Diversification Still Works**

   Diversification is not about holding more stocks—it's about holding different drivers of return. A multifactor portfolio that overweights stocks with desired characteristics, e.g. cheap, high quality, trending, does not require one specific market structure to succeed. Although it won't beat the market every year, it has lower dependence on any single style or market regime, and should offer more balanced sources of return and smoother return profiles across market cycles. As factor premia are structurally independent of mega-cap dominance, they persist even when large-cap leadership changes and could offer complementary return streams relative each other and to cap-weighted indices. Over the long term, balanced exposure across factors and segments can produce more stable compounding, as markets reward participation in systematic and persistent sources of return.

2. **Small Caps Provide an Underused Source of Breadth**

   Institutional investors tend to focus their capital allocation on the stocks of larger companies, finding them less risky, more liquid and offering greater investment capacity than small-cap stocks. As a result, small caps remain structurally under-represented in many portfolios. Although they account for approximately 15% of the global equity opportunity set, institutional allocations to small caps are often below 10%[3]. This matters because small caps provide diversification of both economic exposure and factor expression relative to large caps. First, they have historically earned a return premium compared to their large-cap counterparts[4]. Second, our small-cap multifactor research shows that targeting rewarded factors within this universe can deliver attractive risk-adjusted returns. Their systematic underweight in institutional portfolios therefore represents missed potential source of breadth and diversification.

3. **Rules-Based Design Enables Deliberate Portfolio Construction**

   Transparent, rules-based systematic strategies should allow investors to move beyond the unintended exposures embedded in market-cap weighted benchmarks. By defining the desired exposures in advance and applying them consistently through an index methodology, investors can target rewarded factors, manage concentration, and introduce breadth across market segments in a disciplined and repeatable way. This approach can help avoid excessive reliance on short-term benchmark leadership, mitigate exposure to extreme valuations among dominant index constituents or new entrants (e.g. mega cap IPOs), and seek to support more resilient long-term equity portfolios.

## 3. Implications for portfolio construction

Combining the academic literature's empirical findings and today's markets structural considerations, a resilient equity framework can be structured around three complementary components:

1. **Core: Market Participation**

   Maintain core exposure to large caps, but:

   - Avoid full reliance on cap-weighting
   - Introduce constraints on concentration
   - Ensure exposure is diversified across sectors and drivers

2. **Diversification: Factor Allocation**

   Ensure diversification across economic return drivers by systematically allocating across factors:

   - Value (valuation discipline)
   - Quality (balance sheet resilience)
   - Momentum (trend persistence)
   - Low volatility (defensive characteristics)

3. **Breadth: Broaden the Opportunity Set**

   We believe resilient portfolios should deliberately broaden the opportunity set beyond the dominant names and segments embedded in market-cap weighted benchmarks. This can be achieved by combining alternative weighting approaches, valuation-aware controls and targeted exposure to under-represented areas of the equity market.

   - Use alternative weighting methodologies, such as equal weighting or optimisation, where appropriate, to reduce dependence on the largest benchmark constituents.
   - Apply valuation-aware controls to limit exposure to extended valuations across countries, industries or individual stocks where prices appear less well supported by fundamentals and earnings.
   - Reintroduce small-cap equities as a distinct source of economic exposure, factor expression and long-term return potential.

4. **Cost Awareness: Preserve the Return Premium**

   A resilient equity framework must also be cost aware in our view. Factor premia can be economically meaningful, but turnover, transaction costs, liquidity constraints and capacity limits all influence the realised outcome for investors. Portfolio construction should therefore seek to preserve the return premium by ensuring that factor exposures are implemented efficiently and that rebalancing decisions are proportionate to their expected benefit.

5. **Evolving Factor Definitions: Keep Signals Economically Relevant**

   Finally, we believe factor definitions should evolve as the structure of the economy changes. Traditional measures such as book-to-price, earnings yield or balance-sheet profitability remain useful, but they were developed for a world in which tangible assets represented a larger share of corporate value. In today's market, a growing proportion of investment is directed towards intangible assets, including research and development, software, data, brands and human capital. These expenditures are often expensed rather than capitalised, which can distort conventional valuation and quality metrics. A modern factor framework should therefore complement traditional signals with measures that better capture intangible investment and the economic productivity of innovation, while preserving transparency, robustness and implementation discipline.

Together, these components should create a disciplined framework for building equity portfolios that are diversified across return drivers, resilient to changing market leadership, and better positioned to potentially compound returns over the long term.

## 4. Conclusion

The past decade has been defined by strong performance from a narrow group of mega-cap stocks, reinforcing the dominance of market-cap weighted strategies. While this environment has delivered strong returns, it has also introduced structural concentration and increased reliance on a limited set of return drivers.

This paper demonstrates that portfolios constructed to diversify across underlying return drivers—rather than relying on index composition—have historically delivered more robust outcomes, including improved risk-adjusted returns and greater stability across market regimes.

[3] Source: bfinance, Small Cap Equities: Time for Targeted Exposure? April 2023
[4] Source: Fama, E.F. and French, K.R. (1993), Common risk factors in the returns on stocks and bonds, Journal of Financial Economics, 33(1), pp. 3–56; Ken French Data Library, Dartmouth College, Fama/French 3 Factors (monthly) dataset. **Past performance is not a guide to the future.**

The implication is not that investors should abandon market exposure, but that they should design portfolios more deliberately. We believe combining broad market participation with systematic factor exposure and greater breadth across segments provides a more resilient foundation for long-term equity investing.

If the last decade was characterised by simplicity, the next is likely to reward deliberate and resilient portfolio construction.

# Appendix

## Portfolio construction methodology

The multifactor portfolios are constructed using an optimisation framework in which the objective is to maximise aggregate portfolio exposure to Legal & General's proprietary multifactor score, subject to a defined set of risk, capacity, and implementation constraints. The multifactor score is built by combining the four target factors—Value, Momentum, Quality, and Low Volatility—using an equal active risk weighting approach, so that no single factor dominates the portfolio's active risk.

The optimisation is subject to the following constraints, which are intended to balance factor efficacy with investability, diversification, and benchmark awareness:

- Turnover
- Transaction cost
- Diversification and Liquidity constraints
- Active industry exposure limits
- Untargeted style factor exposure limits
- Minimum position size requirements
- Ex-ante tracking error
- Maximum asset weight
- Maximum weight of the top 20 holdings

Legal & General's proprietary factor scores are constructed based on the academic literature and refined through internal empirical research, robustness testing, and implementation analysis. This framework is designed to capture persistent sources of return while maintaining practical relevance for institutional portfolio construction.



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**Key Risks**
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.