



FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

Issue #235
August 15, 2025

Concentration Risk

For many years now, due to the rise of passive investment vehicles such as index funds and exchange-traded funds, the U.S. stock market has been drifting (at an increasingly rapid pace) towards the mother of all stock market crashes. Virtually all such funds weight their holdings by market capitalization (stock price times the number of shares), so the higher a stock's market cap rises, the more shares these funds have to buy. Now a rising market cap could be a sign of a growing, successful company. But it could also be a sign of extreme overvaluation resulting from a mania (which is always based on a *story*).

Towards the end of a bull market, market breadth narrows (i.e., the percentage of stocks that rise in value declines). This is probably because as the greater fools and dumbest of the Dumb Money is finally drawn into the market, invariably they put their money on the horse or two that are in the lead at the end of the race. This demand from new investors causes the price to rise further. Often these investors quickly receive large capital gains, which may then prompt them to buy leveraged ETFs, take out a margin loan, or buy call options.

In recent decades, the use of market cap-weighted index funds and ETFs has skyrocketed, especially since they are pretty much the default (or only) investment options in most 401(k) plans (which are full of Dumb Money investors). Even most actively managed

equity mutual funds have essentially become clones of the major market indices due to the “career risk” faced by their managers (if the fund suffers a loss but is highly correlated to a major index, the manager probably won't get fired).

During a mania, market cap-weighted index funds become a Doomsday machine, because they *must* keep buying the shares of the most popular and overpriced stocks, regardless of valuation, investor sentiment, insider selling, short interest, accounting fraud, [ESG](#), financial strength, dividend payments, etc. The danger is a continued belief in a theory (the Efficient Market Hypothesis, or EMH) that is based on unrealistic assumptions at *precisely* the worst possible moment.

There are several reasons for this. First, the Smart Money *wants* the Dumb Money to believe that markets are efficient so they can trade against them and take advantage of their naivete. When Warren Buffett recommends individual investors buy index funds, he doesn't do so because he's just a benevolent grandfather dispensing prudent investment advice to the masses for free. Instead, he wants to have a lot of marks that he can trade against so he can *make money*.

When the EMH was first developed, virtually all investors were looking for \$20 bills lying on the sidewalk waiting to be picked up, so there was some theoretical basis for the idea that markets were efficient. Today, most investors have stopped looking for abnormal opportunities, so the case for the EMH has never been weaker.

The second reason for the rise in the popularity of the EMH religion is that it's a *story* that permits *laziness* while promising a great afterlife. The human brain loves stories, especially if they allow the brain to conserve glucose, as our primitive brains still believe that glucose is scarce, as it was for millennia. Researching companies, performing fundamental analysis, making decisions and being patient all require time, effort and money. The brain would very much prefer to scroll through TikTok or binge watch Netflix (which ironically is now the sixteenth largest component of the S&P 500 index with a market cap of over \$511 billion!). The EMH story also allows fund managers and investment advisors to spend time on other pursuits such as marketing or playing golf, since the fundamentals don't matter anymore.

Another reason for the perpetuation of the EMH myth is that a number of academics won fame, fortune and Nobel Prizes by coming up with neat, tidy (and wrong) theories like EMH in their ivory towers. Often they went on to make bank advising hedge funds based on their theories (such as [Long-Term Capital Management](#) before it blew up spectacularly). If new information or ideas come to light that cast doubt on the validity of the EMH, these guys will not be willing to admit that a better theory has come along, so now the spotlight (along with fame and fortune) should shift to the people who developed that theory. The Scientific Method is a great ideal, but the reality is that in the scientific world (which includes economics and finance), progress is made one funeral at a time.

This perfect storm of an over-optimized (and no longer valid) theory, laziness and a mania has resulted in the absurdity that are now the major market indices. For the S&P 500 index, the top eight companies comprise 36.44% of the index. With a market cap of over

\$4.4 trillion, top holding NVIDIA alone comprises 7.65%!

S&P 500 Index Components

#	Company	Symbol	Weight	Price
1	Nvidia	NVDA	7.65%	▲ 182.03
2	Microsoft	MSFT	6.69%	▲ 522.38
3	Apple Inc.	AAPL	5.98%	▲ 234.13
4	Amazon	AMZN	4.14%	▲ 225.17
5	Meta Platforms	META	3.38%	▲ 780.15
6	Broadcom	AVGO	2.50%	▼ 308.42
7	Alphabet Inc. (Class A)	GOOGL	2.17%	▼ 201.83
8	Alphabet Inc. (Class C)	GOOG	2.04%	▲ 203.04
9	Tesla, Inc.	TSLA	1.89%	▲ 341.10

In 1929, Joseph Kennedy (father of JFK)--who was then a stockbroker--[realized](#), “If shoe shine boys are giving stock tips, then it's time to get out of the market.” A year ago I developed a similar heuristic: If a female groupie asks a CEO to autograph her breast, it's time to sell the stock. Last June NVIDIA's CEO happily applied his John Hancock:

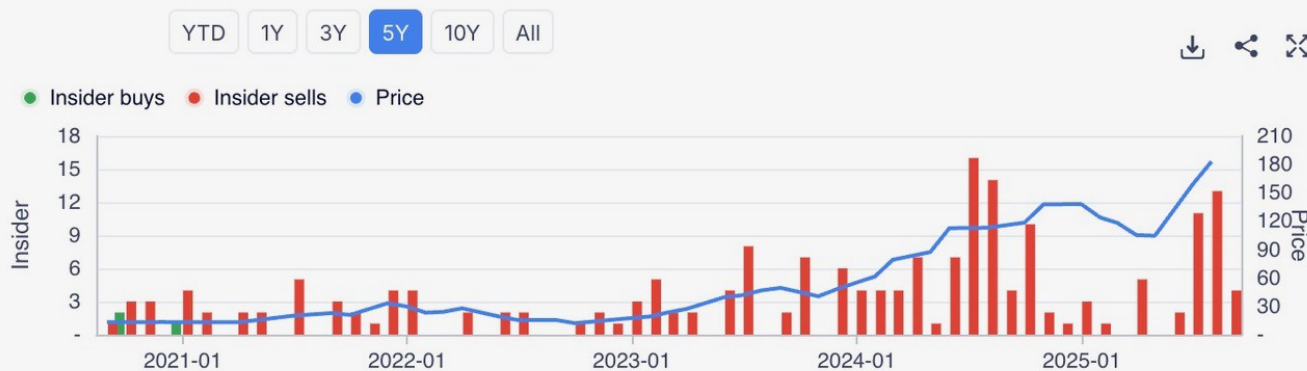


Recently NVIDIA insiders have been following my rule about “staying abreast” of market sentiment:

NVIDIA Corp Volume of Insider Trades

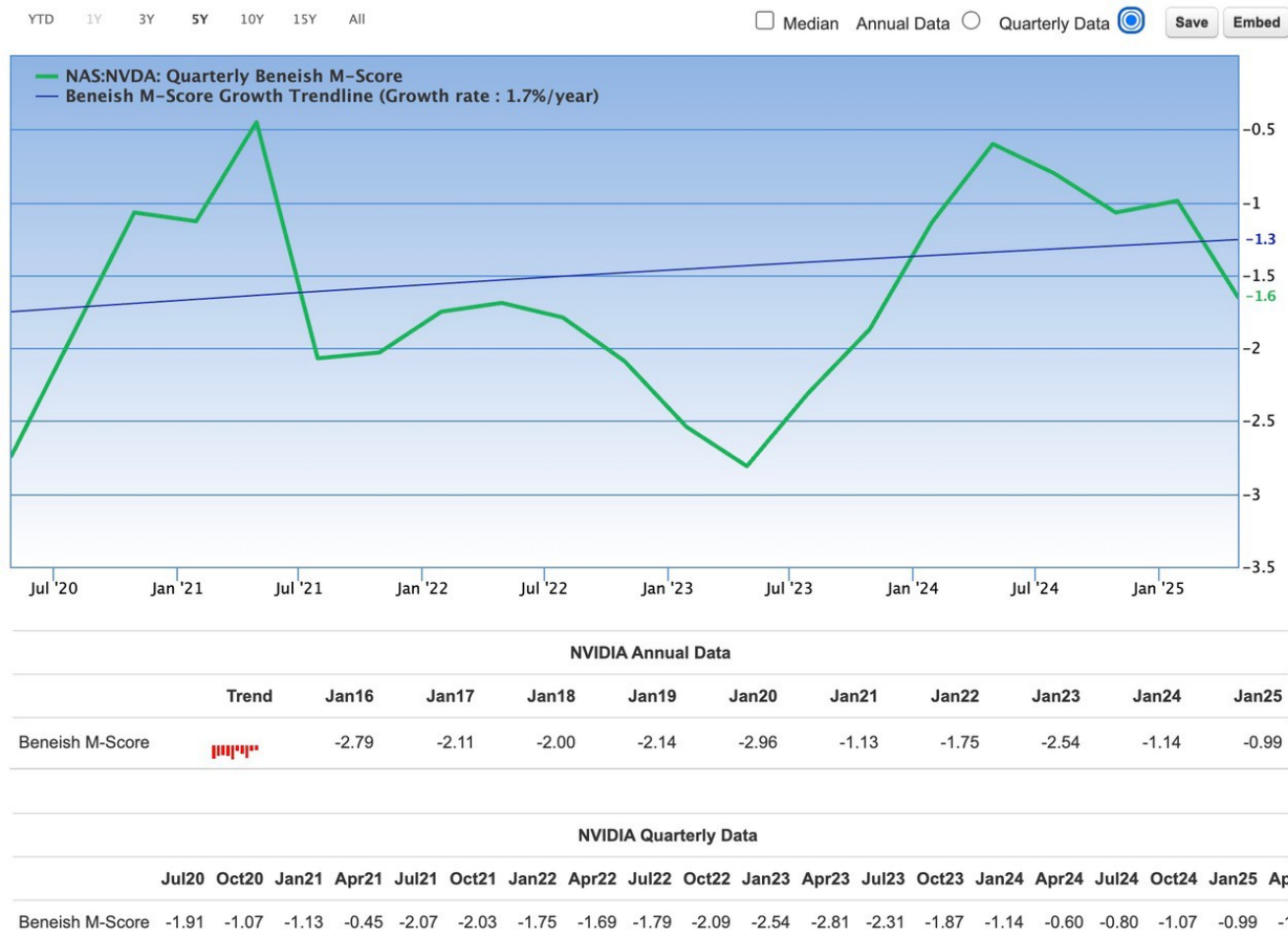


NVIDIA Corp Number of Insider Trades



BTW, has anyone noticed that NVIDIA's quarterly Beneish M-Score (a measure of the likelihood that a company's management is manipulating its reported earnings) has been in the "likely manipulator" range (greater than -1.78) since January 2024 (see chart below)? Would that make me a party pooper, a negative Nancy? Would lower reported profits result in lower capital gains on insider sales of stock, and fewer breasts to autograph? Well that would be a real bummer!

NVIDIA Beneish M-Score Chart



The weighting of the tech-heavy NASDAQ 100 index is even more absurd. The top eight companies (which are identical to those of the S&P 500) comprise over 68% of the index!

Nasdaq 100 Components

#	Company	Symbol	Weight		Price
1	Nvidia	NVDA	14.26%	▲	181.77
2	Microsoft	MSFT	12.49%	▲	522.55
3	Apple Inc.	AAPL	11.17%	▲	234.14
4	Amazon	AMZN	7.74%	▲	225.72
5	Meta Platforms	META	6.31%	▲	780.63
6	Broadcom Inc.	AVGO	4.67%	▼	308.52
7	Alphabet Inc. (Class A)	GOOGL	4.06%	▲	201.98
8	Alphabet Inc. (Class C)	GOOG	3.81%	▲	203.10
9	Tesla, Inc.	TSLA	3.54%	▲	341.25

The vast majority of retail traders today have no idea of the risk they are taking by owning market cap-weighted funds that are heavily invested in [richly valued](#) stocks that are currently beloved by investors.

How beloved? Consider the amount of capital that companies (and thus investors) are throwing at AI. Recently, [Meta offered a 24-year old top AI researcher a compensation package of \\$250 million](#) over four years. At some point, investors' capital will run out and they will demand a return on their investment. But not to worry, because as AI guru Sam Altman has repeatedly stated, OpenAI's long-term strategy for generating revenue involves *asking a future artificial general intelligence system to figure out how to generate a return on investment* for its investors.

Holy crap, that's brilliant! Spend trillions of dollars to create a souped-up version of [Ask Jeeves](#) and then it will tell you how you can earn all of that money back, and then some? Damn, I wish I had thought of that! It reminds me of the infamous speculative venture that emerged during the South Sea Bubble of 1720 that described itself as “a company for carrying on an undertaking of great advantage, but nobody to know what it is.”

Well I listen to numbers instead of stories, so let's look at some numbers. Last year OpenAI had *revenue* (not profits) of [\\$3.7 billion](#), resulting in [a loss of about \\$5 billion](#). Wow, \$3.7 billion is a lot of money (here I'm employing the [mental accounting](#) used by gamblers)! Not even close to say, \$4.4 trillion, but my (primitive) brain tells me it's a very big number!

Seriously, like I saw around 1999 (after which the NASDAQ stock market lost about 80%), profits are passe, not to mention free cash flow and dividends. Revenue doesn't really matter, either, as long as it's growing. Investors will just have to keep rubbing their capital against the magic AI lantern, which will eventually summon the genie that will tell them how they can earn all of their money back. I wish them the best.

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