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The Hidden Cost of Stock Market Concentration: When Funds Hit Regulatory Limits

Based on BFI Working Paper No. 2026-51, "The Hidden Cost of Stock Market Concentration: When Funds Hit Regulatory Limits," by Lubos Pastor, Taisiya Sikorskaya, and Jinrui Wang, University of Chicago

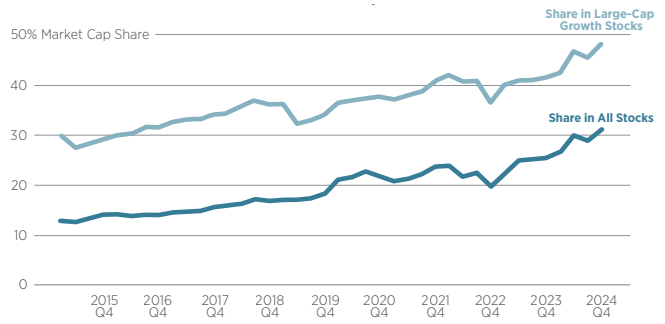
Regulatory limits on fund portfolio concentration can distort stock prices by limiting the ability of optimistic investors to buy as much as they would like, which causes constrained funds to perform worse than otherwise.

The US stock market has grown dramatically more concentrated over the past decade. Between 2015 and 2024, the ten largest stocks went from representing 13% to 31% of total market value, and seven companies alone, the "**Magnificent 7**," make up roughly one-third of the S&P 500 and over half of the Russell 1000 Growth Index. This concentration has created a regulatory problem for a growing number of investment funds.

The reason is that nearly all US **mutual funds** and **exchange-traded funds (ETFs)** must comply with a tax rule known as the "50/5/10 rule" to avoid paying corporate-level taxes (at least 50% of the fund's total assets must consist of securities for which no single issuer represents more than 5% of total assets, and no more than 10% of the issuer's voting securities). In other words, this rule limits how much of a fund's portfolio can be concentrated in a small number of large positions.

Historically, this rule was easy to satisfy, but as a handful of giant companies have come to dominate the market, staying compliant has become increasingly difficult. The share of fund assets close to the limit grew from negligible levels in 2019 to about 8% of all fund assets, roughly $1.4 trillion, at its 2024 peak. In the large-cap growth category specifically, about one-third of funds were affected, representing half of that category's total assets.

Figure 1 · Stock Market Concentration: Share of Top 10 Stocks



Note: This figure shows that between 2015 and 2024, the share of the 10 largest stocks in total market capitalization rose from 13% to 31%. Within the large-cap growth style, the top 10 stocks' share rose even higher, from 30% to 48%. Indeed, just seven companies account for roughly one-third of the total market capitalization of the S&P 500 Index, and over 55% of the Russell 1000 Growth Index, at the end of 2024.

Magnificent 7: a group of high-performing, mega-cap (typically defined by a market capitalization of $200 billion or more) US technology companies: Apple (AAPL), Nvidia (NVDA), Amazon (AMZN), Alphabet (GOOGL), Microsoft (MSFT), Meta Platforms (META), and Tesla (TSLA)

mutual funds: investment vehicles that allow investors to pool money together to purchase a collection of stocks, bonds, or other securities that might be difficult to accomplish on their own

exchange-traded funds (ETFs): a type of pooled investment security that holds a basket of assets, such as stocks, bonds, or commodities, and trades on stock exchanges throughout the day, just like individual stocks. They offer instant diversification, lower fees than many mutual funds, and high liquidity, allowing investors to buy or sell shares at market-determined prices.

Do these portfolio constraints affect stock prices? The authors examine 4,745 US equity funds from 2019 to 2024 and find that when funds approach the regulatory limit, they respond thusly:

- Equity funds trim their largest stock positions, rotating toward smaller-cap stocks and reducing their overall exposure to equities. This forced rebalancing hurts performance.
- Large-cap growth funds that were constrained by the rule earned meaningfully lower risk-adjusted returns in the months that followed, roughly 28 basis points lower over three months across the full sample, and over 1% lower during 2023-2024, when the constraint was tightest.

The authors then examine the effect on individual stock prices, and find the following:

- Regulatory pressure depresses the prices of the largest stocks. When constrained funds are forced to underweight stocks like Nvidia or Microsoft, those stocks may become temporarily underpriced.
- The authors measure how much of each stock is held as a large position by constrained funds and find that stocks with higher such "constrained ownership" subsequently outperform. During 2023-2024, these stocks outperformed by a cumulative 2.3% over six months relative to stocks with no constrained ownership, with the effect being larger for more volatile stocks.
- A trading strategy going long on high-constrained-ownership, high-volatility stocks produced estimated annual outperformance of roughly 8% in 2019–2024 and 12% in 2023-24, though the authors flag this result as only marginally statistically significant given the short time.
- When the authors separate funds into active and passive, they find that both types trim their large positions as they approach or violate the 50/5/10 limit, and that higher volatility amplifies the trimming, supporting the interpretation that portfolio concentration limits can distort stock prices by capping the positions of active investors who are optimistic about the largest stocks.

Bottom Line: A longstanding tax rule limiting portfolio concentration in US investment funds has become a genuine constraint as the stock market has grown more concentrated. Funds affected by the rule respond by trimming their largest positions, especially in volatile stocks, and by reducing their overall equity exposure, thus impairing fund performance after the constraint becomes binding. Further, and importantly, the rule appears to distort stock prices.

This research has implications for the interplay among market concentration, portfolio regulation, and benchmark design. If the trends described above continue, tensions will grow, raising questions about whether current diversification thresholds remain suitable for today's market structure, and forcing a reassessment of regulatory limits meant to protect investors.

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