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BRETT ARENDS'S ROI

# Opinion: This one surprise move can help protect your 401(k)

Should you believe the financial 'geniuses' of Wall Street?

By [Brett Arends](#) [Follow](#)

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Are you as diversified as you think?

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## Referenced Symbols

↑ NVDA +0.75% ↑ MAGS +0.59% ↑ SPX +0.27% ↓ CSCO -0.74%  
↓ MSFT -0.40% ↑ VIOV +1.02%

Alexander the Great may have been the most remarkable person of the classical world. Aristotle may have been the wisest. But Zeno of Elea was surely the most annoying.

The southern Italian philosopher, who was born about 500 years before Christ, was fond of posing trick questions that nobody seemed able to answer. Using various rhetorical devices and convoluted arguments, he is said to have “proven” that an arrow fired from a bow could never actually fly through the air, and that if a tortoise raced against Achilles, the tortoise must always win, as long as it started first.

Apparently Zeno was so clever that philosophers struggled to defeat him in debate. Even today, many say “Zeno’s paradoxes” cannot be disproven.

There’s a simple enough way of dealing with people like Zeno. If I’d lived in his time, I wouldn’t have wasted time debating him. I’d have simply offered to set up a race between a turtle and Achilles — or at least a fast runner — and invited Zeno to wager his life’s savings on the turtle. And if he was so certain an arrow could not move through space, I’d suggest he “prove” his theory by standing directly in front of an archer and letting him try.

Which brings us to the financial geniuses of Wall Street, the current state of the U.S. stock market, and your and my 401(k) plans.

Absolutely brilliant people tell us that large U.S. “growth” companies such as Nvidia **↑ NVDA +0.75%** and the rest of the Magnificent Seven **↑ MAGS +0.59%** are certain to keep outperforming everything else, as they have for several years. Big stocks will keep beating small stocks, they say. Glamorous growth stocks will keep beating boring value stocks. U.S. stocks will keep beating the rest of the world. (Although on the last point they do not sound quite as confident as they did in January, before international stocks started ... er ... outperforming U.S. stocks.)

If they are right, then really, all you need in your 401(k) is a large U.S. stock fund, such as an S&P 500 **↑ SPX +0.27%** index fund. Or maybe even just a large-cap growth fund. Or maybe just the Magnificent Seven, regardless of the valuations.

Don't laugh. The last time Wall Street was saying exactly these same things — in the late 1990s, and before that in the early 1970s — a few big supergrowth stocks were considered “one decision” stocks. Why would you need to own anything other than Cisco Systems **↓ CSCO -0.74%** and Microsoft **↓ MSFT -0.40%**, they said in 1999. Or, back in the early 1970s: Why would you need to own anything other than guaranteed winners such as, say, Xerox or Kodak or Polaroid?

The logical conclusion of this argument is that eventually, a small number of huge companies, nearly all U.S. based, will crowd out everything else. And maybe they already have: Did you know that the 10 “biggest” U.S. companies, meaning the 10 with the highest stock-market valuations, already account for about 40% of the market value of the entire S&P 500 index — and 20% of the value of all the traded stocks in the world?

Booyah! When will it be 50%? Or 75%?

There again, maybe these arguments aren't correct. Maybe, eventually, investors will start to ask how they can continue to make 20% a year from a company already valued at several trillion dollars. They may also start to wonder why they are paying, say, 40 times earnings for shares of a big company when they can pay maybe 10 times earnings for other, highly profitable companies that are smaller. This is what happened after the “Nifty Fifty” bubble burst in the 1970s, and again after the dot-com bubble burst in 2000. It may happen again. Investors who have all their eggs in the large-growth company basket may find themselves far less diversified than they had expected.

When that happens, Wall Street may see a dramatic resurgence of two types of stocks that have been left on the sidelines recently: small-company stocks and so-called value stocks, meaning the stocks of less glamorous, slower-growing companies that also happen to be reasonably cheap in relation to their earnings, dividends and net assets.

Enter [recent research from Javier Estrada](#), a well-known professor of finance at the IESE business school in Barcelona, Spain. After mining nearly 100 years' worth of U.S. stock-market data, he has come to a helpful conclusion. To protect your portfolio, he says, you don't need to add both a small-cap fund and a value-stock fund to your portfolio alongside your broad stock-market index funds, such as an S&P 500 fund. A dedicated small-cap value fund will do.

In his calculations, he settled on a balance of 60% invested in the S&P 500 and 40% invested in small-cap value stocks as a simple two-fund solution. (There are plenty of low-cost index funds that focus on small-cap value stocks. Some, such as the Vanguard S&P Small-Cap 600 Value exchange-traded fund **↑ VIOV +1.02%**, use the quality-screened S&P 600 small-cap index instead of broader indexes like the Russell 2000.)

Historically, you'd think the case for small caps and value — and best of all, small-cap value — would be pretty straightforward.

Historical stock-market data show that if you'd invested \$100 at the end of 1927 in the S&P 500 and just left it there, reinvesting all the dividends, today you'd have nearly \$1 million. But if you'd invested that \$100 in small-cap stocks, today you'd have much more — \$4.6 million. And if you'd invested that money in small-cap value stocks, you'd have \$32 million.

Yes, really. Booyah, indeed.

(Naturally, these numbers are theoretical, ignoring things like fees and taxes.)

Ah, say the clever people on Wall Street, but that's old news. Most of those outsize gains for small caps and value stocks took place decades ago — between the 1930s and 1970s. Since 1980 the picture has been totally different, they say. We've had two booms for large-cap and growth stocks — one during the 1980s and 1990s, and one since the financial crisis. And we've had only one boom for small-cap value stocks, between 2000 and 2007.

Maybe, they say, the outperformance of small-cap and value stocks is a historical artifact, like using whale oil to light your living room.

Maybe. Or maybe these things go in cycles. And maybe, the more that big growth stocks race ahead of smaller and value stocks, the more relatively expensive and the less appealing they become as investments.

The unanswered question is whether these people are wise, like Aristotle, or merely clever, like Zeno of Elea. Without a crystal ball, we can only guess — which is why it makes sense to diversify.

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## About the Author



**Brett Arends** [Follow](#)



Brett Arends is an award-winning financial writer with many years experience writing about markets, economics and personal finance. He has received an individual award from the Society of American Business Editors and Writers for his financial writing, and was part of the Boston Herald team that won two others. He has worked as an analyst at McKinsey Co., and is a Chartered Financial Consultant. His latest book, "Storm Proof Your Money", was published by John Wiley Co.

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