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MARKET CONCENTRATION: CUTTING THROUGH THE NOISE

BY JOHN P. LENEHAN, ASSOCIATE AND BENJAMIN L. DEHAAN, ASSOCIATE

INTRODUCTION

Over the past four quarters, the phrase "Magnificent Seven" has become a household term for retail and institutional investors alike. Although market concentration has been increasing steadily over the past decade, it is only recently that the narrow market has garnered the widespread attention of investors and market pundits. Tech euphoria and advancements of artificial intelligence have driven the growth of the "Magnificent Seven" stocks: Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla. Despite the topic's pervasiveness in today's market commentary, many investors have questions on the historical precedence of market concentration, how long it can be expected to last, and whether it is a good or bad thing, among others. Even more so, investors are seeking ways to mitigate any risks associated with the current market environment. These are some of the questions we will discuss as we explore market concentration in this month's *ClearPoint*.

SETTING THE STAGE

Stock market concentration measures how much of the overall market capitalization is in a small number of stocks. The S&P 500, the most popular benchmark for

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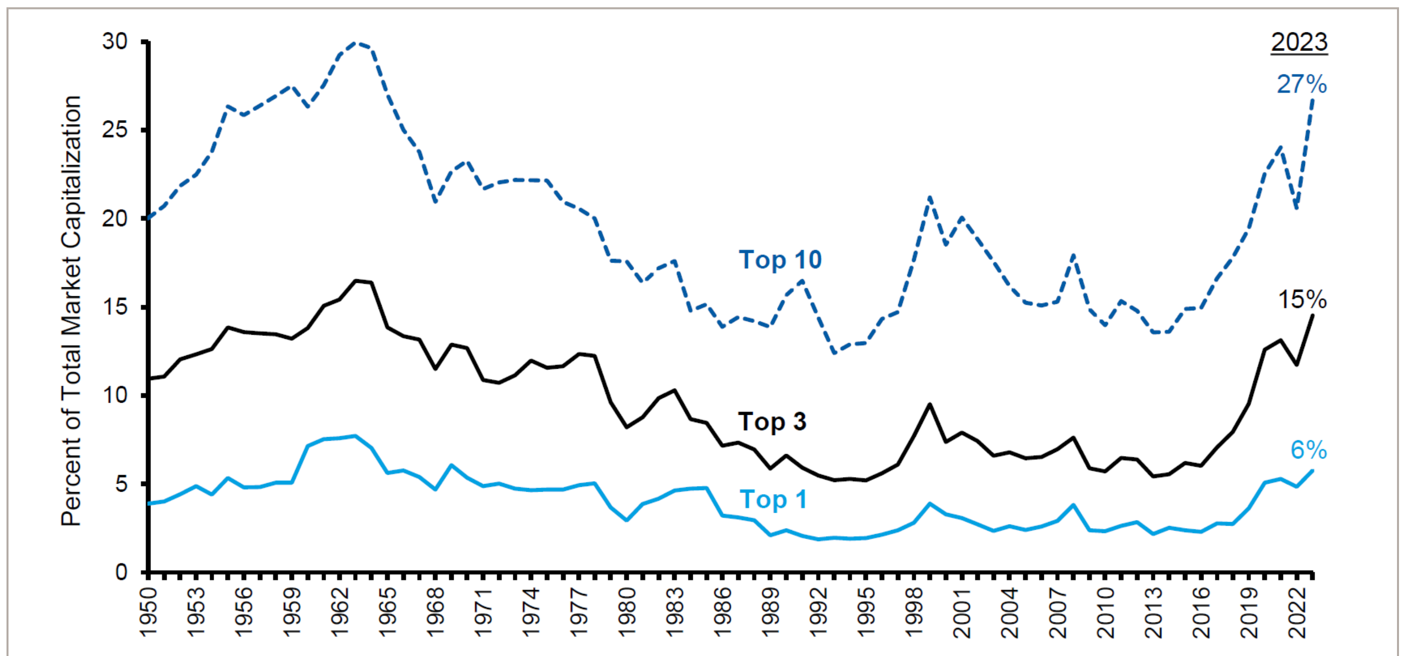
U.S. equity funds, is a market capitalization weighted index. This means that a company's representation within the index is weighted according to the size of its total market capitalization. Said another way, the size of the investment in each stock within the S&P 500 reflects the company's relative market capitalization compared to the others in the index. If an investor were to allocate $1,000 to the S&P 500, they would own more of the relatively larger cap companies and less of the smaller companies within the index.

Market capitalization-weighted portfolios offer investors a simplified, low-cost, diversified investment approach. They also typically provide lower volatility and lower turnover, requiring less rebalancing and reducing trading costs. However, potential drawbacks include underexposure to smaller cap firms in the index and concentration risk, where a few large companies can have a greater influence on the overall index, as is the case today.

The history of stock market concentration reflects the evolution of industries, technological advancements, and changes in investor behavior over time. History has shown that market concentration generally increases during bull markets and decreases during bear markets.[1] However, there is no correlation between high stock concentration and predicting a market correction. Instead, what history has taught us is that these trends tend to stay around, and exogenous risks are typically the cause of reversals, not market concentration.[1]

While today's increased levels of market concentration may be a newer concept for investors, this is not unprecedented. The FactSet chart below shows the market capitalization of the top 10 largest holdings relative to total capitalization, from 1950 to 2023. As recently as 1964, the top 10 largest holdings accounted for roughly 32 percent of the index. Looking even further back, concentration of the top 10 approached 30 percent on multiple occasions, including the early 1900s and around 1875. Looking outside of the US, many smaller stock exchanges in Europe or elsewhere often feature a high level of market concentration whereby a few large-cap firms represent well over 30% of the index.

STOCK MARKET CONCENTRATION IN THE U.S., 1950-2023



Source: Mauboussin, Michael and Callahan, Dan (2024). Stock Market Concentration How Much Is Too Much, Morgan Stanley Investment Management.
Note: Universe includes companies listed on the New York Stock Exchange, NASDAQ, and NYSE American stock exchanges, excluding American depositary receipts; Market capitalizations reflect calendar year-end.

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Many investors today believe that market concentration is too high because it has risen sharply from a much lower level. However, it is also important to remember that this is coming off near all-time lows when the top 10 holdings represented just 14 percent of the total index.[2] But what is the "right" level of market concentration?

One possibility is that large capitalization stocks were mispriced a decade ago, allowing them to deliver very high total shareholder returns through 2023, which suggests that concentration may have been too low. When compared to the twelve largest global equity markets at the end of 2023, the United States was the fourth most diversified market. A study of forty-seven equity markets from 1989 to 2011 found that the average weighting of the top 10 positions was 48 percent.[3] As can be seen, there are several factors that impact market concentration, and it is difficult to determine an ideal level of concentration.

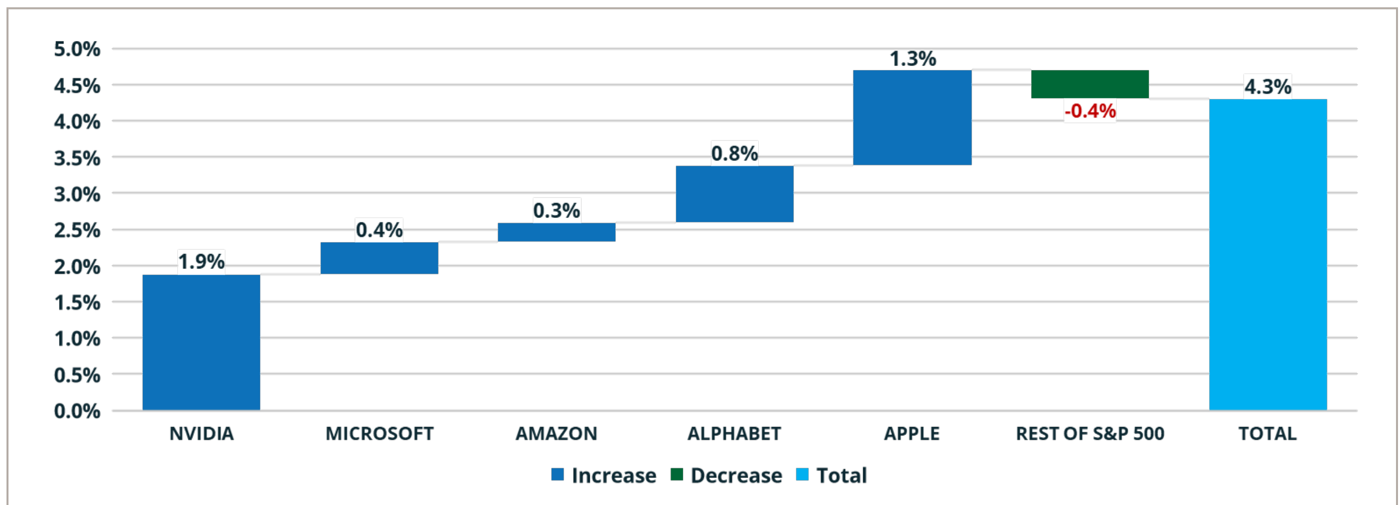
WHERE DO WE STAND TODAY?

The top 10 holdings in the S&P 500 accounted for 27 percent of the index at the end of 2023, nearly double the 14 percent share a decade earlier, according to a recent Morgan Stanley analysis. As of June 2024, they accounted for more than a third of the index.[2] When an index such as the S&P 500 is as concentrated as it is today, investors are not as diversified as they have been in the past. This can work in your favor in narrow market environments, but that reward does come with increased concentration risk.

Market concentration often reflects broader economic trends. For example, a narrow market often results from the dominance of certain industries, economic shifts, technological advancements, or changes in consumer behavior. In the recent past, a narrow market has been centered around market sentiment and optimistic expectations for Artificial Intelligence. Companies that are at the forefront of these potentially disruptive technologies have seen rapid growth, increasing their market concentration.

Companies like Apple, Microsoft, Amazon and Tesla have grown to hold substantial portions of major indices like the S&P 500 and NASDAQ. This means that the S&P 500's performance has been driven by a handful of companies in the recent past. As shown in the chart below, the "Fab Five" were responsible for all the S&P 500's gain in the second quarter of 2024, and the "Magnificent Seven" accounted for more than one-half of the index's 26.3 percent return in 2023.[4]

Q2 2024 S&P 500 RETURNS



Source: Clearstead, Bloomberg LP, contribution to total return, as of 6/30/2024.
Past performance is not an indicator of future results.

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The million-dollar question that investors are grappling with is whether this trend is an anomaly or part of an ongoing pattern that is expected to continue. While it is difficult to predict the future, increased efficiency and growth through artificial intelligence advancements seems to be here to stay.

THE EFFECTS OF MARKET CONCENTRATION ON ACTIVE EQUITY MANAGERS AND WHAT IT MEANS FOR INVESTORS

Active equity managers face a unique challenge in times of heightened market concentration. On average, just 30 percent of U.S. mutual funds outperformed their benchmarks in each year from 1960 to 2023 when the market was characterized by rising concentration, and 47 percent outperformed when there was falling concentration.[3] To determine why this is, we need to remind ourselves that active managers seek to add alpha by finding stocks that are undervalued. Because active equity managers seek to outperform the respective index, they typically own stocks with smaller market capitalizations than that of the overall benchmark.

Outperforming U.S. indices is a tough enough challenge in normal market conditions, let alone in narrow markets where practically all the gains of the index are from a handful of mega cap companies. Put in another way, the percentage of mutual funds that outperform the index tends to decrease when largest cap stocks do the best. In the 1980s, 1990s, and 2010s, the S&P 500 was up 17.5 percent, 18.2 percent, and 13.6 percent respectively. During this time, only 40 percent of active managers beat the index in the 1980s, 36 percent in the 1990s, and 34 percent in the 2010s.[3] During each of these decades, larger cap stocks produced returns significantly exceeding their smaller cap counterparts. The opposite can be observed as well. When smaller cap stocks perform better than large cap stocks, active manager performance tends to increase. In the 1970s and 2000s, smaller cap stocks outperformed larger caps. During these periods, 50 percent of active managers beat the benchmark in the 1970s, and 48 percent in the 2000s.[3] Considering that large cap stocks have outperformed small caps in 9 of the last 10 years, it is becoming increasingly more difficult for domestic active managers to beat the benchmark, particularly in times of heightened concentration.

For investors, it is easy to get caught up in the hysteria surrounding today's narrow market. Undoubtedly, market concentration has risen sharply over the decade. At the end of 2023, the top seven companies in the S&P 500 accounted for 28 percent of the index. The combined market cap of these seven stocks is over $12 trillion, more than four times the market cap of the entire Russell 2000 index—the most common index of small cap stocks.[5] Such market conditions create unique challenges for investors. On the one hand, just a few companies that primarily operate in the same sector are dominating the S&P 500 and other large cap indices. These companies are characterized by significantly high price-to-earnings ratios and are expensive from a valuations perspective when compared to the rest of the market. The risk with abnormally high market concentration is that what goes up is bound to come down at some point, and with it the index that they have come to dominate. Despite the breakthrough of AI technology, the potential for these stocks to become "overvalued" is ever-present and it could be the case that the overvalued stocks dominating the indices today could come down in the future. There is a healthy fear of just how much the Magnificent Seven stocks can come back down to earth. The challenge for investors is to walk the line between having enough exposure to these stocks to take part in meaningful gains, while being diversified amongst other asset classes that are more fairly priced to hedge against the downside risk of the inevitable market correction.

HOW EFFECTIVE FINANCIAL PARTNERS CAN HELP

The challenges investors face when navigating a highly concentrated market highlight the importance of having a financial partner that is committed to fiduciary oversight and that is supported by a robust investment office. In times of narrow markets, effective financial partners add value through the following:

- **Asset Allocation Construction and Review**

  Diversification is an important way to shield a portfolio from the risks associated with narrow markets. Fear of missing out (FOMO) is a dangerous pitfall in the investment world, especially in times of concentrated markets where there is

the temptation to construct a portfolio centrally around the latest buzzword stocks to not miss out on future gains. Constructing an asset allocation that aims to meet the client's objectives by balancing risk profile with spending needs is critical when navigating concentrated markets.

Cutting through the noise of the market and developing a customized asset allocation based on specific objectives and constraints is vitally important. Additional client considerations may include liquidity requirements, comfort with volatility, legal constraints, or organizational preferences.

- **Passive Allocations Combined with Research and Manager Due Diligence**

  Balancing passive allocations to large cap indices along with providing exposure to diversifying sub-asset classes such as small and mid-caps or strategies that ensure prudent dividend exposure in the portfolio are crucial for clients' long-run success. As discussed, active managers have a greater task at hand in beating indices during times of concentrated markets. A game of manager roulette is not recommended. Rather, extensive and thorough manager due diligence is essential to identify high-quality managers who have demonstrated an ability to outperform benchmarks even in narrow markets. To determine high-quality managers, a combination of both qualitative and quantitative factors must be reviewed on a regular basis. This review process should include thorough analysis of strategy, team capabilities, investment processes, terms, key men background checks, reference calls, as well as other considerations such as legal structure and tax implications. At Clearstead, we focus on the Six P's of due diligence: Parent, People, Process, Portfolio, Principles, and Performance. Our viewpoint is that consistency in the first five P's will ultimately lead to desired performance results.

- **Access to High-Quality Private Funds**

  For many investors, private markets can be an attractive space to generate potentially higher risk-adjusted returns or lower correlation to public markets, both of which are meaningful to portfolios, and not just in times of high concentration. Although private markets have gained popularity amongst both institutional and private investors over the past decade, it has never been more important to have a fiduciary that is well-versed in the space and that can access the highest quality managers. Clearstead's dedicated Alternative Assets Team is tasked with uncovering high-quality alternative investments in an increasingly crowded field. Access to these managers can be difficult, and because these investments are private, investment research can be challenging. Alternative investments require additional assessment of liquidity needs within clients' portfolios. Clearstead's research process, client service model, and delivery methods are principal aspects of our approach. A successful alternatives approach must be built over time, through a strong network, and by continuous scouring for opportunities.

- **Commitment to Fiduciary Excellence and Strong Governance**

  In an ever-changing and complex market, it is easy for investors of all types to stumble into any number of pitfalls. It is crucial to partner with a firm that takes fiduciary oversight seriously. Being an effective fiduciary begins with development and refinement of the investment policy statement over time. Additionally, on an ongoing basis, fiduciary responsibilities should be tracked, reviewed, and communicated with clients. As previously discussed, assessing asset allocation and spending needs is another important task of effective fiduciaries. Monitoring tax implications and reviewing manager and advising fees also demonstrates strong governance and is an important factor to monitor in all types of markets.

- **Client Education and Effective Communication**

  Despite their importance, the positive impact of the preceding points is minimal if there is no clear communication between the financial partner and the client. Investors should be provided with regular education on relevant topics that provide context on the market environment, past and future portfolio decisions, and lesser-known asset classes such as private markets. Effective communication from the fiduciary empowers investors to make informed decisions and

builds trust in the fiduciary relationship. Through the clear communication of complex concepts, potential risks, and rationale behind recommendations, effective fiduciaries cut through the noise of market uncertainty and eliminate the temptation to make knee jerk reactions to changes in the market or based on the latest buzzwords. Regular, transparent communication helps to affirm that the client remains aligned with their financial objectives and solidifies confidence in the financial partner's ability to provide strong governance and oversight of assets.

THE BOTTOM LINE

Despite its recent time in the spotlight, concentration within the S&P 500 and other indices is nothing new. Narrow markets, where returns within an index are led by a handful of large market cap companies, is not necessarily a bad thing, and has largely been driven by improving fundamentals, however it carries with it unique challenges for both active managers and investors. Understandably, market concentration causes unease about the possible loss of sufficient diversification and the prospects that the largest stocks are overvalued. These concerns are important to monitor and underscore the importance of having an effective fiduciary to maintain long-term thinking and an even keeled approach that accounts for the various factors that make each client unique.

Source:
(1) Global Financial Data
(2) https://www.cnbc.com/2024/07/01/how-magnificent-7-affects-sp-500-stock-market-concentration.html
(3) https://www.morganstanley.com/im/publication/insights/articles/article_stockmarketconcentration.pdf
(4) Bloomberg
(5) https://www.mellon.com/insights/insights-articles/a-closer-look-at-magnificent-seven-stocks.html

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Performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.

MARKET BENCHMARK RETURNS

August 31, 2024		1M	3M	12M	YTD
US Large Cap	S&P 500 Index	2.4%	7.4%	27.1%	19.5%
US Small Cap	Russell 2000 Index	-1.5%	7.5%	18.5%	10.4%
Developed Intl	MSCI EAFE (Net)	3.3%	4.6%	19.4%	12.0%
Emerging Intl	MSCI Emerging Markets (Net)	1.6%	5.9%	15.1%	9.5%
Real Estate	FTSE NAREIT All REITs Index	5.4%	15.3%	20.8%	10.4%
Core Fixed	Blmbg. U.S. Aggregate Index	1.4%	4.8%	7.3%	3.1%
Short Fixed	Blmbg. 1-3 Year Gov/Credit index	0.9%	2.7%	6.3%	3.5%
Long Fixed	Blmbg. U.S. Long Government/Credit	2.1%	6.7%	7.5%	1.2%
Corp Debt	Blmbg. U.S. Credit Index	1.6%	4.6%	9.0%	3.5%

Source: Bloomberg

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