



ACG Insights: Equity Index Concentration

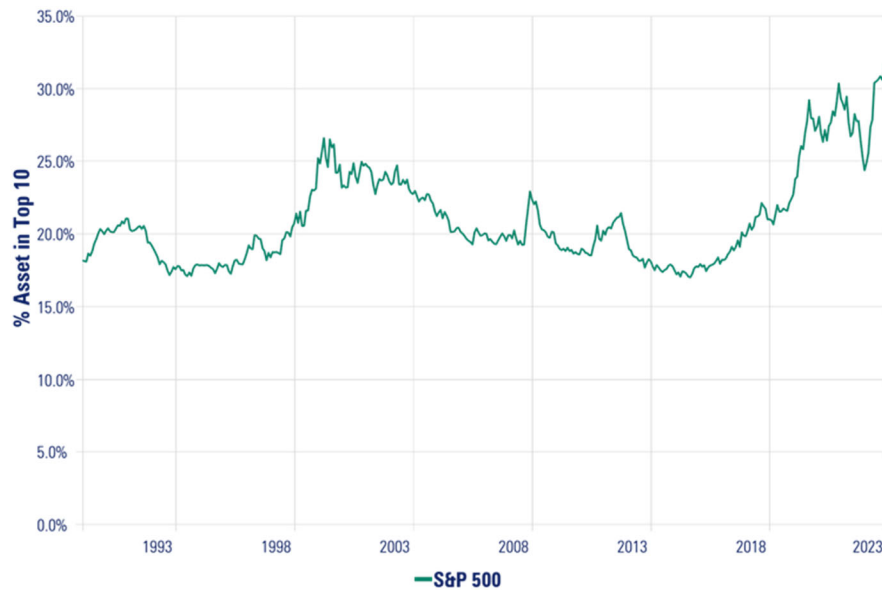
Executive Summary

- **S&P 500 index concentration has reached a new all-time high (Exhibit 1). This has led investors, especially those who use passive vehicles, to evaluate the potential implications**
- **There are approaches to alter exposure, but they may be costly, challenging, or not make sense from a long-term perspective**
- **Investors need to understand the concentrated exposures they are assuming when allocating to broad market indices**

Background:

Don't put all your eggs in one basket. Easy enough. But what happens if one of your "core" baskets gets more concentrated due to the invisible hand of the market?

Exhibit 1: Index Concentration Over Time¹



This is in reference to U.S. Large Cap Equity indices, where currently, a small number of securities are having an outsized influence on overall index performance relative to history. A heavily concentrated index reduces the benefits of diversification and can overexpose a portfolio to company or sector specific risk, which could lead to higher volatility. Currently, the top 10 holdings of the S&P 500 make up 32% of the index relative to the long-term average of 20%. The Russell 1000 growth index is even more concentrated, with the top 10 stocks accounting for 52% of its weight!

¹ Source: Morningstar Direct, 1/1/1990 – 11/30/2023

How did we get here, what are the implications, and what should investors do?

Index Construction and the Magnificent 7

The S&P 500 and Russell 1000 are examples of market-cap weighted indices that mirror the structure of the market by giving larger companies greater weights in the index. Sizing holdings in this manner is efficient due to its ability to reflect the market's collective assessment of the relative value of each stock. Growing stocks take up more of the portfolio, while underperforming ones lose ground and become less significant. Absent an active view, investing in a passive index fund is an excellent approach to get exposure to the equity risk premium.

Whether due to a recovery after a substantial sell off in 2022 or hype related to Artificial Intelligence, seven technology behemoths referred to as the Magnificent 7 have delivered much of the outperformance in 2023.

Exhibit 2: Magnificent 7 Weights, Returns, and Valuations²

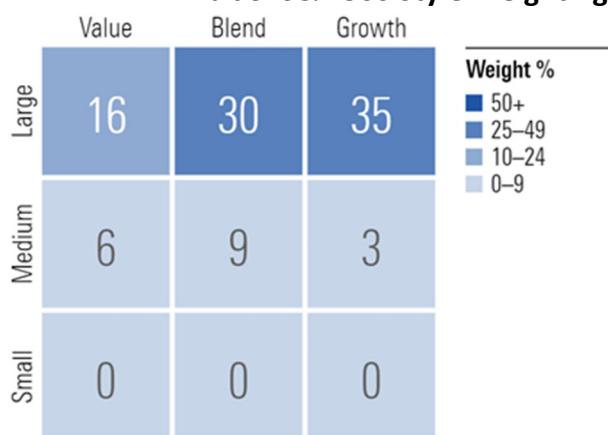
Company	Sector	S&P 500 Weight	YTD Return	2022 Return	P/E Ratio (TTM)	Forward P/E
Apple Inc	Technology	7.2%	50.6%	-26.3%	31.0 x	29.5 x
Microsoft Corp	Technology	7.0%	56.9%	-27.9%	36.7 x	33.4 x
Alphabet Inc Class A & C	Communication Services	3.8%	59.5%	-38.9%	31.6 x	21.2 x
Amazon.com Inc	Consumer Discretionary	3.5%	83.1%	-49.6%	76.5 x	40.2 x
NVIDIA Corp	Technology	3.0%	235.3%	-50.3%	61.7 x	24.8 x
Meta Platforms Inc Class A	Communication Services	2.0%	194.2%	-64.2%	28.9 x	20.8 x
Tesla Inc	Consumer Discretionary	1.7%	106.6%	-65.0%	77.5 x	73.0 x
Magnificent 7 Weighted Avg.		28.2%	75.2%	-39.3%	44.1 x	32.2 x
S&P 500			25.6%	-18.1%	21.6 x	19.4 x

Strong performance relative to the remaining 493 companies in the index has driven their index allocation to new heights. On the one hand, this is a feature not a bug of market-cap weighted indices and no one would complain about being overexposed to outperforming stocks. But on the other hand, with market shocks to the technology sector or AI theme, excess gains could turn into disproportionate losses.

Passive Approach

The objective of a passive allocation to U.S. Large Cap equities is to obtain diversified exposure to the returns generated by these companies, which mostly reflect the expansion of the overall economy. The trade off is you are relinquishing management of the holdings to the market. Due to higher valuations of Magnificent 7 stocks, the passive allocation strategy has acquired a growth bias. (Exhibit 2 and 3).

Exhibit 3: S&P 500 Style Weighting³



² Source: Morningstar Direct and Yardeni Research as of 12/20/2023

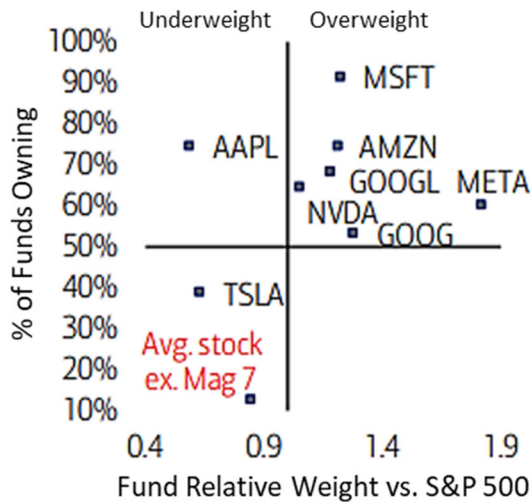
³ Source: Morningstar Direct

Free riding off the collective wisdom of the markets for a very low fee has yielded good results over long periods of time, but it does leave investors exposed when markets act irrationally rather than wisely. It is reasonable to draw parallels between current market conditions and the tech bubble of the early 2000's, but there are no guarantees indices will share the same fate.

Possible Modifications

If you believe index concentrations have gone too far, what actions can you take? Active managers, while compared to their benchmarks, can deviate within their universe according to the best opportunities available. However, with the exception of Apple and Tesla, active managers as a group presently have even larger allocations to the Magnificent 7 than the S&P 500 (Exhibit 4). The inherent trade-off in active management between alpha generation and benchmark tracking can make it challenging to underweight strong performing constituents.

Exhibit 4: Active Large Cap Fund Magnificent 7 Positioning⁴



Another option would be to supplement the market-cap weighted position with different equity sleeves such as a value biased or equal-weight index fund to diversify the overall exposure. These baskets could be customized to a client's concentration comfortability – albeit with higher costs. Positions would also require dynamic adjustments.

A final less complicated solution would be to rebalance allocations to other market segments with better risk/reward prospects. Given the strong performance of U.S. Large Cap equities, the typical investor is probably a little overweight Large Cap Growth relative to target allocations. Perhaps rebalance into Small Caps as highlighted in our previous ACG Insights.

Conclusion

This is not a recommendation to directly reduce exposure to the Magnificent 7. These are great businesses with unique competitive advantages that could allow for the index concentration phenomenon to persist for some time. But no matter how great, investors must be cognizant of the concentration risks associated with investments tied to a particular index. More granular portfolio decisions ought to be evaluated on an individual basis, considering investment objectives, the array of opportunities, and the associated costs and risks accompanying various options. Identifying a market inflection point can only be determined in hindsight, yet it is crucial to consistently monitor your eggs and your baskets.

⁴ Source: FactSet, BofA Global Research as of 9/30/2023

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