INSIGHTS

HOW CONCENTRATED IS THE MARKET NOW?

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COVID-19 is responsible for unique market trends this year. Large growth companies continued to outperform their smaller, value-oriented counterparts, but did so at an unprecedented rate. While such a divergence gives us pause, it does not come as a surprise that cloud-based tech companies would benefit from a year spent working from home and shopping online. The "Big Five" tech giants – Apple, Microsoft, Amazon, Facebook, and Google parent Alphabet – posted an average return of 32% since the beginning of the year, while the rest of the companies in the S&P 500 lost an average 4.35% over the same time period.

The success of the Big Five's business models during COVID-19 as well as the effects of passive index investing have given us a top-heavy market. Recapping previous letters, the most popular stock market index convention gives heavier weights in the index to larger companies. The S&P 500, as well as the Nasdaq 100, and the broad-based Russell indices are all examples. This index design perpetuates momentum, as their rising prices are followed by increasing weight in the index. This requires the manager of an index fund to purchase more shares at higher prices. If a company's price drops, the fund will then have to rebalance by selling shares at a lower price to accommodate the lower weighting.

Over the past two years the concentration of the largest companies increased across most indices, with the Big Five making up 14% of the S&P 500 at the beginning of 2019, rising to 23% today. The growth-focused Nasdaq 100 index is even more concentrated, with the same companies comprising 46% of the index. Even the Russell 3000, containing the 3000 largest publicly held companies in the U.S., has a 19% concentration to these five. The increased concentration and high performance of the Big Five has led to the S&P 500 returning 5.57% year-to-date when weighted by market cap but losing 4.48% over the same period if each stock is given an equal weight. This trend is concerning as history shows a high correlation between market volatility and concentration.

As fundamental analysts we focus on company earnings, cash flows, and balance sheets, but still recognize the importance of observing technical data points such as market structure, volumes, and price movements. One such technical factor we look at is the difference between the number of advancing and declining stocks over given time periods. When an index exhibits strong gains in periods where relatively few stocks have positive returns, the tendency is for the index to revert to its mean within the next year. The handful of market leaders propelling the market to new highs ultimately fail to generate enough fundamental earnings to justify their elevated valuations, which generally results in a large market drawdown. Only 42% of stocks in the S&P 500 have positive returns this year, compared to 80% in the recovery following the Great Recession in 2009.

Clearly the returns of a handful of companies are buoying the stock market and this recovery is not broad-based.