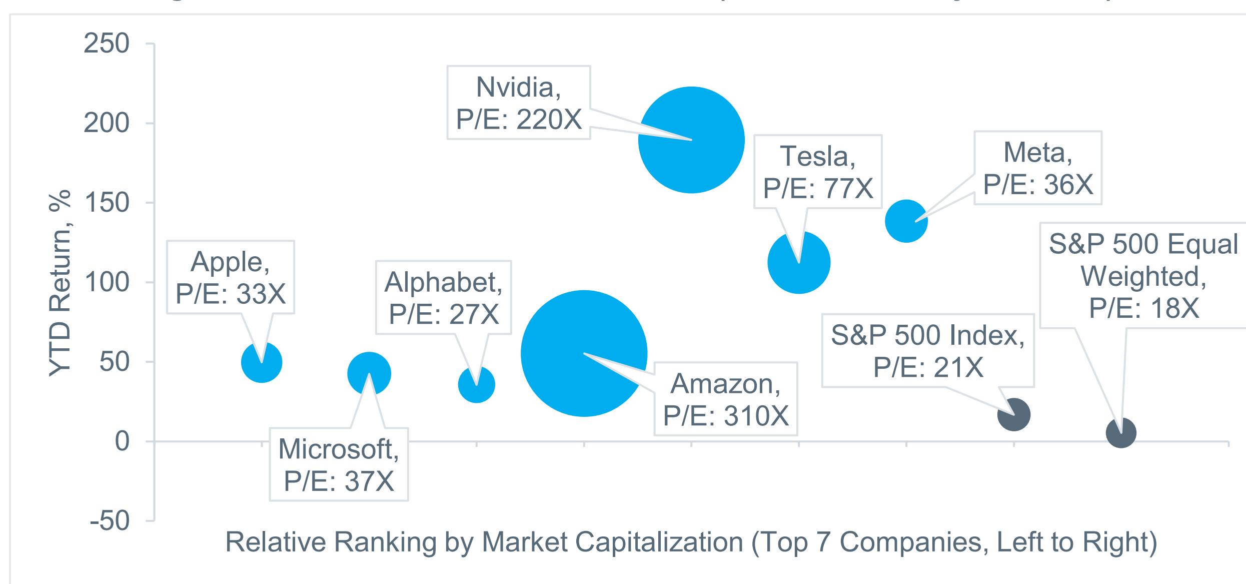
US Stock Market Concentration

The drivers of price movement in public markets are forever shifting and are often difficult to discern and isolate. The first half of 2023 is no exception, as many forces continue to impact investor decisions and market results. However, there is one trend that has garnered significant attention: the largest index holdings in the US stock market are again the dominant drivers of total index returns.

US Stock Market Concentration

Figure 1 illustrates the performance of the top seven stocks (by market capitalization weight) since the start of 2023 and their current valuations, compared to those of the S&P 500 and S&P 500 Equal Weighted Indexes. Investors rationalize these valuations based on the size, scale, competitive advantages, and cash balances of this mega-cap set. Further optimism is based on the potential of artificial intelligence to entrench the existing moats of these companies more firmly. Collectively, these stocks make up nearly 28% of the S&P 500 and have earned a weighted year-to-date return of over 19%, as of June 30, 2023. The entire S&P 500 Index has earned a return of 17%, implying that the remaining stocks in the index have delivered a negative weighted return over the same period. The performance of this top group has been off the charts as some investors have seemingly looked past their relatively high valuations.

Figure 1: Recent Returns and Valuations (Circles Scaled by P/E Ratio)

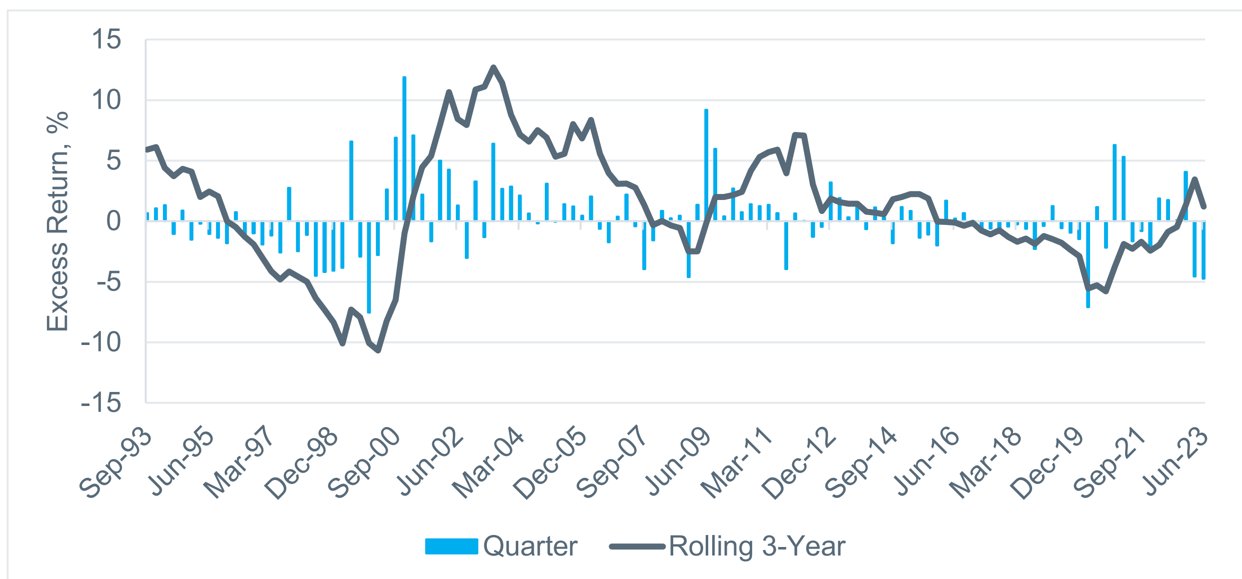


Source: Morningstar and Bloomberg. As of June 30, 2023.

Wary active investors or those concerned with index concentration only need to look back 18 months to remember a time when the top companies of the index outpaced the rest of the constituents to the same extent. However, when spread over a longer-term period (**Figure 2** uses 36-month rolling windows) and viewed over a 30-year horizon, the recent trend can be put into a fuller context. The market has experienced extended periods where a narrow group of winners appreciates rapidly. However, longer-term returns tilt

slightly in favor of the index constituents as a whole. The 3-year excess return of the S&P 500 Equal Weighted Index versus its market-cap-weighted counterpart has averaged +1% over the 30-year period shown, even with the current period included. It is worth noting that these excess returns are achieved with higher volatility, increased mid cap exposure, and a lower liquidity profile given the even distribution of weight across mega cap, large cap, and mid cap stocks within the index.

Figure 2: S&P 500 Equal Weighted Index Rolling Excess Returns vs. S&P 500 Index

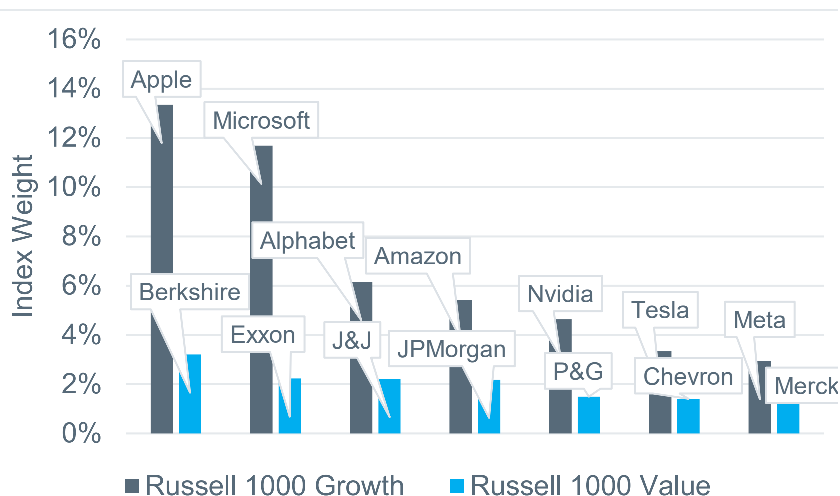


Source: Standard & Poors. As of June 30, 2023.

Style and Active Management Considerations

The impact of this recurring trend is felt across active US large cap managers—but given the size of these companies in the growth indexes, the affect is most acute in the large cap growth asset class. **Figure 3** illustrates the top-heavy nature of the Russell 1000 Growth Index when compared to the Russell 1000 Value Index. In short, the top holdings in the Russell 1000 Growth Index are more likely to drive index returns higher or lower as a group given their combined weight—a dynamic which is not as pronounced in the value index. At over 45% of the index weight, the top 7 stocks in the Russell 1000 Growth Index contribute significantly more stock-specific risk than their value counterparts.

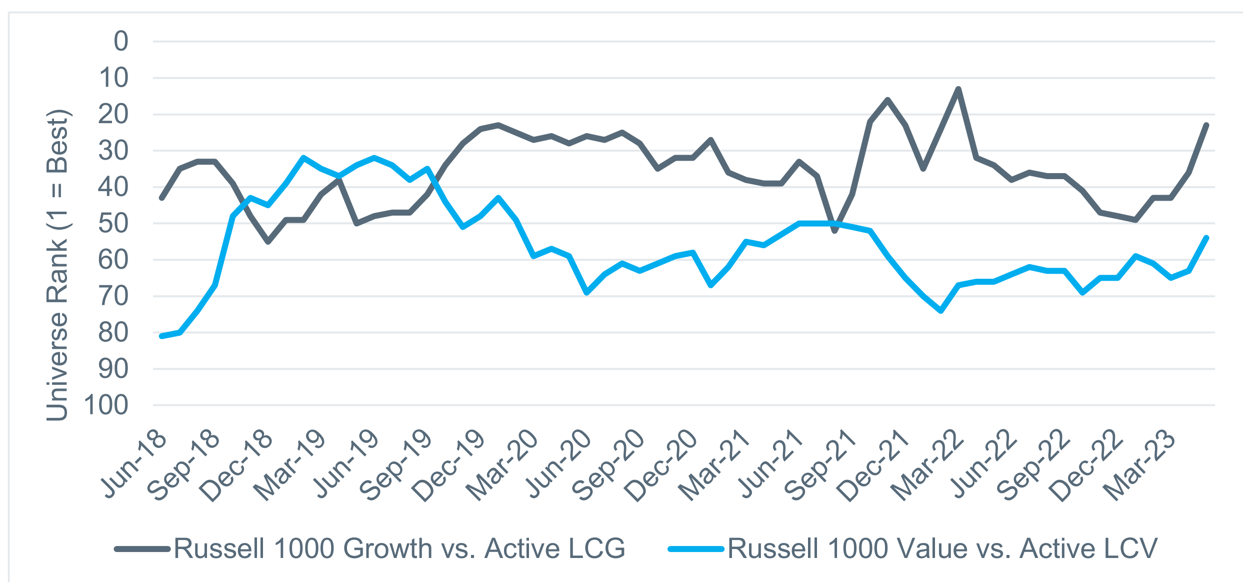
Figure 3: Style Index Concentration (Top 7 Holdings)



Source: FTSE Russell. As of June 30, 2023.

As in past periods where the top growth stocks dominated the returns of the Russell 1000 Growth Index, active large cap growth management can have difficulty adding value by investing in stocks lower on the cap spectrum given the impressive returns of the highest weighted stocks. The mega cap growth group has been a key driver of recent absolute returns with the Russell 1000 Growth Index returning 29.0%, year-to-date, through June 30, 2023, compared to 5.1% for the Russell 1000 Value Index over the same period. These near-term returns represent a reversal from the environment experienced in 2022. The return of -7.6% for the Russell 1000 Value Index in 2022, while negative, significantly outpaced the sharp drop of -29.1% for the Russell 1000 Growth. The current environment is difficult for active managers, especially those who are significantly underweight one or more of this mega cap growth group. **Figure 4** shows recent ranking data for each style index versus the net active manager returns in the eVestment Large Cap Growth and eVestment Large Cap Value peer groups. As shown by the gray line, the 12-month return of Russell 1000 Growth Index ranks in the top quartile compared to the active management universe as of May 31, 2023.

Figure 4: Rolling 12-Month Return Ranks vs. Active Management



Source: eVestment. As of May 31, 2023.

The cyclicality of the mega versus mid cap relationship (and growth versus value) should be part of any discussion when reviewing the short-term performance of an individual active manager or full equity composite structure. For investors concerned with the impact of the return contribution of the top stocks in the index, it may be an opportune time to discuss whether there is flexibility within their current structure to seek further diversification or perhaps rebalance from their US equity allocation if it is approaching an upper limit. However, corrections to mitigate portfolio or manager biases should not be made in reaction to near-term trends. Rather, they should always be made within the context of an existing asset class structure, and changes to strategic asset allocation targets should be applied based on long-term assumptions and strategy.

Disclaimer of Warranties and Limitation of Liability

This document was prepared by RVK, Inc. (RVK) and may include information and data from third party sources. While RVK has taken reasonable care to ensure the accuracy of the information or data, we make no warranties and disclaim responsibility for the inaccuracy or incompleteness of information or data provided or for methodologies that are employed by any external source. Past performance does not guarantee future performance. This document is not intended to convey any guarantees as to the future performance of investment products, asset classes, or capital markets.

About RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Boise, Chicago, and New York City. RVK is one of the five largest consulting firms in the world, as reported by *Pensions & Investments' 2022 Special Report–Consultants*. Additionally, in April 2023, RVK received a notable award as a *Coalition Greenwich Quality Leader* among large US investment consultants, based on Greenwich's 2022 study. Coalition Greenwich is an industry-recognized third-party firm which asks plan sponsors to rank their consultants on a series of key metrics. Notably, RVK is the only firm among large US consultants to receive an award for a sixth consecutive year. Coalition Greenwich issued the award on April 25, 2023 based on their February through November 2022 study. No direct or indirect compensation has been paid by RVK in connection with obtaining or using this award. To read more about the Greenwich award, please refer to the following URL: https://www.rvkinc.com/about/about.php. RVK's diversified client base of nearly 200 clients spans over 30 states, and covers endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenue from clients for investment consulting services.