

Market Concentration

In recent years, a few mega-cap growth stocks in the tech sector have dominated market returns and come to represent an ever-larger share of total market capitalization. Besides leading to record levels of concentration, this lopsided performance has had important implications for active portfolio management, equity valuations, and market risks.

Strong Returns, Stretched Valuations

A few mega cap high tech stocks – affectionately called FANMAG for Facebook, Amazon, Netflix, Microsoft, Apple, and Google – have enjoyed returns that far exceed other stocks in the S&P 500 (Exhibit 1). This has led to increasingly high capitalizations and valuations for these stocks and record high market concentration (Exhibit 2).

The market domination by the few is occurring in a broader context of extraordinary price movements. These include the fastest ever recovery from a bear market that propelled the market up by nearly 40% from its low, a high level of three-standard deviation daily market moves, and signs that crowd psychology, rather than fundamentals, is driving some individual stock price movements.

EXHIBIT 1: Mega Cap Tech Stocks Far Outstrip Market Returns

Source: Bloomberg. Index, 1/1/2015 = 100.

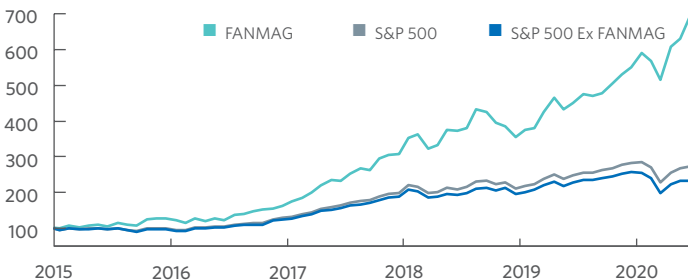


EXHIBIT 2: Market Concentration at Four-Decade High

Sources: Compustat and Strategic.

Data through June 2020.



The recent market dynamic is far from the norm. Typically, companies with the largest market capitalizations underperform the broader market. Over long periods, the underperformance of the 10 largest stocks relative to the rest of the market has been substantial, averaging over 1% per year during the past 40 years. Since 2015, however, this normal trend has reversed. The largest capitalization stocks have outperformed by a wide margin, with the degree of outperformance so far this year approaching 25%.

The domination of the market by a few mega-cap stocks has wrong-footed active managers by complicating the difficulty of active management in two ways. First, it has significantly narrowed the opportunity set for active managers. Failing to hold the hot few hurts relative performance. Second, the size of the performance penalty for not investing in these names has grown to high levels given their degree of outperformance. Buying into the FANMAG growth story has been the key to outperformance, despite valuations justified by little more than expectations for continued extraordinary growth.

From Concentration to Calamity

This is not the first time that a small number of big, growth-oriented market darlings have skyrocketed. In the past, these periods of concentration and high valuation have been the tip of the iceberg of broader market excesses and instability and harbingers of a generalized market decline. The “Nifty Fifty” was such a group in the early 1970s, temporarily commanding valuations that, as now, were not justified by fundamentals. More recently, there have been in the past 40 years four instances including today in which the ten largest constituents of the S&P 500 have represented 25% or more of the market. On the previous three occasions, the subsequent market decline averaged 20%.

Could This Time Be Different?

Great fortunes have been lost believing that, “This time is different.” The arguments supporting this claim change from time to time, but all ultimately mask signs of froth and growing market risk. The current rationalization is as follows. The favored few will continue to grow rapidly and over time ultimately justify their current valuation. The top 10 are all household names and global leaders with scalable business models providing innovative and widely appreciated services in sectors that represent the future and are currently benefiting from lax anti-trust enforcement and light taxation. Their sustained outperformance is an indicator of strength, not risk.

As in the past, there are many plausible stories justifying the current market dynamic. Time will tell whether this time is truly different.

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