

SALT INSIGHT

By: Greg McMaster, Head of Client Partnerships
Greg Fleming, Head of Global Diversified Funds

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Current equity market dominance and concentration risks

We are currently seeing a period of equity market euphoria. Everyone is well versed in the story of the magnificent seven, and the impact these stocks have had on markets throughout 2023. However, in 2024, as equity markets reach all-time highs, the concentration of stocks driving these highs are even more concentrated. Concentration can negatively affect portfolio diversification, both geography-wise (i.e. US vs. Rest of World) and industry-wise (Information Technology vs. the other 10 Industry sectors.)

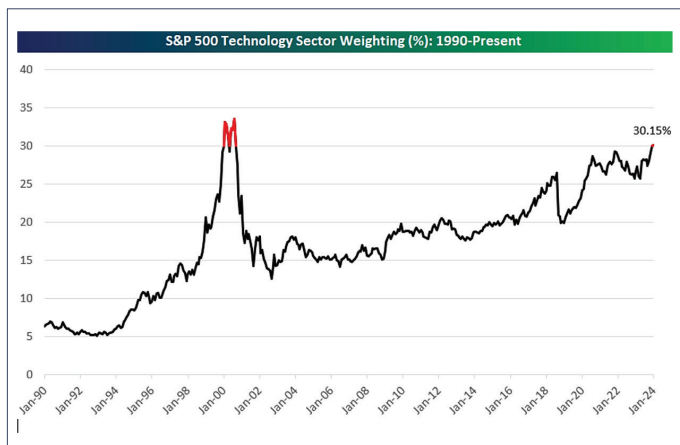
So far in 2024, with the US S&P 500 Index having rallied 15%, the contribution of the "Big Five" (Apple, Microsoft, Alphabet, Amazon and Nvidia) accounts for over half of that gain. As a result, Technology's weighting in the S&P 500 Index is now at a post-2000 high, now above 30%. That means that passive funds, holding component stocks at market capitalisation weightings, are more than usually exposed to the market impacts of both elation and disappointment in the Information Technology sector.

As for the Magnificent 7, (the Big Five plus Tesla, and Apple) these companies represent 56% of the YTD index return to end-May, with the tell-tale statistic being that the 7 averaged an 8.1% gain for the May month, outperforming the broad market (which averaged +2.6%). S&P itself has written that this indicates an equity market that "is still top-heavy."¹

As an active manager, these periods (when one industry sector or geography substantially dominates returns) can take a toll on relative performance compared to a traditional broad benchmark or index. If the stocks leading the charge are not aligned to a particular investment philosophy or investment style, it can appear that a manager may not be doing a good job. However, it can also make another active manager look exceptionally good. With this, some may say active management is too hard to pick, so let's just go passive.

Our appointed global equity manager, Morgan Stanley Investment Management (MSIM), highlights in a recent note, active versus passive needn't be an either/or decision. They argue there's a strong case for both index investing and active management to co-exist in portfolios. How they are balanced can be determined by an investor's investment objective, preferred time horizon, and appetite for risk – whether the definition is tracking error or the risk of losing money.

However, being an index (or passive) investor today, isn't so passive at all. Firstly, you need to make an active choice to be passive, but secondly you then need to decide which index(es) you are going to invest in. According to the Index Industry Association^[1] there are over three million stock indices to choose from – which equates to more than fifty times more indices than stocks!



Source: MarketWatch, data to 31 May 2024

Then there's risk. By owning more, an investor may hope to benefit from the positive effects of diversification. But is owning everything regardless of quality or valuation really the best way for investors to diversify a portfolio? Equally, with the focus of so many managers and investors on relative risk, the market has provided a comfortable place to take shelter. But is weighting a bet based on size sensible, given that most widely recognised and invested indices are typically market-cap weighted? In bull markets, market-cap weighted indices in particular can become increasingly biased and lopsided as valuations for those stocks perceived as "winners" are stretched, and their weights mechanically increase in the passive indices. Recent research^[iii] from Morgan Stanley observed that S&P 500 concentration is at an historical extreme, increasing its vulnerability to a steep correction as the cycle turns.

This risk is further compounded by the connected aspects of the largest stocks that dominate several equity indices. Of course, an investor may attempt to diversify some of this thematic risk by tracking a global index, but with the U.S. weighting in global indices at an all-time high^[iv], they may not achieve the diversification expected.

While passive funds provide broad-based exposure and nimble, cheap access to tactical themes, there is still an opportunity to be selective – particularly given indices' biases.

So back to active management. Like passive fund options, there is plenty of choice for investors to choose from. But one option to consider is to ignore the relative game of investing, constantly measuring yourself against an index

that may, or may not, be relevant to your objectives and true time horizon. We believe that the investment strategy we have selected, run by MSIM's International Equity Team, a concentrated, benchmark agnostic approach, may offer a useful counterbalance to passive investment.

- *We seek to own what we believe to be the highest quality companies in the world. Our focus is on high quality companies at reasonable prices, those that have the ability, in our view, to sustain their already high returns on operating capital, compound their earnings and cashflows steadily over time, and exhibit resilience in tough times.*
- *Selecting a long-term, high conviction, high active share portfolio offers a commitment to remain invested and resist behavioural biases to buy high and sell low. We seek to act as owners for the long term, not tactical renters for the short term.*
- *We pay attention to the fundamentals of what we own more than the current price or performance of what we don't. Our focus is, and always has been, on the absolute: absolute price, absolute performance, and absolute quality.*
- *Investors who seek minimal tracking error participate fully in the market's ups, but just as crucially, fully in the market's downs. Investing in an active portfolio of high quality companies whose earnings can compound steadily over time offers reduced risk of permanent loss of capital.*

i <https://www.spglobal.com/spdji/en/documents/commentary/market-attributes-us-equities-202405.pdf>

[i] www.indexindustry.org 14/11/2018

[iii] Morgan Stanley Wealth Management, Global Investment Committee, January 19, 2024, "Consequences of Concentration".

[iv] Source Factset: Peak US weighting of MSCI World 29 March 2024 (70.9%), trough 31 March 2008 46.7%. 20 year average 57%.

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