



WEALTH MANAGEMENT

SEPTEMBER 2024

MARKET CONCENTRATION

*WHAT IT MEANS
FOR INVESTORS*



Craig Goryl, CFA[®]
*Chief Investment Officer/
Equity Portfolio Manager*

Cabot Wealth Management
www.eCabot.com

MARKET CONCENTRATION

WHAT IT MEANS FOR INVESTORS

In this white paper, I cover what “market concentration” means, what it looks like today, and why it matters.

You may have seen headlines or articles that state: *The market is concentrated today*. This means a small number of companies make up a very large portion of the stock market’s value. As a result, the top few have an unusually powerful impact on the market’s return and risk characteristics. There are three major implications for investors which I’ll address in this paper:

- Widely followed indexes like the S&P 500 do not paint a complete picture of the broader market, and certainly not the broader economy.
- Concentration has brought on talk of market bubbles, but evidence suggests this is not one.
- The S&P 500 is not well diversified today. Therefore, it carries more risk than is commonly assumed.



Craig Goryl
Chief Investment Officer

Craig serves as Chief Investment Officer and is Senior Portfolio Manager of Cabot’s Growth & Income Strategy, a diversified equity portfolio that aims for moderate risk by focusing on quality companies trading at discounted valuations. Craig joined Cabot in 2011 as an equity analyst responsible for finding, researching, and monitoring investment ideas across sectors and geographies. Prior to Cabot, Craig worked at Gerson Lehrman Group managing primary research products for institutional investors, and at Putnam Investments in various positions, including equity analyst. Craig holds a Bachelor of Arts degree in Economics from Cornell University. He is a CFA® Charterholder and a CFA Society Boston member. He has volunteered to teach financial literacy at Year UP and Citizen Schools.

CONTENTS

I. INTRODUCTION	05
What is Market Concentration? What Does it Look Like Today?	
II. HOW DID WE GET HERE?	08
III. WHY DOES THIS MATTER TO INVESTORS? WHAT ARE THE RISKS?	09
IV. WHAT TO DO?	13
V. CONCLUSION AND SUMMARY	14
Reasons to Avoid Mirroring the S&P 500 Today	
VI. APPENDIX	15
Tech Stocks Up on the Promise of a New Innovation - Is this a Bubble Again?	

I. INTRODUCTION

WHAT IS MARKET CONCENTRATION? WHAT DOES IT LOOK LIKE TODAY?

When someone asks, “How did the market do?” the most common answer cites the return of Standard & Poor’s 500 Index (shorthand, the “S&P 500” or just “the S&P”). It represents the largest 500 public US companies by their market value. The S&P 500 and “the market” are often used interchangeably. That’s because the S&P 500 represents about 80% of the total US public stock universe in value.¹

However, when the S&P is doing well, that doesn’t necessarily mean most stocks are doing well. Why? The answer has to do with the difference between a *simple average* and a *weighted average*. A simple average counts all components equally. A weighted average, like most market indexes, counts bigger components more. The S&P 500 uses a weighted average methodology. Specifically, it is a capitalization-weighted index. The more a company is worth, the more it counts in the index. And today there are a handful of companies that count for a LOT of this index. The three most valuable companies in the US at the end of the second quarter of 2024 (Apple, Microsoft, Nvidia) account for more of the index than the bottom 350 stocks put together!

Here is a hypothetical example of what that might mean: Nvidia is the most valuable chipmaker in the world and the third largest S&P 500 component. If Nvidia’s stock doubled (which it already did in the first half of 2024) and every other stock stayed the same, the S&P 500 Index would rise 6.6%. If instead Dupont or General Motors (GM) stock doubled and everything else stayed the same, the S&P would rise *less than 0.2%*! They simply don’t move the needle the way that Nvidia does.

I did not choose GM and Dupont randomly. Each at one time held the title of “LARGEST S&P 500” component. Both were, at different times, the most valuable company in the US and the most important contributor to the S&P 500. Only twelve companies have held that top spot in the last century. However, the contribution of those former #1s to the S&P 500 today is almost insignificant.

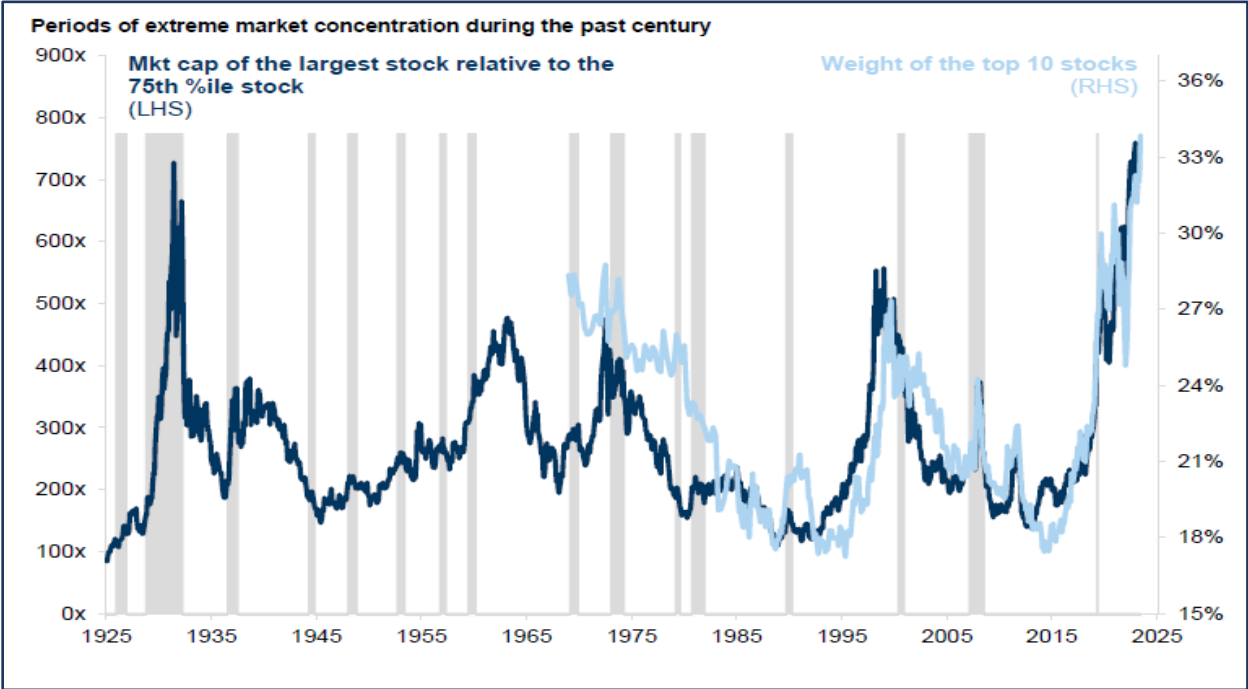
Why is all this important? The more weight is at the top of the index, the less the index will reflect most companies, even large, established ones like GM and Dupont. And today, that is what is happening. The S&P 500 is increasingly a representation of a few companies, rather than many. It offers a picture of “the market” that is not very complete.

How concentrated is the market today? I think the answer is best shown with pictures.

In the chart below, the dark blue line compares the weight of the largest stock in the S&P 500 to the 75th percentile stock. Think of that as stock #375, or “the middle of the bottom half” of the 500 companies in the index. The light blue line compares the weight of the top 10 companies to the total

¹ <https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview>

(the data does not go back as far for this measure). Both are ways of asking “How much weight is at the top?” Both measures are at historic highs.



(Source: Goldman Sachs)

On the next page is another visual representation, called a treemap chart. The blocks here are proportionate to each company’s weight in the S&P 500 Index as of July 2024. (Note: Colors indicate return year-to-date, green = positive and red = negative.) The very large blocks really stand out: Apple (AAPL), Microsoft (MSFT), Nvidia (NVDA), Alphabet (GOOG), Amazon (AMZN) and Meta (META) are the largest blocks. Collectively they take up about 30% of the picture.



(Source: <https://finviz.com/map.ashx?st=w52> 7/24/24)

Notice too that the biggest blocks are all green. It does not look like 173 of the blocks (more than 1/3 of them) in the chart are red, does it? They are, but the massive green swaths (that represent those tech giants) dominate the picture. Here are a few more statistics for the first 6 months of 2024, which illustrate the distortion caused by high market concentration:

- Less than one-quarter of companies in the S&P 500 have done better than the S&P 500. Turning this fictional Lake Wobegon (where all are “above average”) on its head, most stocks have performed below the average.
- 38% of S&P constituents had a negative return in the first 6 months (the index was up 16%!)
- The S&P 500 was up 4.3% in the second quarter. The “equal weight S&P”, a simple average, which gives every company the same weight, was *down* -2.6%.

II. HOW DID WE GET HERE?

The top stocks today – the top 6 in particular (Nvidia, Apple, Alphabet, Amazon, Meta, Microsoft)- share many similar characteristics, and those characteristics tell us a little about how they got to be so valuable. They have the following in common, which have made them very profitable, fast-growing, and appealing to investors:

- These companies are highly global and highly digital. They are not constrained by the size of the US economy, and mostly not constrained by the need to manufacture physical goods, allowing them to grow faster and longer than most companies in history.
- They are technology-enabled, allowing them to create brand-new markets and disrupt large existing ones.
- Those first two attributes make them massively scalable, meaning they can grow very fast, very profitably, without much more hiring or infrastructure.
- They have piles of cash on their balance sheets to invest in their business if needed.
- The businesses are fundamentally stable, thanks to subscriptions and repeat behavior that keep the sales coming, without much sensitivity to swings in the economy. They feel “safe.”
- They have wide moats: it would be very difficult for an upstart to compete with them because of highly sticky products, powerful network effects, and consumer habits. They’ve also been built through years of research and development, and are often protected by patents.
- They have nearly monopolistic market positions, with little regulatory pushback, either because they’ve built their dominance organically (rather than by acquiring competitors) or simply through lax antitrust enforcement.

These attributes are highly prized by investors, employees, and business partners because they have helped generate enormous profits in the past, with expectations for more in the future. That creates a virtuous cycle: these companies can easily raise capital. They can attract the most talented employees who may look at past success as a promise of future stock option riches. And they can bring in other companies as partners or acquisitions. Competitors tend to take the “if you can’t beat ‘em, join ‘em” approach.

There is another factor that has supercharged the rise in value of these six companies more recently. It is excitement over Artificial Intelligence or AI. When OpenAI put its generative AI tool called ChatGPT in the hands of ordinary people in November 2022, it spurred tremendous enthusiasm over the power of AI. What had been mostly theoretical became real to investors.

These six tech incumbents, with some of the deepest pockets, the most talented engineers, the most advanced computing infrastructure, and the most aggressively competitive and entrepreneurial management teams, would surely be the biggest beneficiaries of this next tech boom.

That ChatGPT launch is credited with powering a market rally that began in January 2023. But participation in the rally has been limited and focused on the top. You can see that in the final spikes of concentration in the earlier chart.

Some market commentators have pointed to the market-moving rally in these tech stocks as evidence of a bubble. This is a fascinating question worth digging into. However, since it is ancillary to the scope of this paper, I will save that discussion to the end, in an Appendix.

III. WHY DOES THIS MATTER TO INVESTORS? WHAT ARE THE RISKS?

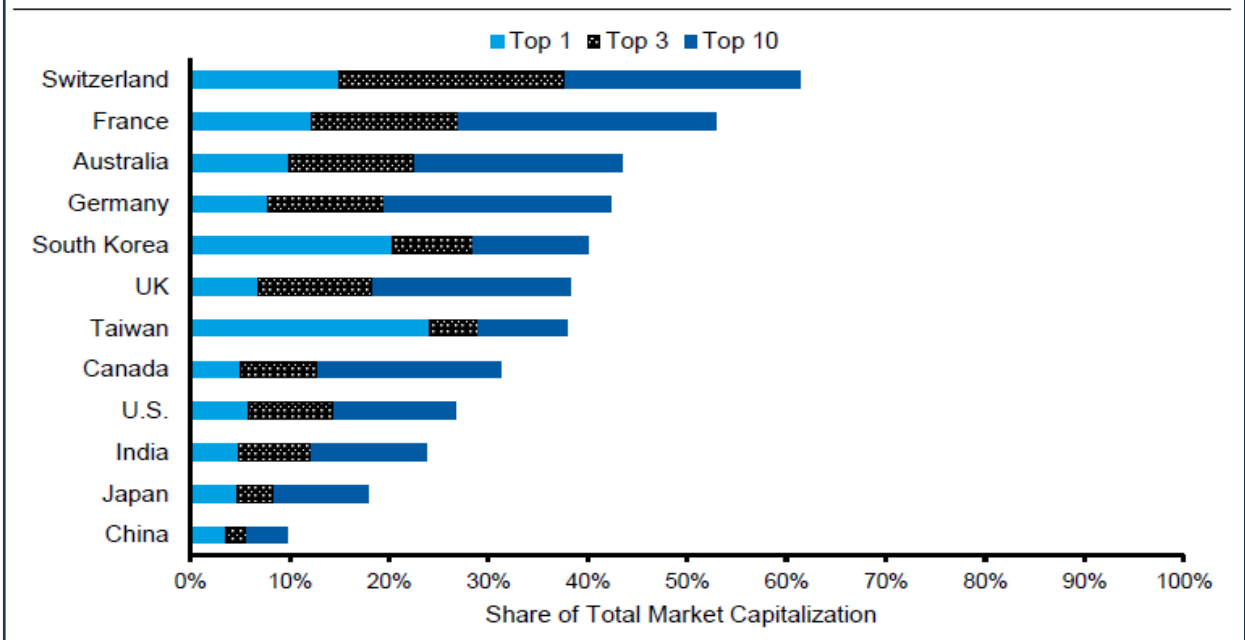
Most people think of the S&P 500 as broadly diversified. Increasingly, it isn't.

As this paper has tried to show, the index is dominated by a few large companies. What is more, these companies share many similar characteristics, and risks, which means their stocks behave similarly:

- They are tech driven and tend to move with that sector.
- They have high P/Es, meaning much of the value the market ascribes to them is far into the future. This makes the stocks sensitive to inflation, interest rates, and sentiment.
- As toothless as antitrust enforcement has been during their rise the past decade, the government has gotten more aggressive under the past two administrations. All six companies we've discussed face scrutiny today from the Department of Justice and other authorities.
- They have been propelled most recently by optimism about the promise of AI. If AI faces hiccups - as many new technologies do - investor disappointment could hit them all at the same time.

With 30% of the index comprised of only 6 stocks that tend to move together, that index is not broadly diversified. However, there is no rule that says it has to be. And nothing says the S&P must revert to a diversified index. Plenty of other countries and industries have even less diversified markets:

Exhibit 3: Stock Market Concentration in the Largest Global Equity Markets, 2023

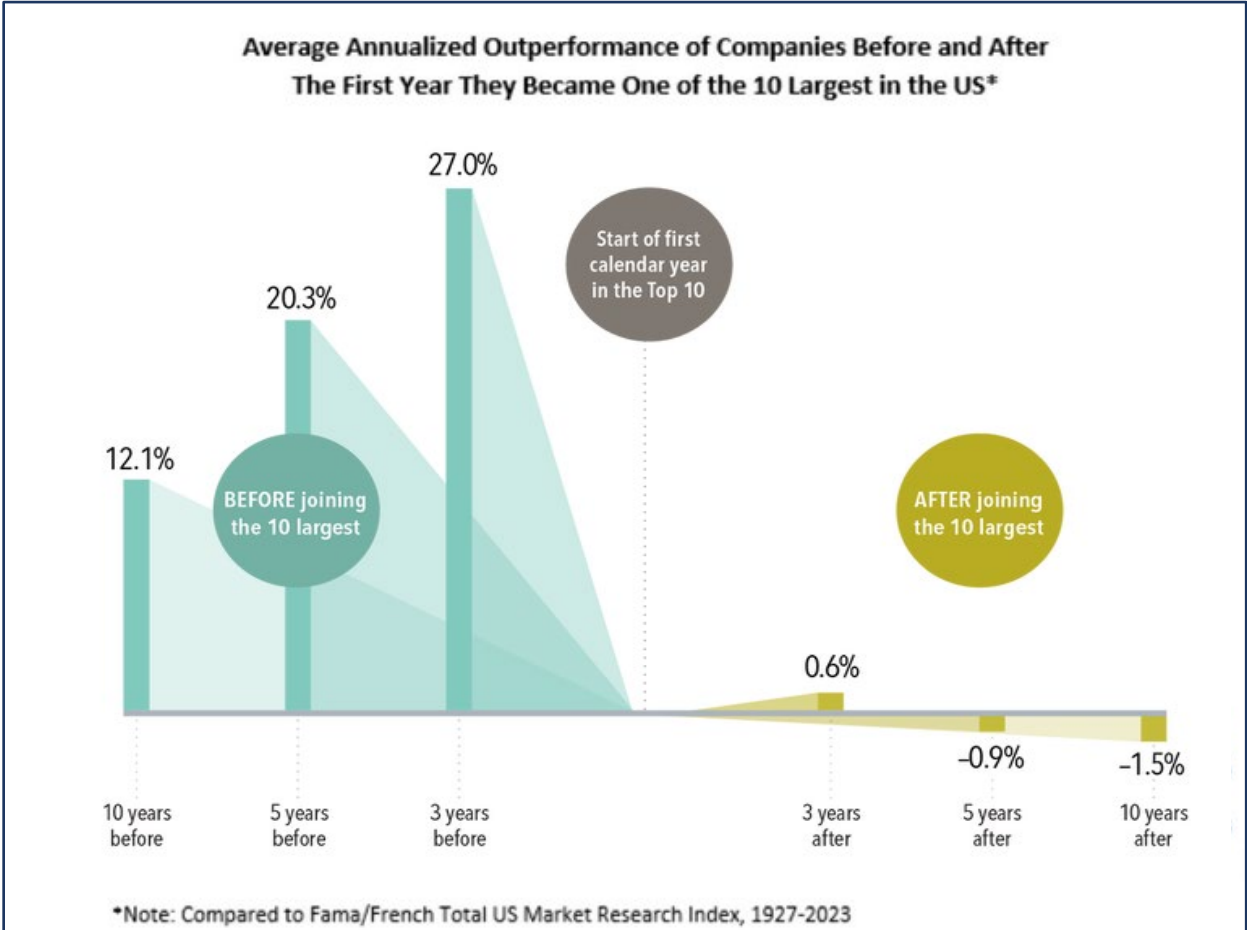


Source: FactSet and Counterpoint Global.

Note: Stacked bars reflect cumulative concentrations; Universe includes companies on the following stock exchanges: Switzerland: SIX Swiss Exchange; France: Euronext Paris; Australia: Australian Securities Exchange (ASX); Germany: Xetra (Frankfurt Stock Exchange); South Korea: Korea Exchange; United Kingdom (UK): London Stock Exchange; Taiwan: Taiwan Stock Exchange and Taipei Exchange; Canada: Toronto Stock Exchange; U.S.: New York Stock Exchange, NASDAQ, and NYSE American; India: Bombay Stock Exchange (BSE); Japan: Tokyo Stock Exchange; China: Shanghai Stock Exchange and Shenzhen Stock Exchange.

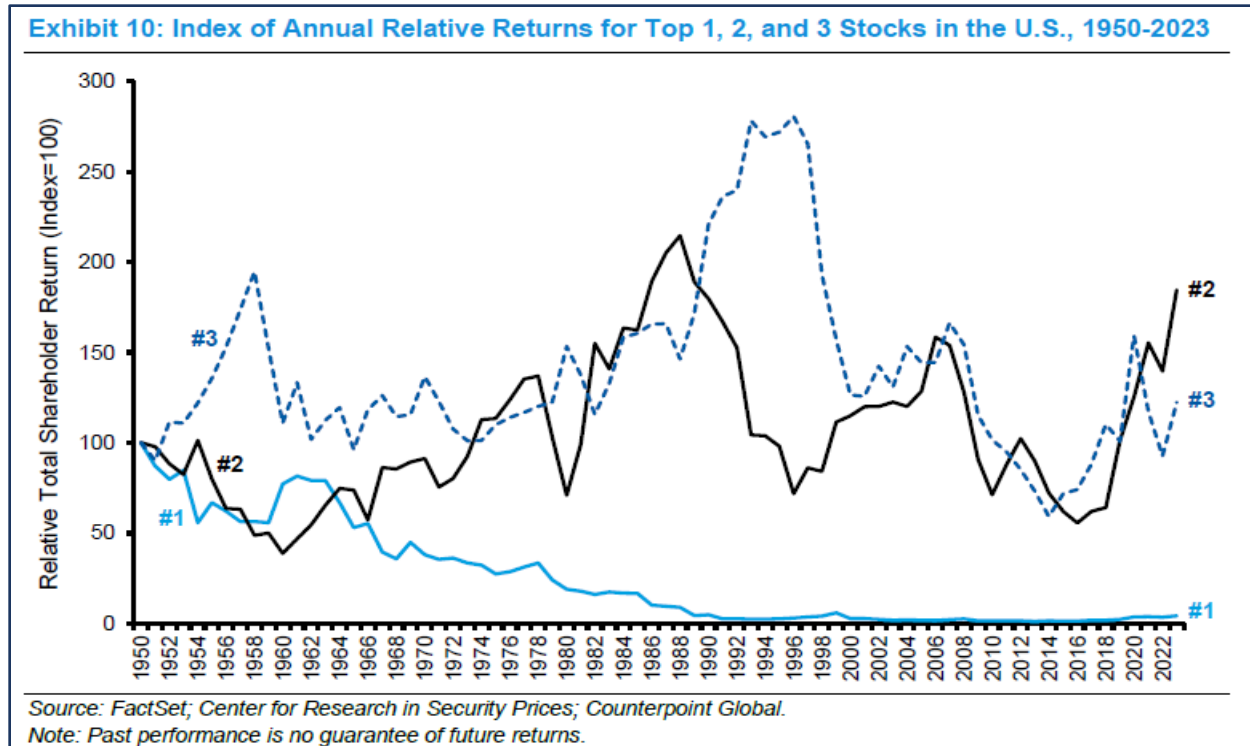
We don't get to choose what risks exist in the market. However, we can choose how to deal with them. Money managers like us increasingly face a dilemma: We can (1) diversify and spread out exposure to a broader swath of companies and risks or (2) follow the most popular index and take comfort knowing that whatever happens, our clients will have company. We don't think that second approach is a responsible one.

There is another risk, which I alluded to earlier in my example of Dupont and GM. As New England Patriots fans know well, when you're at the top, everyone is gunning for you. In the past, companies that have reached the top 10 in size tend to underperform in subsequent years:



Source: <https://www.wealthshape.com/blog>

Historically, the top company tends to underperform after it gets there.



Three companies, Apple, Microsoft, and Nvidia, have all held that title at one point this year. If history holds, that is 20% of the index that could be vulnerable.

Should we believe that the longer historical evidence will hold? Or should we believe this current breed of leaders, some of the best businesses ever built, have more durable moats than their predecessors?

I think there are fair arguments on both sides, but I would not bet that this time is different. One reason is that these giants are increasingly competing with each other. That presents a scenario where they simply can't all win. Consider the following:

The market for internet advertising has expanded fast enough to support high growth for Alphabet, Meta, and Amazon. As the market matures, however, they can't all outgrow it. They will run into each other in the search for growth.

Alphabet has dominated search, but new forms of finding information are appearing, Digital assistants and bots like those from Apple, Microsoft, and Amazon aim to horn in.

Nvidia produces the best chips for AI processing. Their biggest customers included Alphabet, Meta, Amazon, and Apple. Yet all these companies are also trying to produce their own chips to gain an AI edge. If any succeeds, that could put a hole in Nvidia's business.

Microsoft, Amazon, and Alphabet are building out infrastructure for cloud services. Until now there has been sufficient demand to fill all cloud capacity. If that changes, they will be fighting each other for the same customers.

Google pays Apple an estimated \$20 billion to be the default search engine on iPhones. It's an arrangement that makes both companies happy, but one that a judge recently found anticompetitive. One ruling against one company could negatively affect both; combined they are roughly 10% of the S&P 500.²

AI computing requires a lot of power. Yet each of the six companies *alone* weighs more than the entire Utility sector *combined*. What if the competition is ultimately for electricity, not intelligence?

In the past these companies have won huge markets to themselves. Now they are more likely to collide. And if winning is embedded in the price of all six, then some of these giant stocks are due for a fall.

IV. WHAT TO DO?

At Cabot, we believe proper diversification is key to preserving the wealth of our clients. We don't let individual stock position sizes get too big. We diversify all the equity portfolios we manage with at least some international exposure.

In this sense, we've never felt the all-US S&P 500 Index is an appropriate benchmark (See whitepaper: [Indexes and Benchmarking](#)). However, its high concentration today makes the S&P look less appropriate than ever.

If a client came into our office with 30% of their wealth in six stocks that tend to move up and down together, we would recommend that they diversify. I'd venture to guess almost any financial advisor would. That is exactly what owners of S&P 500-tracking funds own. Probably many of them *feel* broadly diversified. They are not. Despite its 500 members, the index looks unbalanced today.

A concentrated portfolio can have large swings up and down. For those tracking the S&P in recent years, concentration has been a good thing. The big stocks have gotten bigger and taken the index up with

² https://www.barrons.com/articles/google-antitrust-ruling-alphabet-stock-3d5cf4a3?st=04gcsw4npz7lrbo&reflink=desktopwebshare_permalink

them. But past performance is not a guarantee. And the high returns of the S&P over the past 10 years compared to other indexes (Russell 2000, MSCI EAFE, MSCI EM) have come at a cost of decreased diversification. If that risk cuts the other way, the S&P holders will wish they had opted to spread things out.

V. CONCLUSION AND SUMMARY

REASONS TO AVOID MIRRORING THE S&P 500 TODAY

Market concentration has reached a level not seen in decades. It distorts the picture of the market painted by widely followed indexes such as the S&P 500. What's more, the nature of concentration today – focused on a handful of stocks with very similar characteristics and risk, therefore moving together – looks dangerous.

Investors looking to preserve their wealth should ensure they are properly diversified. That may require looking under the hood of some funds and portfolios, because not all offer the diversification needed.



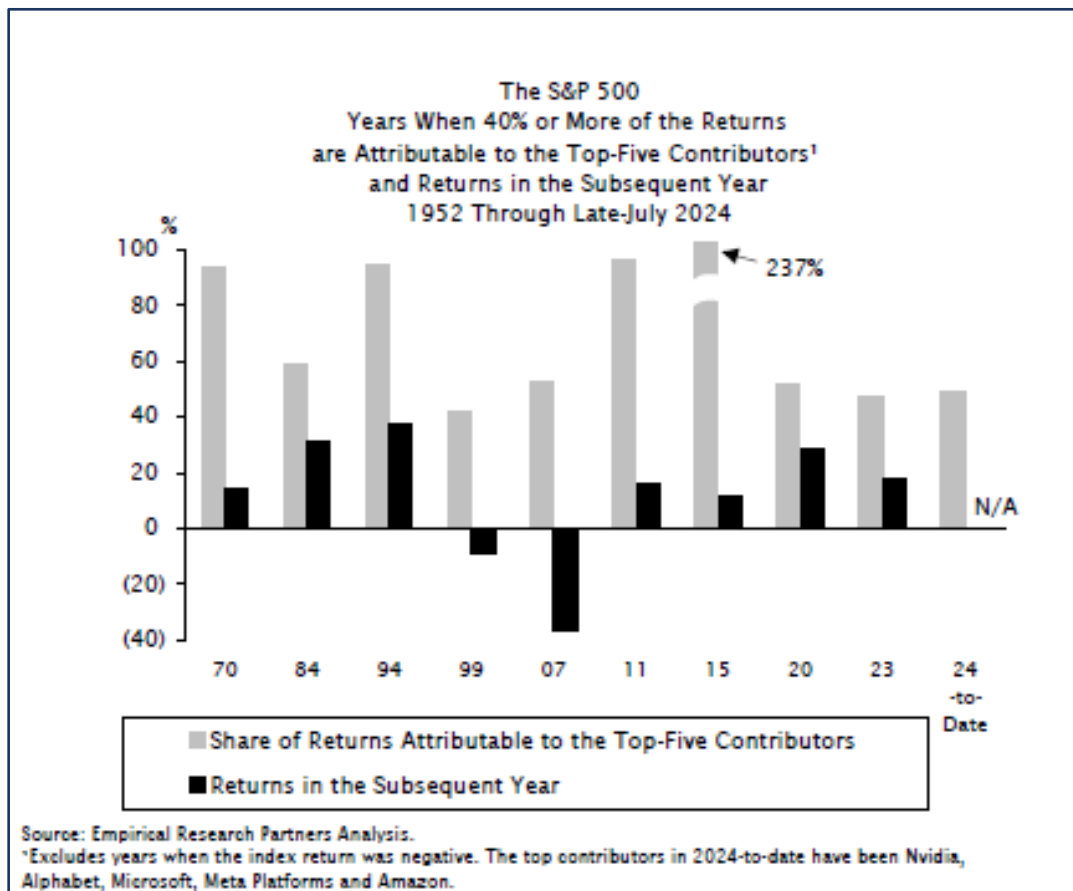
VI. APPENDIX

TECH STOCKS UP ON THE PROMISE OF A NEW INNOVATION - IS THIS A BUBBLE AGAIN?

Many commentators have drawn comparisons between the strong performance of these tech stocks and the tech/internet boom in the late 1990s. Looking again at the earlier charts, concentration also spiked in 1999 and in the mid-late 1960s, known as the “Nifty 50” era, where it was common wisdom to just buy the top 50 or so blue-chip stocks without regard to price.

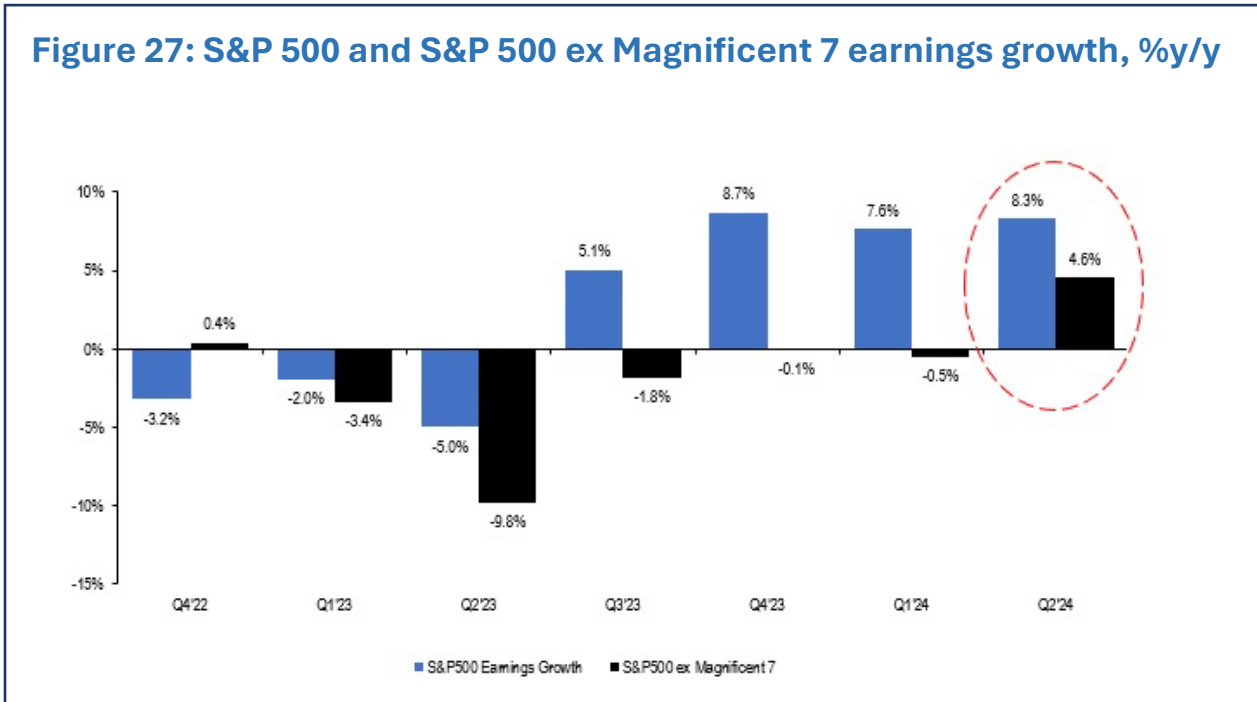
However, concentration also spiked in market downturns, like 2009 and 1932. I do not believe concentration alone is evidence of a bubble. Here are four reasons I am not overly concerned:

- 1.) History says that even when the S&P 500's returns are concentrated among a few constituents, as they have been this year, the next year's return is not bad:



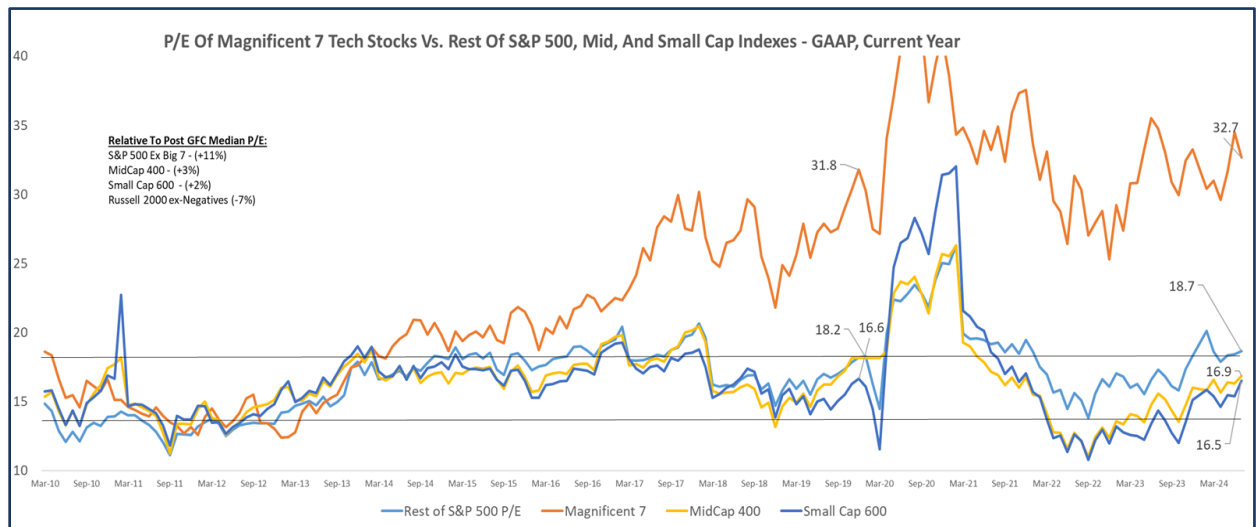
- 2.) The big stocks are way up for a sound reason: their profits are way up. Unlike the tech and nifty-fifty bubbles, the rise in size of the top six has coincided with the rise of their profits. They

are growing faster than other S&P 500 companies. (This graphic refers to the “Magnificent 7, a nickname for the six companies previously mentioned, plus Tesla):



Source: J.P.Morgan, Datastream, Bloomberg Finance L.P.

3.) Faster growing companies deserve a premium price. How much of a premium? This chart compares the P/E ratio of the Magnificent 7 to the rest of the S&P 500 and to small- and mid-cap indexes. To me, the current valuation of the giants looks uncomfortably high, but not crazy, considering their much faster growth.



Source: Raymond James

- 4.) Today's giants certainly don't look crazy relative to famous bubble periods. Goldman Sachs data shows that the Price-to-Earnings ratios of "bubble stocks" have historically been much higher than today:

Exhibit 27: Dominant companies today are not as expensive as those in previous 'bubble' periods in history

	Size		Valuation	
	Market weight	Market Cap (\$ Bn)	*24m fwd P/E	*24m fwd EV/Sales
Magnificent 7 (2024)				
Microsoft	7.0%	3040	27.2	9.8
Apple	6.0%	2610	22.8	6.3
NVIDIA	5.3%	2317	31.1	17.3
Amazon	4.2%	1837	31.1	2.6
Alphabet	3.6%	1559	16.7	1.8
Meta Platforms	2.6%	1127	21.4	6.1
Tesla	1.3%	569	40.3	4.0
Magnificent 7 (2024) Aggregate	30.2%	13058	25.1	4.8
Tech Bubble Leaders (2000)				
Microsoft	4.5%	581	53.2	19.2
Cisco Systems	4.2%	543	101.7	17.5
Intel	3.6%	465	42.1	11.5
Oracle	1.9%	245	84.6	19.0
IBM	1.7%	218	23.5	2.3
Lucent	1.6%	206	37.9	4.1
Nortel Networks	1.5%	199	86.4	6.4
Tech Bubble Leaders (2000) Aggregate	19.0%	2457	52.0	8.2
Japan Financial Bubble (1989)				
Nippon Telegraph and Telephone	6.9%	157	100.1	
Industrial Bank Of Japan	4.6%	105	154.2	
Sumitomo Mitsui Banking	3.4%	77	49.2	
Bank of Tokyo-Mitsubishi	3.3%	75	49.8	
Fuji Bank	3.1%	71	52.8	
Dai-Ichi Kangyo Bank	2.9%	65	44.0	
Sakura Bank	2.8%	62	62.1	
Japan Financial Bubble (1989) Aggregate	27.0%	613	67.0	
Nifty 50 (1973)				
IBM	7.1%	48	35.5	
Eastman Kodak	3.6%	24	43.5	
Sears Roebuck	2.7%	18	29.2	
General Electric	2.0%	13	23.4	
Xerox	1.8%	12	45.8	
3M	1.4%	10	39.0	
Procter & Gamble	1.4%	9	29.8	
Nifty 50 (1973) Aggregate	19.9%	135	34.3	

*Actual (LTM) P/E and EV/Sales data from 02/01/1973 for Nifty 50. **LTM P/E data and EV/Sales from 27/12/1989 for Japan Financial Bubble. ***24m fwd P/E and EV/Sales data from 24/03/2000 for Tech Bubble.

Source: Datastream, FactSet, Goldman Sachs Global Investment Research

DISCLOSURE: Any advice or suggestion is provided for informational purposes only and is not a solicitation to purchase any investments or services described herein. Please consult your advisor to determine if an investment strategy is appropriate for you. Past performance of either the domestic or international markets or any specific investment is not predictive of future results, nor will diversification alone protect from loss.