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Equity Indexes: Broadly Diversified or Concentrated and Risky?

OCTOBER 2020

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Snapshot

- Many equity indexes, such as the popular S&P 500 Index, are often considered broadly diversified because they hold a large number of securities.
- Today 25% of that index is concentrated in just the five largest stocks by market capitalization—and it is not the only top-heavy equity index.
- The significant outperformance of the five largest stocks has led to investors falling into the recency bias trap—believing what has happened recently is likely to continue forever—but given enough time though, market sentiment has always shifted and once high flying stocks are often relegated to underperforming.

Most investors, even those based outside the U.S., are quite familiar with the S&P 500 Index. The index represents 500 of the largest U.S. companies and is often used as a model for popular passive mutual funds that seek to mirror its performance. One of the reasons that it is often used as a model by passive investors is its perceived diversification. After all, how can an index with 500 stocks not be diversified? Of course, if that's not diversified enough, investors can easily find indexes that include more U.S. companies. The Russell 1000 Index represents about 1,000 U.S. large and mid-cap stocks. Or there is the Russell 3000 Index which adds another 2,000 U.S. small companies to that list and represents about 98% of the investible U.S. equity market. Many investors, including SEI, believe it's prudent to diversify equity holdings globally. Here, investors may look at the MSCI ACWI Index, which contains more than 3,000 constituents from 23 developed and 26 emerging markets. Now that is an index that is truly diversified, right?

Not as Diversified as You Think

While all of these indexes hold a diverse group of companies in a broad range of sectors, and across the globe in the case of the ACWI Index, they are also market capitalization weighted. The exact methodologies by which each index provider calculates company index weights varies somewhat, but invariably leads to the largest companies receiving the largest weights in the index. If we look at the S&P 500 Index in Exhibit 1, we can see that historically the top five stocks make up about 12% of the index, rarely falling below 10% or rising above 15%. But in 2020, the top five companies are approaching 25% of the index's market capitalization. Do you still think the S&P 500 is a well diversified index?

EXHIBIT 1

Weight of Top 5 Companies in the S&P 500

Source: FactSet as of 8/31/20.

While the S&P 500 Index is the most glaring example of this extreme concentration in the top five holdings, it's certainly not the only index that is extremely top heavy right now. Even though the Russell indexes add about 500 or 2,500 stocks to the equation, the recent numbers don't change much in terms of top five concentration. Because of the market capitalization construction of these indexes, adding small and mid-cap stocks really doesn't do much because their weights are small compared to the top five. One way to demonstrate this is to simply compare the market cap of Apple (the top holding for all the indexes we have referenced in this paper) to the Russell 2000 Index which is composed of the smallest 2,000 stocks in the Russell 3000 Index. As shown in Exhibit 2, Apple alone has a market cap that is nearly as large the market cap for those 2,000 small companies combined. If you had a spare $2 trillion or so to invest, would you rather buy all of Apple or all of the 2,000 small cap companies in the Russell 2000 Index? Before you answer, consider that Apple was once a small cap stock and which one of those investments would provide more diversification.

EXHIBIT 2

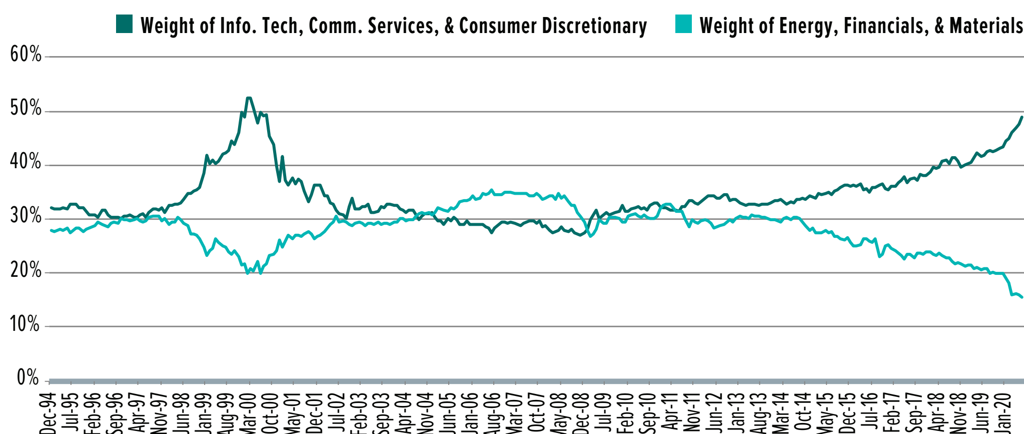
Market Cap Comparison of the Russell 2000 vs. Apple Inc. Stock

Source: FactSet as of 8/31/20.

These same dynamics have also resulted in indexes becoming relatively concentrated in just a few sectors. As seen in Exhibit 3, approximately half of the S&P 500 Index is comprised of just three sectors—Information Technology, Communications Services and Consumer Discretionary. This is the highest concentration in these sectors since the Tech Bubble. It's no coincidence that these sectors contain the top five stocks (Apple and Microsoft in Information Technology, Alphabet and Facebook in Communications Services, and Amazon in Consumer Discretionary). Meanwhile, the Energy, Financials, and Materials sectors comprise a meager 15% of the index. This is the lowest level of concentration in these sectors in over 25 years and well below their peak of 35% circa 2006.

EXHIBIT 3

Combined Weight of Growth Sectors vs. Value Sectors in the S&P 500



Source: FactSet as of 8/31/20.

Concentration Usually has a Bad Ending

At SEI we don't like to be too concentrated because it adds risk to the portfolio. We're also big believers in value—one of our equity alpha sources—which tends to lead us away from the most popular stocks in favor of unloved opportunities. Of course many investors seemingly believe that the top five stocks will continue to lead markets higher over the next several decades. Being students of both behavioral finance and history we just don't think that is a likely scenario. This belief is a clear example of recency bias—that is recent trends will continue indefinitely. Investing history is littered with periods of highly concentrated performance in a small group of stocks for short time periods. The aftermath of these periods of concentration is often a period of poor performance for once high flying, market leading stocks.

In Exhibit 1, one can easily see the popping of the Tech Bubble in 2000. Or if we go a little further back, to the early 1970s, there were the "Nifty Fifty"—a list of the top 50 stocks per brokerage firm Kidder Peabody (later merged with PaineWebber, which later merged with UBS). These stocks were often considered "one decision" stocks, in that investors would only ever need to make the decision to buy them but never sell them. Perhaps some of these stocks, Wal-Mart for example, have earned the "one decision" moniker, but the "Nifty Fifty" also included the long-ago bankrupted Standard Brands Paint. There are plenty of other stocks in the group to suffer spectacular declines as they bottomed out in 1974. Xerox, Avon and Polaroid fell more than 70%, 80% and 90%, respectively from their 1972/1973 highs.

Given the current sentiment Apple, Microsoft, Amazon, Facebook and Alphabet feel an awful lot like “one decision” stocks. They are all market leaders and seemingly well run companies with impeccable balance sheets and high growth rates. Certainly these are great companies, but are they good investments? Some things these companies have in common with Xerox, Avon and Polaroid include rich valuations and margins driven by favorable competitive positions that may be difficult to sustain on a permanent basis. Whether it is due to regulatory changes or competitive business pressures and margin erosion combined with a shift in market sentiment, if we look at history and given enough time, market leadership has always changed and we expect the Value Alpha Source to be rewarded.

We’ll conclude with one last chart. The top 25 stocks of the Russell 1000 Index include some high flyers like Netflix and Tesla that have significant debt and spotty profitability. This leaves the slightly broader set of mega-cap stocks an additional source of vulnerability that isn’t evident when looking at only the top five companies. Even with some juicy profit margins among the top five companies, the P/E premium of the top 25 stocks by market cap has spiked upward in an unusually abrupt manner recently and is currently wider than any time since the late 1990’s tech bubble.

EXHIBIT 4
Traling P/E Premium of the Top 25 Stocks in the Russell 1000
(August 1990 - August 2020)

Source: FactSet as of 8/31/20.

Glossary

Alphas source: Alpha source is a term used by SEI as part of our internal classification system to categorise and evaluate investment managers in order to build diversified fund portfolios. An alpha source is the investment approach taken by an active investment manager in an effort to generate excess returns. Another way to define an alpha source is that it is the inefficiency that an active investment manager seeks to exploit in order to add value.

Market Capitaliztion Weighted Index: A company's market capitalization is calculated by multiplying the total shares outstanding by the share price. A market capitalization weighted index will include the entire market capitalization of all the index constituents, hence companies with larger market capitalizations will comprise a larger portion of the index.

Index Definitions

MSCI ACWI: The MSCI ACWI Index is a market-capitalization-weighted index composed of over 2,000 companies, and is representative of the market structure of 48 developed and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The index is calculated with net dividends reinvested in U.S. dollars.

Russell 2000 Index: includes 2,000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

Russell 3000 Index: The Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

S&P 500 Index: an unmanaged, market-weighted index that consists of 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice.

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200188.02 IMU (10/20)