SEEYOND

Equity Insights

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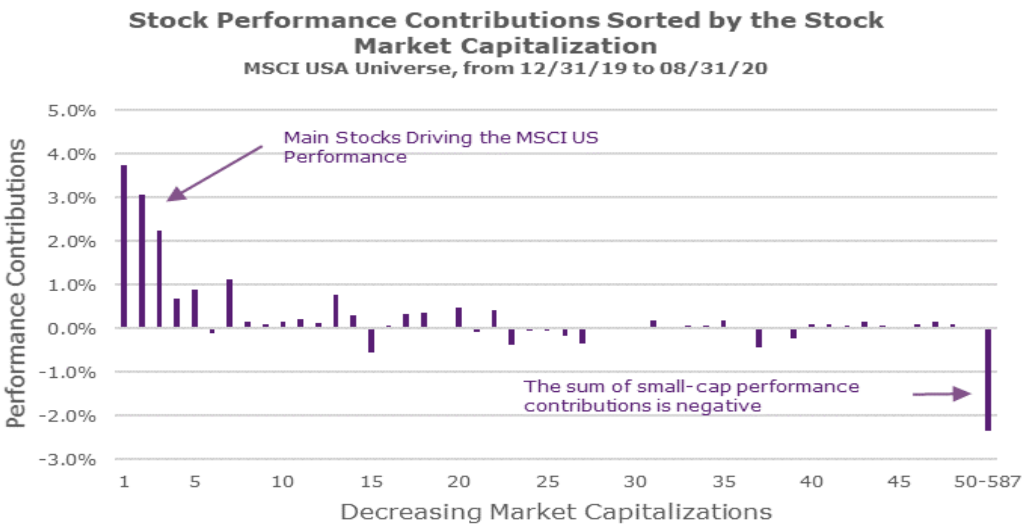
Hyper-concentration on market cap-weighted indices: challenging active portfolio managers

In this paper, we will demonstrate that the level of concentration on the MSCI USA index reduces the possibility of generating outperformance, causing a scarcity of diversification and stock-picking possibilities. MSCI USA Mega caps have largely been favored in 2020 - more so than in 1999, at the peak of the dotcom bubble (according to our metrics). We herein focus on the US equity market for three main reasons: (i) the severity of the concentration phenomenon there, (ii) the weight of the US inside the global market, and (iii) to remain concise (this phenomenon of concentration is also present across Asian markets).

1. *A pool of 600 stocks to pick from… really?*

Figure 1 below displays individual stock performance contributions to the MSCI USA's overall performance in 2020 (ranked by market cap, in descending order; e.g. the largest contribution being Apple, left); this performance is calculated from the beginning of 2020 until the end of August.

Figure 1:



Figures mentioned refer to previous years. Past performance does not guarantee future results.

Over the period, we observe that the performance of the MSCI USA (around +11%) mostly owes to the largest market caps. Considering the top 5 market caps in particular: their cumulative contribution to the index performance is 46% as of end of August 2020. A similar calculation on the 1999 top 5 Mega caps yields a 35% contribution *only* to the overall index performance. Bottomline: 2020 "Megacaps"[1] are making an outsized contribution to the US market performance and, as we will demonstrate, other positive performance contributors mostly ride the same wave.

The "Megacaps" are, to date[2]: Apple (Hardware and computer equipment), Amazon (Retailing), Microsoft (Software and services), Alphabet (Media and entertainment) and Facebook (Media and entertainment).

2. *Mega-cap stocks eating up mid-and-small caps*

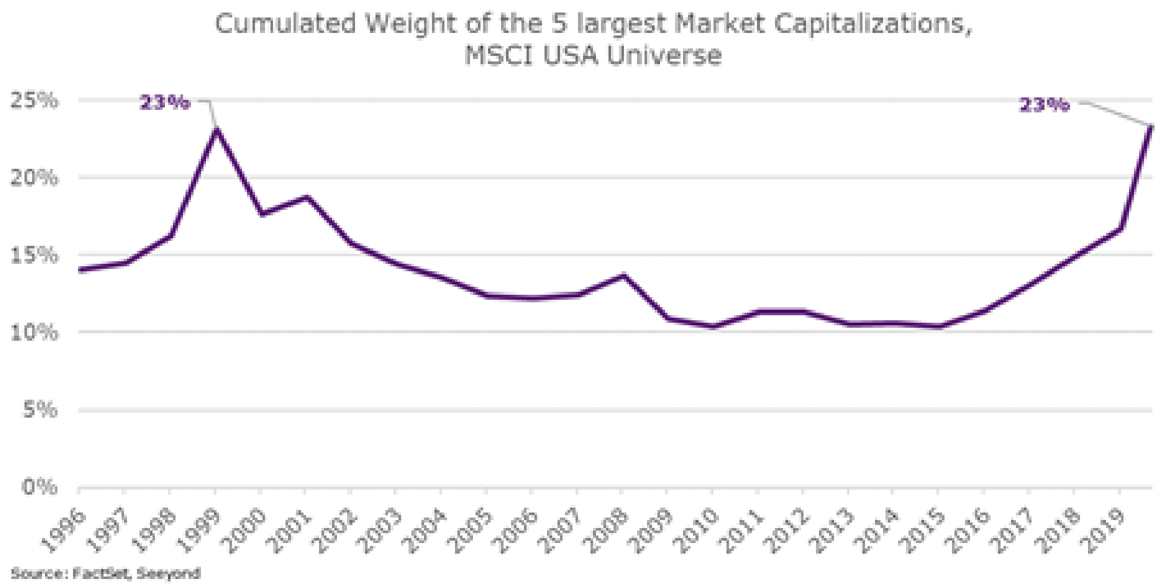
Let's have a closer look at the consequences of concentration on the MSCI USA Index.

Figure 2a below demonstrates that the cumulative weight of the "Megacaps" is quite similar to that of 1999; i.e. roughly a quarter of the index's total market capitalization.

Meanwhile, Figure 2b reveals an even more pronounced relative concentration than in 1999. In fact, the "Megacaps" average is at 72x the median index weight today, versus 47x in 1999. This indicates an even more fragmented market than in 1999: on the one hand, a private club of powerful heavyweights… and on the other, a weakening army of mid-and-small cap stocks fighting for relevance in the index.

Concentration measurements of the top 5 market capitalizations of the MSCI USA

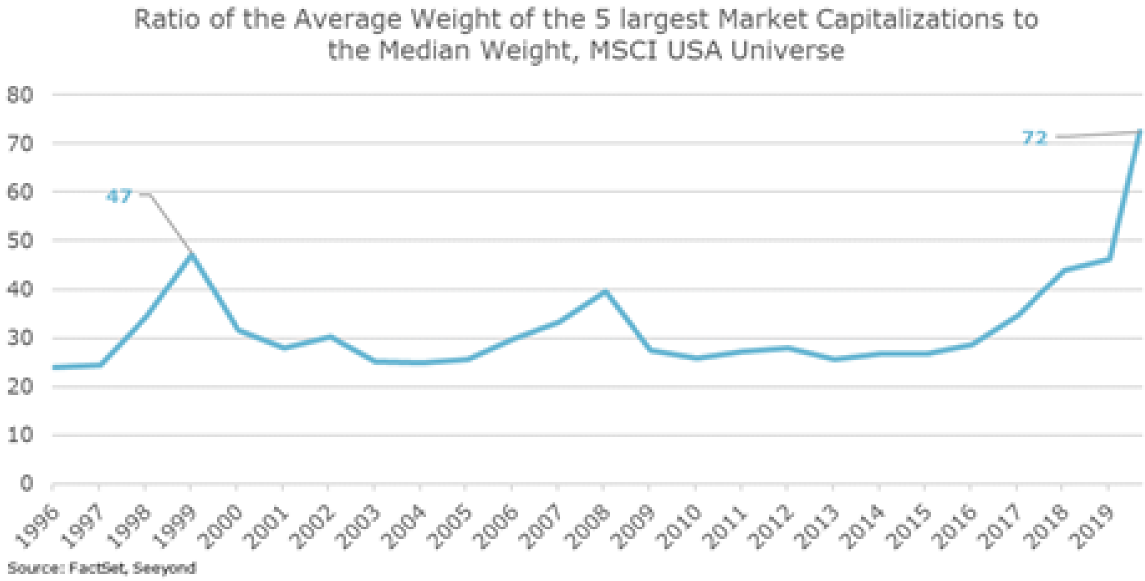
Figure 2a:



[1] In the rest of the note, we use the term "Megacaps" to refer to the top 5 market capitalizations of the MSCI USA Index.

[2] The stock industry, according to the second level of the GICS® classification, is mentioned in brackets.

Figure 2b:



This phenomenon could be explained by the importance of passive management today. A sometimes-used argument is that passive management induces buying pressure on large-cap stocks, and selling pressure on small-cap ones. In parallel, active management especially focuses on selecting mid-and-small-cap stocks in an attempt to outperform those cap-weighted benchmarks. This asymmetry is extremely restrictive, making it harder for stock pickers to actively select outperformer when benchmarks are designed with little concern for diversification.

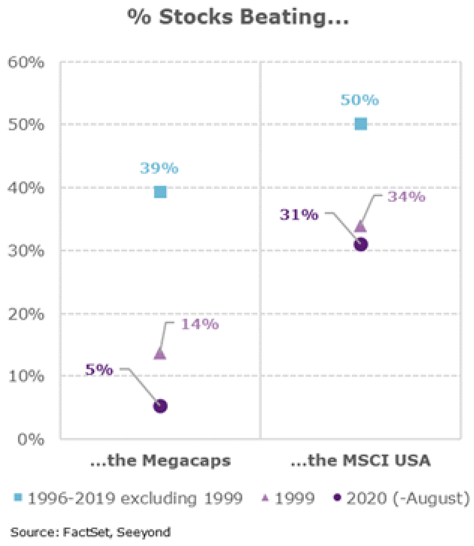
3. *Opportunities for stock picking drying up*

We have seen that the exceptional performance of "Megacaps" largely contributes to the performance of the MSCI USA index, as of August 31, 2020 (see Figure 1).

Figure 3 below displays the percentage of stocks beating a top 5 market cap basket as well as the MSCI index in 1999, in 2020, and between 1996-2019[3].

[3] The "Megacaps" basket is a portfolio composed of the top 5 market capitalizations of each year and weighted according to market capitalizations.

Figure 3:



The results are striking: it has ever been so difficult to select stocks able to beat the "Megacaps". The odds to such an achievement are now almost three times smaller than in 1999! That year, only 14% of stocks outperformed the "Megacaps" basket; and on a longer history (since 1996)… 40%.

1999 and 2020 are similar, with a third of the stocks outperforming the index. This figure is significantly lower than the historical average of 50% chances to beat the MSCI Index as a stock picker.

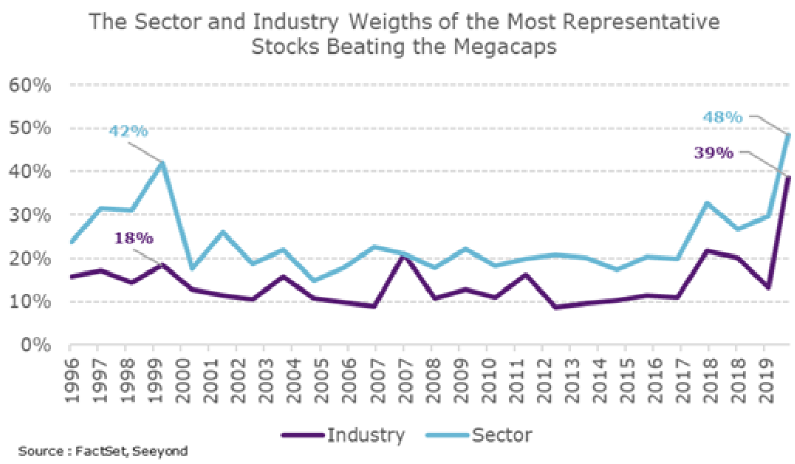
One could be fooled into thinking that one in three stocks (i.e. 200 for a universe of 600 stocks) beating the index is significant and can still lead to a successful stock-picking. The trouble is: this ratio is irrelevant given the level of index concentration and the resulting weak opportunities for sector diversification. In fact, which sectors do the "Megacaps" outperformers belong to[4]?

Today, the 3 industry sectors (out of 24) most representative of stocks able to beat the "Megacaps" are: Software and services, Retailing, Health Care Equipment & Services. These stocks are riding the Microsoft/Amazon wave, or directly linked[5] to the *Covid-19 theme*. In 1999, the top three industry sectors able to outperforms the "Megacaps" all belonged to the Technology sector, namely: Software and Services, Technology Hardware and Equipment, and Media and Entertainment.

Figure 4 below also adds to the above: while the weight of the sector that most represents "Megacaps"-beating stocks (1 in 11) was similar in 2020 and 1999 (48% vs 42%), industry picking is now critical in 2020 (1 in 24); more so than it was in 1999 (39% vs. 18%)…

[4] We remind that there are 11 sectors and 24 industry groups according to the first and second GICS® classification levels. The industry group-simplified here in industry- allows a sharper level of analysis since a sector can be composed of several industries.
[5] That industry within the Health Care sector has often been in the top 3 in recent years.

Figure 4:



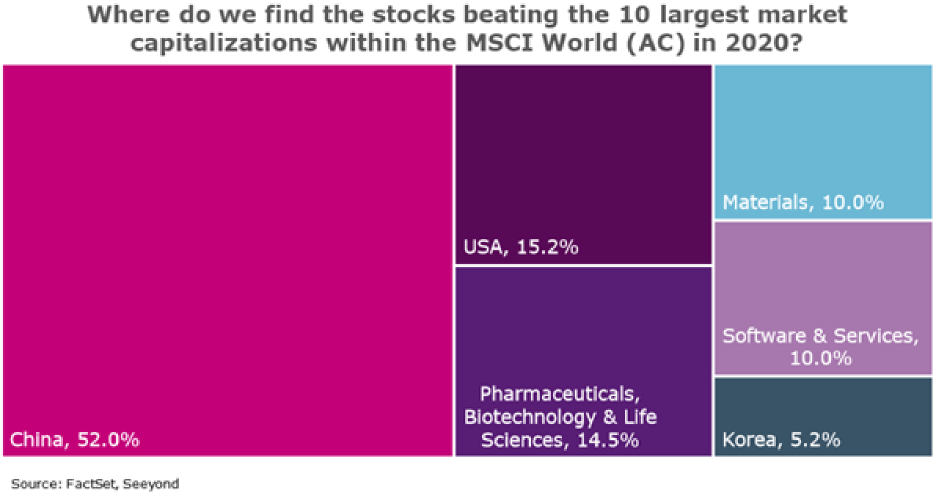
It is therefore easy to understand the problems that such a market configuration could entail, both in the context of stock picking and in terms of diversification.

4. *Towards the end of diversification?*

This concentration phenomenon also has a significant impact -though to a lesser extent- on other geographical areas. Taking example of the MSCI World All Countries universe (covering all world markets, including emerging countries): there, only 10% of stocks (versus 40% historically) are able to beat the ten largest market caps in the world[6] (including emerging countries). Figure 5 below: almost 70% of these stocks belong to three countries and about a third of those are concentrated across three industry sectors. Financial flows, which translate aggregate investor behavior, still seem to converge onto a relatively small number of happy few stocks.

[6] The performances are in USD and the studied period is from January 2020 to August 2020. The top 10 market capitalizations of the MSCI World (AC) are: the top 5 in the US market, Alibaba (China), Johnson & Johnson (USA), Tencent (China), Visa (USA) et Nestlé (Switzerland).

Figure 5:



This investor appetite for certain securities can be explained by various factors, for example: the growth of passive management, thematic bets on Megatrends, the Covid-19 pandemic, or the Fear Of Missing Out. This phenomenon is self-reinforcing by nature; also, this procyclicality will likely trigger increasingly violent market shocks[7]. Thus, this situation of extreme concentration is a concern, be it rational (i.e. a change of economic paradigm / passive management) or irrational, since it ultimately underlies *in both cases* either the disappearance of diversification, or the existence of a bubble ready to burst (worse in certain respects than 1999); or worse, a chain reaction of both combined, for an undetermined amount of time.

5. *Conclusion*

The prevailing performance engine that are “Megacaps” in the MSCI USA/World indices, their extreme concentration levels and over-predominant industry sectors/countries make it very difficult to beat the index without mimicking or exaggerating their construction biases. In other words, taking a diversified approach to building an equity portfolio would not pay off in 2020. Will this year mark the peak of the recent *market dislocation* phenomenon? In any case, this dislocation shakes up decades old and well-established investment principles: consideration for diversification, equity fair valuation, risk premiums as in the old *value* management style. In this context, it would be interesting to reevaluate the appropriate way of approaching these principles of asset management… *today*.

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[7] It is worth noticing that technology stocks do have a large amount of intangible assets making them more difficult to value. As a result, it is not easy for investors to bet in a contrarian and market stabilizing ways.

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Seeyond, an affiliate of Natixis Investment Managers, specializes in active quantitative portfolio management. By adding active oversight to disciplined quantitative investment processes, Seeyond offers strategies that seek to optimally reward risk in three core areas of expertise: equity strategies, multi-asset strategies, volatility & overlay strategies. These strategies leverage Seeyond's proprietary quantitative research.

Seeyond, a team of 26 recognized professionals with 18 years of industry experience on average, manages EUR 9 billion of assets[1]. Seeyond's solutions are marketed by the global Natixis Investment Managers' distribution platform, one of the largest asset managers in the world[2], and via the retail networks of Groupe BPCE, the second largest banking group in France[3].

> For further details: www.seeyond-am.com and

1 Source: Seeyond, as of 30/06/2020

2 Cerulli Quantitative Update: Global Markets 2019 ranked Natixis Investment Managers (formerly Natixis Global Asset Management) as the 17th largest asset manager in the world based on assets under management as of 31/12/2018.

3 Source : BPCE S.A. – 31/12/2019

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