EXTREME CONCENTRATION AND IMPACT ON STRATEGY:

Market Concentration Has Been Extreme….but Not Everywhere.
What are the Strategy Implications for Growth and Value Investors?

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The US equity market has reached levels of concentration surpassing the tech bubble of more than 20 years ago. Using data provided by S&P Global, the market capitalization weight of the top 10 stocks in the S&P 500 Index ended the first quarter of 2021 at 26%, similar to its peak in 2000. Emerging markets, as measured by the MSCI Emerging Markets Index, are seeing a similar concentration “spike.”

The driver has been the price appreciation of a small number of large, growth stocks, mostly in the technology sector. Rather than treat this as an aberration of limited interest to value investors, I believe examining current concentration trends in the context of past market experience may provide valuable insights, especially when analyzing value and growth indices side-by-side.

These concentration spikes have coincided with growth indices outperforming their value counterparts by significant margins; this should not be surprising.

EXHIBIT 1: CONCENTRATION IN S&P 500 GROWTH AND MSCI EMERGING MARKETS GROWTH INDICES AT OR NEAR TWO-DECADE HIGHS*

*The historical ranges (highs and lows) for each index based on quarterly data over the period 3/31/2001 to 3/31/2021.
Source: Brandes Institute, S&P Global, as of March 31, 2021. Past performance is not a guarantee of future results. One cannot invest directly in an index.
The S&P 500 Growth Index (SPG) concentration reached its highest quarter-end level since 2000 at March 31, 2021, while the equivalent for the S&P 500 Value (SPV) was close to its 20-year low. The 50% concentration measure for the SPG reflects a remarkable condition: for an index with almost 300 constituents, the largest ten stocks account for around half its capitalization.

The MSCI Emerging Markets Growth (EMG) and Value (EMV) sub-indices show the same pattern: EMG concentration was near 50%, while the EMV concentration was close to its 20-year low, under 20% as of 3/31/2021. The pattern was different for developed, non-US markets, with the concentration of the MSCI EAFE Growth Index (EAFE G) close to its long-term average. The reason? This spike in growth concentration has been substantially driven by a few stocks in the United States and Emerging Asia. From a worldwide perspective, using data from MSCI, the top ten stocks in the MSCI ACWI Index as of March 31, 2021 included eight from the United States, one from China and one in Taiwan. There were none in Europe nor in the developed Asia-Pacific markets.

The recent growth-stock spike has meant bad news for active managers in growth and value disciplines. Recent manager underperformance may not reflect a lack of skill, but a mathematical circumstance. Growth managers may be benefiting from the wave of growth index outperformance (vs. value), but for them to outperform the growth index itself, they almost need to overweight the mega-cap stocks leading the charge. For managers with a stated process and an eye on risk management, such a tactic may be hard to do without violating internal disciplines.

Value managers may be able to outperform their value index, as the growth mega-stock spike is irrelevant for that comparison. But when benchmarked to the aggregate index (e.g., the S&P 500 Index), any active management gains against the Value Index likely have been overwhelmed by value style underperformance.

Historically, such spikes have tended to be transient after reaching extremes, and long-term investors may want to assess how growth and value stocks may perform as concentration recedes. Exhibit 2 shows that after the concentration spike in the tech bubble at the turn of the century, top ten concentration declined for five years (to 2005), and it was not until another three years had passed (2008) that performance for the S&P 500 Growth Index surpassed its Value counterpart on a trailing three-year view.

**EXHIBIT 2: S&P 500 GROWTH INDEX (SPG) TOP TEN CONCENTRATION AND SPG VS. S&P 500 VALUE (SPV) 3-YEAR TRAILING RELATIVE ANNUALIZED RETURNS, 12/31/2000-12/31/2020**

Note that when the bars are below zero, SPG is underperforming SPV.

![Exhibit 2: S&P 500 Growth Index (SPG) Top Ten Concentration and SPG vs. S&P 500 Value (SPV) 3-Year Trailing Relative Annualized Returns, 12/31/2000-12/31/2020](image)

Source: Brandes Institute, S&P Global, as of December 31, 2020. Past performance is not a guarantee of future results. One cannot invest directly in an index.

However, timing—even in extreme environments—is nearly impossible. And value investors may be all too familiar with the pain of calling a top too early. However, digging down to another level within concentration may provide some clues. The spike in concentration in the US and EM growth indices has been driven by a very small number of stocks. Investors typically focus on “top ten” as a concentration measure, but now the driver may be the top three or four, leading to “concentration within concentration.” This narrowing of concentration is important, as it has not happened in prior concentration peaks. The current narrowness leaves those indices exposed to significant idiosyncratic risk (i.e., the risk that just one or two of these mega-stocks drops sharply). To measure this “Top 10 Narrowness,” I used the standard deviation of the market cap weights of the top ten stocks. See Exhibit 3.
To provide perspective, the Top 10 narrowness numbers for the value indices (S&P, EAFE and EM) and the EAFE Growth Index were close to or below one at year end 2020. These values have rarely exceeded two over the past 20 years, yet the narrowness numbers for the S&P Growth and EM Growth Indices are close to four. The concentration measures of these two growth indices are more than double that of the other indices shown in Exhibit 1. This narrowness measure (concentration within concentration) is four times higher.

As a practical illustration, at March 31, 2021, the largest three stocks in the MSCI EM Growth Index accounted for more than a third of its market cap, averaging around 11% weight each, based on data from MSCI. The remaining two-thirds was spread over the other 534 constituents, with an average weight of just 0.12% each!

Exhibit 4 shows the sharp increase in Top 10 narrowness for both the S&P 500 and EM Growth Indices, largely occurring since the end of 2016. This measure for the S&P 500 Growth Index has rarely moved above two, even in the immediate post-bubble period of 2001-2.

The narrowness measure for the MSCI EM Growth Index has also been in that range for the past 15 years. It did surge in 2003-4, when one stock grew to represent 14% of that index. Narrowness for the MSCI EM Growth Index then declined over the following seven years.

**EXHIBIT 4: TOP 10 NARROWNESS HAS INCREASED SHARPLY IN THE PAST THREE YEARS FOR S&P 500 GROWTH AND MSCI EMERGING MARKETS GROWTH INDICES**

Source: Brandes Institute, S&P Global, MSCI, as of March 31, 2021.
It should not be surprising that the recent surge in concentration/narrowness in these indices has coincided with the significant outperformance of growth indices against their value counterparts. The contribution of those few mega-cap growth stocks is a driver for both effects. And the ability of active managers to beat their respective style benchmarks has also been impacted.

Exhibits 5 and 6 show that in the first 10 years of this century, the median active manager generally performed respectably against its style benchmark for both growth and value, inside the US and internationally. (See the Appendix for details on the peer groups used in this study.) The “Active Works” maroon and orange lines are above zero for a substantial part of that period. But in more recent years, the US active manager medians for both styles have struggled to add value. The active EAFE median Growth and Value managers have done a bit better, with added value in some periods but certainly not all. (As a sidenote, the manager data in these charts is net of fees; if measured gross, this would push the maroon and orange lines up a bit, but not by enough to change the broad conclusions).

**EXHIBIT 5: IN THE US, AS THE GROWTH STYLE OUTPACED VALUE IN THE PAST DECADE, ACTIVE MANAGERS IN BOTH STYLES HAVE STRUGGLED TO BEAT THEIR RESPECTIVE STYLE BENCHMARKS**

*Active Works* Lines Measure Median Manager Return Relative to Respective Style Benchmark

The Gray Line Reflects SPG-minus-SPV returns on an Annualized, 3-Year Trailing Basis

Source: Brandes Institute, S&P Global, MSCI, Morningstar data, as of December 31, 2020.

**EXHIBIT 6: IN NON-US DEVELOPED MARKETS, ACTIVE MANAGERS HAVE DONE BETTER THAN THEIR US COUNTERPARTS IN ADDING SOME VALUE AGAINST THEIR RESPECTIVE STYLE BENCHMARKS**

*Active Works* Lines Measure Median Manager Return Relative to Respective Style Benchmark

The Gray Line Reflects EAFEG-minus-EAFEV returns on an Annualized, 3-Year Trailing Basis

Source: Brandes Institute, S&P Global, MSCI, Morningstar data, as of December 31, 2020.
One reason behind the decline in added-value from active management in recent years may be the collapse of cross-sectional dispersion. This is the standard deviation of returns of all the stocks in an index for a given period and, as such, indicates the potential for active management. If cross-sectional dispersion is very low, (indicating that most stocks are moving similarly) then it is difficult for active managers to beat the index and vice versa.

Exhibit 7 shows cross-sectional dispersion spiked in prior periods of high index concentration (e.g., the internet bubble in 2000 for SPG and the Financial Crisis of 2008-9 for SPV). Dispersion has remained subdued for much of the time since 2009. This reinforces the message in Exhibits 5 and 6: it has been harder for active managers to add value in the most recent decade.

**EXHIBIT 7: S&P 500 CROSS-SECTIONAL DISPERSION IS LOW, 1/31/95 TO 4/30/21**

![Cross-Sectional Dispersion Chart](source: Brandes Institute, S&P Global, as of April 30, 2021 (the most recent date for which we had data))

The current combination of high concentration and low cross-sectional dispersion suggests that style performance may dominate active management value-added as long as these conditions persist. Any increase in dispersion should benefit value managers in particular.

Exhibit 8 illustrates a striking similarity between cross-sectional dispersion and the ability of active value managers to outperform. Over the period shown, S&P 500 cross-sectional dispersion had a correlation of 72% with value managers’ relative performance (measured on a 3-year trailing basis) compared to 16% for growth managers. A continued increase in dispersion could be a positive signal for value managers in 2021 and beyond.
In conclusion, the implications of the analysis in this paper are that for investors who measure their managers against the broad indices, their recent success or failure has been substantially driven by the style indices themselves, not by the ability of the managers to outperform their style benchmark.

If and when this concentration/narrowness spike reverses (and I am not so foolish as to predict a timeframe!), I believe active management will see a resurgence.

I believe value should outperform growth if the narrow leadership among a few mega-cap growth stocks falters, and especially if the momentum behind that change carries through to other stocks in tech and similar sectors.

Growth managers could find it easier to beat the growth indices as underweighting the largest stocks could become an advantage instead of a handicap, with leadership moving from the few mega stocks to a more diversified group.

Value managers’ ability to beat the value indices likely would not be affected as the concentration spike does not materially impact the value stock universes. However, a turnaround in value index performance may turn a headwind into a tailwind versus the broad indices and an increase in cross-sectional dispersion could strengthen that tailwind.

These effects may be most pronounced for US and emerging market equities and more moderate in the developed, non-US indices (e.g., MSCI EAFE).

For investors, such a turn could have a major impact on how they assess their portfolios and their managers, both in quantitative and emotional terms. It has been common in my 40+ years of experience for investors to look only at the performance of their portfolios against a “headline” broad index and ignore the difference between style performance and manager performance. But now that we are at such extremes of relative style performance, it’s important not to confuse active management success with the success or otherwise of the style. Recently, performance against headline indices has been driven substantially by style while active management (versus style) has worked for managers outside the US. Even many US value managers have been close to the value benchmark on a gross of fees basis.

Investors wanting to benefit from this growth to value shift might also consider their allocations to specific managers. In a previous Brandes Institute article, “The Value of Perseverance,” I noted a tendency for some value managers to become more “growth-like” in the face of persistent value style underperformance. I’d suggest that “doubling down” on those managers which have held firm to value principles may prove to be a more profitable strategy.
APPENDIX: THE DATA

PEER GROUPS

Peer groups are based on US-registered mutual funds in the Morningstar database. They include, as of December 31, 2020, all funds in the following universes except for duplicate entries and index funds:

(The numbers in parentheses represent the number of funds in each of the respective peer groups.)

- US Large Cap Growth (360)
- US Large Cap Value (313)
- Foreign Large Cap Growth (116)
- Foreign Large Cap Value (92)
- Emerging Markets Growth (66)
- Emerging Markets Value (32)

As the peer group members were based on inclusion as of end 2020, there is survivorship bias in all these peer groups. In the context of this article, this makes it more difficult for funds to beat the median, and hence implies the results should be robust.

There are no separate Value and Growth Emerging Markets universes in Morningstar, but the EM universe funds are labeled by style, and the peer groups in this article consist of those funds labeled in the respective styles.