Is the Index Investable?

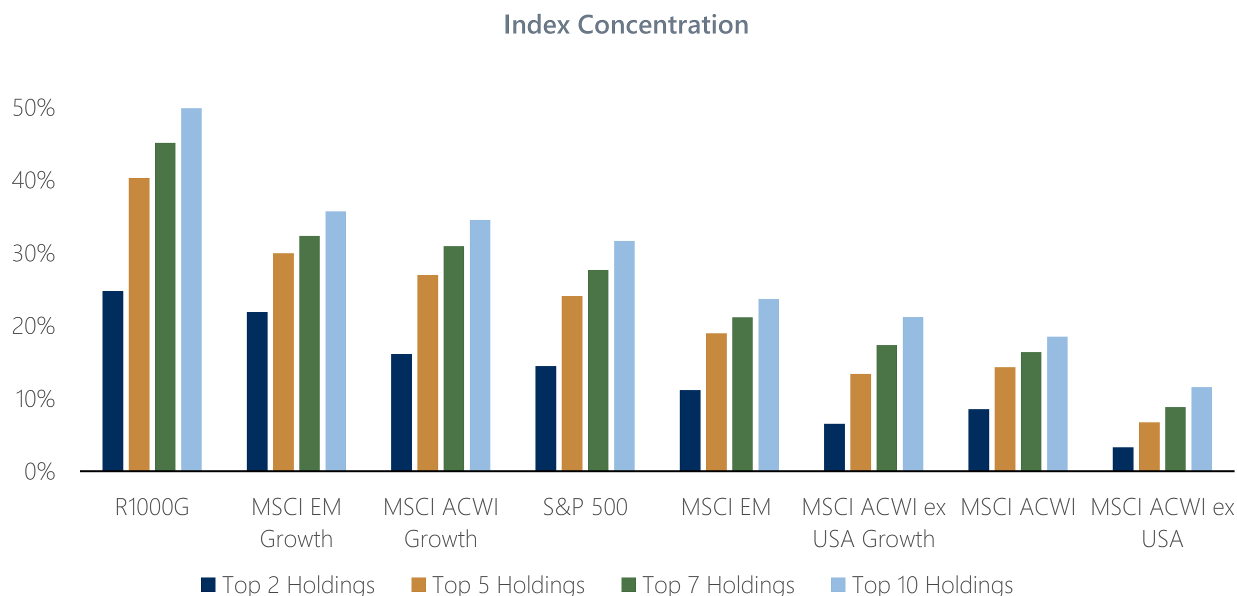
July 2023

As index concentration levels have soared over the last decade, reaching unprecedented levels in the U.S., it raises several questions about investor suitability, risk, and return potential moving forward. The most extreme example of index concentration can be found in the Russell 1000 Growth Index (R1000G) where the top seven holdings account for more than 45% of the index. The S&P 500 Index is not much better with 28% in these positions. While high index concentration is most notable in U.S. growth stocks, the same phenomenon can be found in Emerging Markets where the top seven holdings represent 32% in the EM Growth index and 21% in the broader EM index. For global investors the top seven holdings represent 16% in the ACWI index and 31% in the ACWI Growth index. We believe extreme benchmark concentration has the potential to influence and induce investors to take risks that 'prudent' investors would avoid in order to minimize the risk of large losses. Below we examine some of the rules put in place by regulators in the U.S. and Europe to protect investors from concentration risk. We also look at how the largest index constituents have performed historically, focusing on the R1000G index, and the impact on market returns in recent years from the current index behemoths. Lastly, we illustrate the dynamic nature of the top index weights over time, highlighting the danger of being overly exposed to today's top companies.

Regulators' View on Concentration

Rules concerning concentration vary across different regulatory regimes, for example in Europe's highly regulated markets, the norms are different from the U.S. and there are stricter rules on concentration. UCITS funds, which are pooled fund vehicles in Europe, treat concentration much more strictly and it is necessary to comply with the "5/10/40 rule". In summary, this says that a maximum of 10% of a UCITS fund's net assets may be invested in securities from a single issuer, and that investments of more than 5 percent with a single issuer may not make up more than 40% of the whole portfolio. This prudence is then modified to provide exceptions for index funds that follow indices such as the R1000G (which would otherwise be un-investable), so where the fund is replicating a stock market or other index, the maximum limit per issuer is lifted to 20% of net assets (or 35% in exceptional circumstances). Even in the U.S., where concentration rules are laxer, a mutual fund classified as "diversified" can hold no more than 25% of the portfolio in positions with 5% or greater weights - the R1000G has over 30% in such positions. We think this tells its own story. The R1000G is deemed too risky by European regulators and does not meet U.S. diversification standards for active investors to conduct what we consider normal active management such as taking overweight positions in the largest companies in the benchmark.

The R1000G is more concentrated than most indices – some comparisons:



Source: FactSet, Russell, MSCI

The Risk of Reversal

Why does it matter? After all the R1000G has performed extremely well and better than the other indices listed above. The strong performance of the index and the inability of many active managers to "beat the market" over the past 5-10 years has raised questions about the role of active management in the large cap growth universe. Performance is only one side of the equation, however, while volatility and the risks of a reversal of the momentum which has driven a small group of stocks to dominate is another. Seasoned investors remember the pain of such reversals in the first TMT (Technology, Media and Telecoms) boom to bust cycle in 2000 - 2002. At the time the market had grown increasingly narrow and concentration levels reached then historic highs in the late 1990's, leaving the index vulnerable to a sudden reversal in market leadership.

Let's look back at the leaders of the U.S. stock market when concentration was at its highest in 2000 with perfect 20/20 hindsight:

	Market Cap $B March 31 2000	Market Cap $B June 15 2023	Annualized Stock Return 3/31/00 – 6/15/23
Microsoft	557	2,589	10.7%
GE	513	115	-2.1%
Cisco	533	212	-0.2%
Intel	442	149	-0.3%
Wal-Mart	252	425	6.4%
Oracle	222	343	6.1%
IBM	212	126	3.4%
Group Average	-	-	3.4%
S&P 500	-	-	6.8%
R1000G	-	-	6.3%

Source: FactSet, Russell. Seven largest index weights in the S&P 500, March 31, 2000, Source FactSet, SGA calculations. Annualized stock return is total return.

As the table shows, of the then seven largest companies only Microsoft has since managed to meaningfully outperform the S&P 500 and R1000G Index – a rather impressive feat considering the stock's extended period of underperformance from 2000-2013. Three of the seven companies listed (GE, Cisco, and Intel) on the other hand have delivered negative (!) absolute returns since 2000. The remaining three companies on the list (Wal-Mart, Oracle, IBM) have delivered positive, but rather lackluster returns either in line with or below the market returns. As a group, these stocks have delivered only about half the return of the market, on average, since March of 2000.

Let's fast forward to today and look at the largest companies and most recent winners:

	Market Cap $B June 15 2023
Apple	2,925
Microsoft	2,589
Alphabet	1,600
Amazon	1,304
NVIDIA	1,055
Tesla	811
Meta Platforms	723

Seven largest index weights in the S&P 500, June 15, 2023, Source FactSet

The seven companies in the table above, also known as the "Magnificent Seven" given their strong performance over the past 5-10 years, dominate U.S. stock market indices today. But, as indicated by the list of winners from 2000 it should not be assumed that the leading names of today will withstand the test of time and maintain the growth that propelled them to the top of the index. It should also not be assumed that high compound returns will result from the top index constituents moving forward. The data above and the analysis we present below is a salutary warning about the risks of being overly focused on the winners of today instead of looking for the winners of tomorrow.

Is the Index Investable?

Indeed, looking at the historical data we see that the top positions in the R1000G tend to lag the rest of the index on a go-forward basis over 5 and 10-year periods:

Annualized Return Relative R1000G – Next 5 Years (2000 – 2022)

	Top 2 Positions	Top 5 Positions	Top 10 Positions
Average Relative Return	+2.9%	-0.4%	-1.1%
Median Relative Return	-1.0%	-1.0%	-1.7%

Source: FactSet, SGA calculations. Data from 2000-2022. Based on rolling 5-year periods starting each calendar year end. 18 observations. Each period's return is based on the average excess return for the companies in the group.

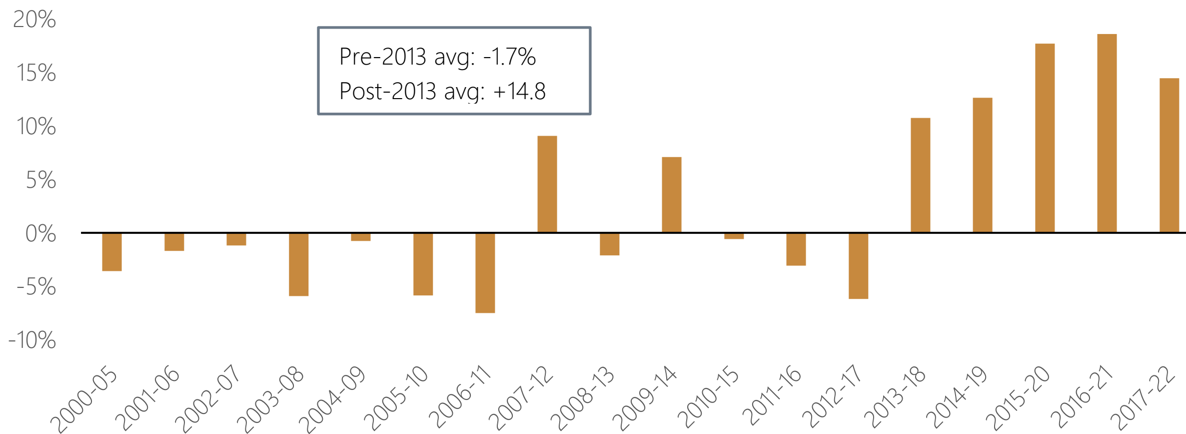
Annualized Return Relative R1000G – Next 10 Years (2000 – 2022)

	Top 2 Positions	Top 5 Positions	Top 10 Positions
Average Relative Return	0.0%	-0.9%	-1.6%
Median Relative Return	-1.5%	-1.4%	-1.6%

Source: FactSet, SGA calculations. Data from 2000-2022. Based on rolling 10-year periods starting each calendar year end. 13 observations. Each period's return is based on the average excess return for the companies in the group.

A notable exception is the outperformance of the top 2 positions in the 5-year table. Looking at the data in more detail, however, we find that this outperformance is driven by a clear change in trend since 2013:

Top 2 Positions Annualized Relative Return vs R1000G - Next 5 Years



Source: FactSet, Russell

Dissecting the data further we find that the outperformance has been driven primarily by two companies – Apple and Microsoft. The outperformance of these two companies has been a key driver of the rise in concentration over the past decade and an important factor in the R1000G's strong performance. In fact, let's examine the trailing 1-, 3-, 5-, and 10-year performance data for the R1000G excluding these two companies:

	1-Year	3-Year	5-Year	10-Year
R1000G	9.5%	12.8%	13.8%	14.8%
R1000G ex Apple & Microsoft	6.3%	9.3%	10.5%	12.4%

Data as of 5/31/2023. Source FactSet, Russell, SGA calculations

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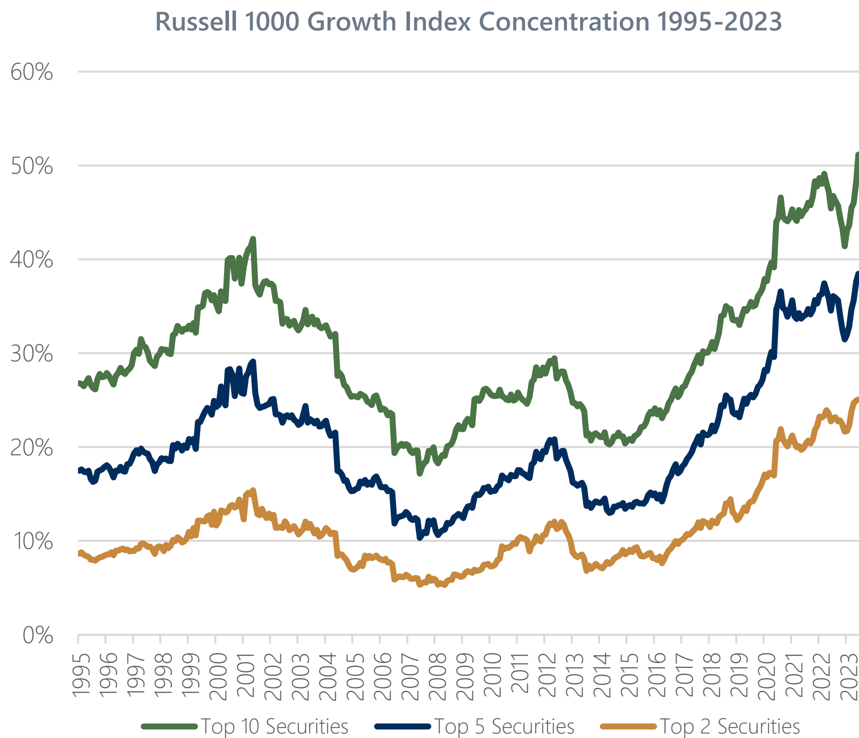
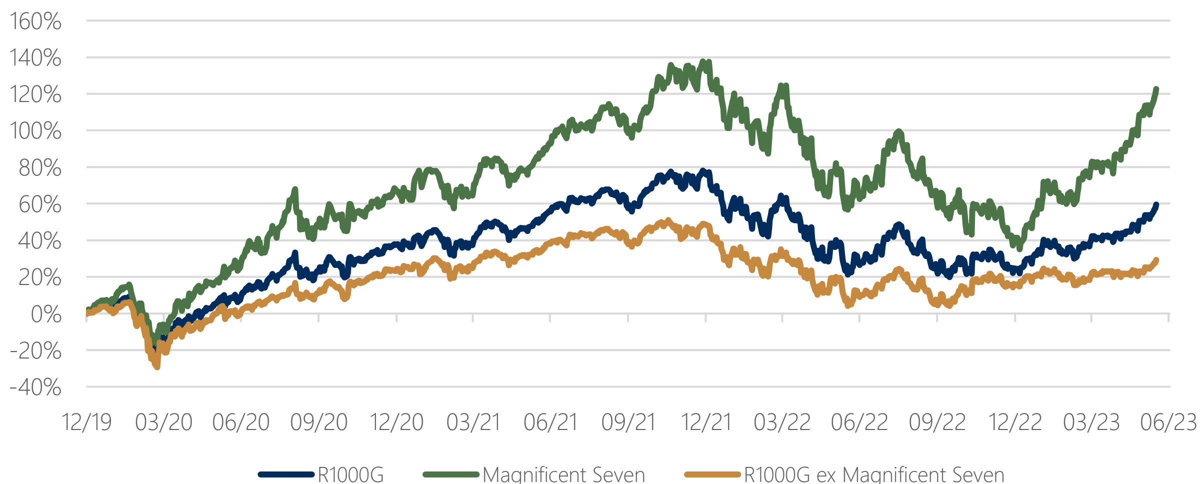
While it is not unusual for a few of the largest companies to maintain leadership for a period of time due to their competitive dominance, the last 10 years have been extraordinary in terms of the duration and magnitude of outperformance of the top companies. As a result, the R1000G is now more concentrated than ever and even more concentrated in the top 10 positions than two thirds of active US large cap growth managers.



Data as of 6/30/2023. Source: Strategas, FactSet, Russell.

One of the reasons this matters is because managers are judged against their benchmark index over short, medium and long-term performance. Let's go back and examine how the "Magnificent Seven" have performed in recent years and the impact these stocks have had on overall returns due to the highly concentrated nature of the R1000G:



Data as of 6/15/23. "Magnificent Seven" are: Apple, Microsoft, Amazon, Alphabet, Nvidia, Tesla, Meta Platforms. Source: FactSet, SGA calculations.

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Clearly a manager with a high degree of overlap with these stocks fared well in 2020-21, disastrously in 2022, and then incredibly well again thus far in 2023. As such a manager's relative exposure to these stocks would outweigh all the other successful and unsuccessful investment decisions made during these periods. Short-term judgements about a manager against a benchmark dominated by these stocks becomes difficult to say the least.

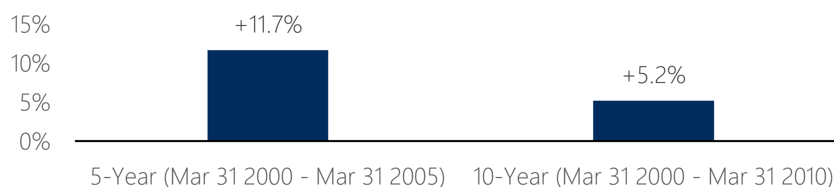
A Long-Term Perspective

We can only speculate about where concentration levels go from here, but we know that market leadership does evolve over time as the winners of tomorrow replace the winners of the past. The chart below from U.K.-based think-tank Economic Research Council illustrates the dynamic nature of the world's largest companies over time.

Source: ERC analysis of FT and Google Finance data via Visual Capitalist

Rising concentration and extreme market narrowness as we have seen in U.S. growth stocks over the past several years has been a headwind for active managers, such as ourselves, who build portfolios in a bottom-up, benchmark indifferent manner with an absolute return mindset. Risk management through prudent position sizing and valuation discipline has largely gone unrewarded over the past 10 years. It is possible, of course, that these trends continue, however, we would be highly surprised if the rise in concentration we have witnessed over the past 5-10 years continues over the next 5-10 years. As we have illustrated above, the track record for the largest companies in the index has been subpar when taking a longer-term view and with concentration at the extreme levels we are seeing today it leaves the index highly vulnerable to a reversal in leadership once again. Bottom-up risk management and diversification across growth drivers is likely as important as ever and could lead to significant portfolio protection if the tide turns and concentration recedes. As a guide we can look back at the track record of the John Hancock U.S. Global Leaders Growth Fund which was launched by one of our co-founders in 1995, and where we have served as a sub-advisor since the inception of SGA in 2003. As concentration peaked in March 2000 the Fund outperformed the R1000G by +11.7% and +5.2% per year over the following 5 and 10 years*.

John Hancock U.S. Global Leaders Growth Fund (USGLX) Annualized Excess Returns vs R1000G



**Note: SGA does not claim John Hancock U.S. Global Leaders Fund's track record as its own. John Hancock U.S. Global Leaders Fund performance data is sourced from FactSet and does not include all possible expenses such as sales charges which may be charged to certain investors in the Fund.*

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While uncomfortable in the short-term, we must be content with the fact that we have no control over the composition of the benchmark and indices. Instead, we continue to focus on what we can control – putting together portfolios of the highest quality, resilient businesses, that are well-positioned to deliver above-average growth in earnings and cash flows over the long term with lower levels of risk. Our fundamentally driven, bottom-up process has served our clients well over time, but just as any other disciplined investment process, it inevitably goes through periods of out- and underperformance. We recognize that periods of underperformance can be challenging and test our client's patience but remain committed to our time-tested process and approach to risk control and have confidence that our clients will be rewarded and benefit from the long-term compounding potential of the companies in our portfolios over time. As French philosopher Jean Jacques Rousseau famously said, ***"Patience is bitter, but its fruit is sweet"***.

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