Episode 63

Concentration issues: Focusing on the top-heavy U.S. equity market

The Investment Research team unpacks the risks of elevated concentration in U.S. equity markets

Lara Rhame (00:05):

Welcome back to the FireSide Podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist. Today's episode of FireSide is going to focus on the equity market and specifically on the incredible concentration we are seeing. I'm joined for this discussion by Andrew Korz, a director on our research team. He is truly one of the engines driving our fantastic equity research, in conjunction with Brian Cho. Brian and Andrew and I had the pleasure of being a part of an incredible piece of research called "Concentration issues: A look at the top-heavy U.S. equity market." So, let me set the stage: we're recording on June 14, 2023, and the S&P 500 is up—what should we call it, Andrew—about 14% today? That seems good, right? What's the problem? Well, I'm going to kick off this podcast with a scary story—maybe a scary statistic.

Lara Rhame (01:06):

The top 10 stocks of the S&P 500—and these are names we all recognize and almost certainly we all own them—the market cap of these top 10 stocks is about $11 trillion. Which, in and of itself, is a staggering number. But it puts it into even greater context when you realize that that $11 trillion is equal to the entire market value of the whole U.K. market, plus the whole German market, plus the whole French equity market, plus the entire Japanese equity market. When I then add on that an equal weighted S&P 500 has been pretty much flat for most of the year, not only are you seeing this incredible concentration, but you're also seeing this divergence of performance. So, Andrew, I've hopefully scared everyone into listening to this podcast: let's get more perspective. I want to kick you off by understanding a little bit more of what's going on here.

Andrew Korz (02:10):

I think you really kicked it off well there, Lara. I'm just going to kind of pile on with a couple more stats, just to really bring to the fore how remarkable the returns thus far this year have been. And, you know, I'm really excited about this podcast and this research because I think this is probably the most important question for most investors today. So, just to kind of piggyback on what you were saying: the top 10 stocks in the S&P 500—2% of the firms in the index—they have together driven 11.5% of the total 14% return in the S&P 500 this year.

Lara Rhame:

Incredible.

Andrew Korz:

Right? They, together, are up a total of about 42% year to date. The S&P 490 is up about 3.5% or 4%. So that's 42% versus 3.5% for the rest of the stocks.

Lara Rhame (3:06):

And I think this is an issue because we've always had a small number of stocks that are really dominant—that's not new—but this level of concentration is what's truly extraordinary.

Andrew Korz (03:18):

Absolutely. Absolutely. Just to put that in greater context, this is the highest contribution from the top 10 for a half of a year in the history we have, which goes back to the early 1950s. The previous high was in 1975, when the top 10 drove 11% of the gain in the first half of the year, but the index was up 40% that year. So, it was a much broader return environment in which the top 10 had just sort of went along with the rest of the market. I think just to kind of zoom out a bit and to begin our discussion, investors have clearly been the beneficiary of this concentration, which we're going to get more into. These ten stocks now comprise about 33% of the index, which is the highest since the mid 1970s. So, investors have been the beneficiaries of this, but I think it also really highlights a crucial risk going forward for investors. So, here in research, we always want to be looking ahead, not looking backward. So, I think while investors have been beneficiaries, it is one of, if not the key risk for equity investors going forward.

Lara Rhame (04:22):

I think that's going to be a recurring thread throughout our next 20 minutes of discussion, because these aren't bad companies. I think this idea that, hey, it hasn't been a bad strategy and the idea of investing completely without these companies in your portfolio seems ill-conceived. They are good companies. I'm not a stock analyst. I think the idea is that not only why should we care, but is what's wrong with that? What's wrong with these companies that are outperforming so well, having so much concentration within the index?

Andrew Korz (05:01):

Sure. I think that's a particularly pertinent question right now, given the last six months, the answer might have been very different six or eight months ago after these stocks had a really poor 2022. But sitting here today, the biggest reason that we should care is that these stocks are pretty remarkably expensive, both from an absolute basis and on a relative basis.

Lara Rhame (05:22):

In terms of putting new money towards today in terms

Andrew Korz (05:23):

If you're putting new money to work today this should be a concern of yours. So, the top 10 today as a cohort traded a Ford PE of about 30 times. They traded a free cash flow yield, which is another way we'd like to look at valuation of below 3%. So, they're yielding on current price and sort of forward 12 month free cash flow yielding less than 3%, the 10 year yield 3.8%. So, on an absolute basis, they look very expensive on a relative basis, they look equally expensive. The top 10 is trading at the highest premium to the rest, kind of the total S&P 500, since the mid 1980s. You're sort of talking about a market that's trading at 19 times earnings right now.

(06:12):

The market overall is very expensive and these stocks are trading at the highest premium to that in close to 40 years. A lot of this sounds a bit bublish and I think some of it, certainly we've seen the impact of the hype around AI. Some of it does feel a bit bublish. But I think to your point Laura, this is very different than say the lead up to the .com bubble. These stocks have proven business models, not just the prospect of potential profits in the future but current really strong cash flow, you think of the Apples, the Googles, the Microsofts of the world, they're entrenched, they dominate their markets. The issue isn't necessarily that these companies are speculative in nature, but they're just expensive right now and the entry point is

probably as bad as it's been in a pretty long time. So, I think two things can be true at once. These can be great companies and this can be a pretty poor entry point for them today and that has given their size, that has a massive impact on broad equity exposure.

Lara Rhame (07:14):

So, let me just look at a different angle of owning these stocks and how they trade and how they perform and what their runup has been. I think something that we talk a lot against the backdrop of traditional investments and the 60/40 and how there are risks with that model now and 2022 was really important reminder that diversification can break down with those two broad sort of fixed income and stock baskets. One of the things that we really observed was that last year they trended together they both, they both fell. That was particularly unique because normally when you have an equity market, drawdown, bonds do better and bonds, you get a, that bond performance improvement. So last year, you know, 2022, they both fell. I think one of the really critical conclusions that we draw is that these stocks trade with a very high correlation to, relatively high correlation to interest rates or of fixed income. I know we have a lot of questions about that but take us through the trading dynamics and the correlations of these, because that is also really critical piece of the constitution story.

Andrew Korz (08:35):

Absolutely. What I would say is that 13 years leading up to 2022 really thirteen consecutive years of financial repression, whatever you want to call it. Zero interest rates. An extended period of that has delivered us a market that is super concentrated in stocks that benefit from that environment. These are great businesses on the pure fundamental side, but from the valuation standpoint, that industry environment had a really significant impact on the valuations of these stocks.

Lara Rhame (09:05):

When your denominator is zero, these stocks, we've observed this in the past, they're almost trading like long duration zero coupon bond. All the growth is in the future. There's no discounting.

Andrew Korz (09:19):

Exactly, they're very sensitive to sort of future discount rates. So, if you look at, we ran just very simply, the three-year rolling correlation of these stocks relative returns to long-term treasuries, and seven of the ten have a significantly negative correlation to interest rates or a positive correlation to bond prices, however you want to look at it. If they all have sort of this dynamic that means they all move together and if you look at their average correlation to each other, they do tend to move together more so than top tens in the past historically. So not only do they comprise a significant portion of the equity market, but they tend to move together.

Lara Rhame (10:00):

I've been making this joke about, it's not just one elephant in the middle of the living room, it's ten elephants in the middle of the living room, and there's a herd mentality there.

Andrew Korz (10:07):

It's like really they all stomp to one end of the room

Andrew Korz (10:09):

That sort of delivers two major problems. One is just simply diversification within inequities. We saw in 2022, these stocks were down 34% together and they drove a lot of the downside in the stock market last year. This year they're up 42% and they've driven a lot of the upside. They're

moving together. So, that's number one. then number two is sort of a bigger picture question that you alluded to about portfolio construction. We've sort of relied on this yin and yang between bonds and stocks. When you have such a dominant cohort of stocks that are geared to lower interest rates, it does sort of mess up this stock bond correlation. We have to think about that when building portfolios going forward.

Lara Rhame (10:52):

Absolutely, and it makes the macro cycle that much more important. I'm not just saying that, because that's my thing.

Andrew Korz (10:59):

Talking in your book there.

Lara Rhame (11:01):

Everyone should read the macro research too. Let me just ask, since we're on macro, let'sstay in my comfort zone. Are these stocks recession proof? I think that's a really important question. Unfortunately, some type of mild recession is in my forecast, and yet a recession is not a foregone conclusion. I will readily acknowledge that. I just think it's important to understand, these companies, I think, and this maybe I'll lead the witness a little bit, Andrew, because I think of these companies back when they were startups and they were just growth by any means necessary. There didn't seem to be any limit to that. But they seem to be acting in some ways a little bit more like traditional cyclical companies. Close the loop on us of how they're different and how they respond to any economic sensitivity.

Andrew Korz (11:55):

I do think they've matured a bit in the sense that you saw what happened last year and a lot of these stocks got over their skis in terms of hiring, in terms of spending the pandemic. I mean I think meta was the perfect example of that, where they had the whole metaverse thing and they were spending tons of money and the market really penalized them for that, and then they pulled back on the spending and they've more than doubled since then. So, you are seeing this dynamic where these companies that were pure growth companies before are now becoming cashflow producing more, and a lot of them buy back a lot of stock. It's a slightly different dynamic now, but to your question about are they recession proof?

(12:33):

Are there business models, recession proof? No. It depends. So, I think a lot of them do reside in dominant positions in their industries, but these industries are cyclical to different degrees. You think about digital ad sales. That's where kind of meta and Google and to a certain extent, Amazon plays that relies on spending by a lot of times by small and mid-sized businesses that can be cyclical. Tesla, as much as we want to think they're some revolutionary technology company, and in some respects they are, they're still a car company. They're an auto company. They're a consumer durables company. Apple sells very expensive consumer products. Pretty soon they're going to be selling a $3,500 headset. These things wax and wane with the economy. Microsoft sells business software.

(13:19):

I think these markets are cyclical and while these companies do hold dominant positions in those industries, that doesn't mean that their fundamentals aren't sort of geared to the economy. The second thing I would talk about, and Laura, you and I talk about this a lot. These companies do have such big market values now, because they are in huge industries, and they accrue most of the value in those industries. But eventually you kind of outgrow your industry. You need to start building new products and moving into other parts of the market. We are

seeing that a bit within or between these top 10 stocks. So, you think about again digital ad sales. Amazon is becoming a bigger player there and sort of competing with Meta and with Google. Meta is getting into the e-commerce world with their Facebook marketplace. In cloud it's Microsoft against Amazon, and maybe Google, we'll see. In AI, you have Microsoft with open AI against Google and what they're trying to do there.

Lara Rhame (14:14):

That I think was one of the most that really struck home to me when you were pointing that out to me. When Chat GPT came out and I think when Microsoft released a search engine and Google reacted and well I think we'll continue to react?

Andrew Korz (14:30):

They're not done.

Lara Rhame (14:31):

But I think the fact that they're starting to drift into each other's lanes is really important because they've kind of grown as much as they can in their own spheres and you see the limitations, that they're starting to head up against.

Andrew Korz (14:48):

When you see the margins in some of these markets it's no wonder. I mean, Jeff Bezos has a famous quote that he, he says, your margin is my opportunity. I mean, eventually if we do start to see some more competition in these markets and margins get squeezed even a little bit, that impacts the growth rate and at these multiples that these stocks are trading at right now, that implies pretty strong growth into the future. So, look, again, we don't know what's going to happen. AI can be revolutionary but you're making a pretty big bet buying these stocks, these valuations in that type of size.

Lara Rhame (15:20):

So, I'm an equity investor. Our clients are dealing with two problems. They're dealing with, maybe, cash that they've brought in. They're interested in where to put that to work and they're also dealing with gains that feel, on paper look good, but when they peel back the onion, maybe feel a little less structurally sound. We talk a lot and we have a lot of solutions that offer investors help with diversification. But at the same time, it can be hard to and I feel like diversification is the unsung hero of portfolio construction. I think what do we do with all of this? I think I want to really drive towards, as investors, how do we solve for this problem? Do we need to do we just stick with these stocks because they've done so well for us over the past two to twenty years. What do we do with this?

Andrew Korz (16:17):

I don't think they're going out business anytime soon. No, I'll say that, but I think this is one of those times in history after a 40 plus percent gain in these stocks year to date. This is one of those times where you have a major risk, this concentration risk and this valuation risk that the market is giving you a chance to proactively rectify right now. You had a great run this year, but the entry point now to your point for new money is not great. I would, I would sort of posit four things that we should be thinking about right now. Number one is to fight complacency. The top 10 over history, we're not talking about the last year or two, the top 10 over the past seven, eight decades tends to underperform the market as a whole,

Lara Rhame (17:04):

This is something, and again, I'm just going to put in another soft plug for the paper that's available on our website on the insights tab. This paper really has more quantitative and more granular information about all this and charts and one of the most striking is what you're alluding to Andrew. That these top 10 stocks don't usually pull the whole index up. It's usually the other way around. it's another reason why this is a really, I think, unique environment

Andrew Korz (17:34):

History shows that there's always sort of this replacement, there's ups and downs in terms of concentration since 2015. In 2015, top 10 was only 16% of the S&P 500. Today it's 33%. So, you've ridden that increase in concentration up led by these stocks, and it's been a great ride. That's an anomaly historically. The market, again, has given you an opportunity to rectify that. How do you do that? Number one, I think this cohort is very unique. They have similar characteristics. To your point, you need to understand the macro cycle. They almost trade like bonds at this point. They almost trade as a distinct asset class. It's either sort of like you buy fangs or you buy kind of equal weight US equities. They're very, they have very different macro drivers.

(18:16):

Understanding the cyclical component of this, because there are still going to be times where they outperform, is going to be very important given their size. Number three, I think diversify globally. The US is really the only market. It's super unique because it does have these tech giants. No other market really has that, and thus no other market really has this concentration issue. I think if you're looking to diversify, a great way to do that is to go to other parts of the world, which it's not sexy right now. The US has been dominant, so it's tough to say that right now. But look, the valuation premium in the US is as high as it's been. It's a good time to look elsewhere. Then number four is get more active. Active strategies have been terrible since 2015, mostly because it's almost impossible to beat a market that is getting more and more concentrated pretty much without fail. The outperforming companies get a higher weight in the index and then they continue to outperform it. You have to chase these names up and active managers have just not been able to keep up. To the extent that this concentration stays here or even comes down a bit, active strategies are going to have a much better chance of outperforming.

Lara Rhame (19:22):

I think this is all so critical, Andrew, as we enter the last half of the year, because we had a tough 2022, there's been this sort of overarching concern about an economic slowdown, but so far growth has stayed really solid and markets have done pretty well. I think again, today the Fed may be raising rates, maybe not. I think the large expectation is that they're on hold, but the rate hike cycle may not be done yet. I think the macro cycle is still very, very much in question. And as we look ahead, I think this question recession, no recession, where are interest rates going to go? These big macro drivers have really brought this concentration issue, I think front and center for a lot of investors. It's getting a lot of attention right now, which is why this paper was so perfectly timed. Bring it home for us.

Andrew Korz (20:16):

Let me just summarize. We talked about a lot here. The way I would summarize this is like this, number one, the market is more concentrated than it has been at any time since the mid 1970s. Number two, most of the largest stocks are highly correlated with bonds and with each other by extension. Number three, these stocks trade at evaluation premium to the overall market, which is already trading at an incredibly high level. That premium is at a four decade high. Fourthly, and we didn't really talk about this, but I'll kind of mention it, the macro environment that helped these stocks flourish, which we've sort of deemed the, the great moderation, globalization or the increase in globalization, I would say, and the ultra low interest rates that have come with that. I would argue that is under threat in a way that it hasn't been in

decades. We don't know to what degree yet. There's a ton of uncertainty around that, but that uncertainty is not priced into these stocks.

Lara Rhame (21:17):

I think this is important because we've really have dug into this through our research. It's really not just that we think de-globalization may experience and it may experience this massive reverse, it's that the pendulum has stopped swinging towards further globalization. That pendulum swinging towards globalization has been an incredible lift to these large high growth tech companies.

Andrew Korz (21:41):

The work that we've done the brilliant research that Brian Cho has done, shows that the, the majority of the margin expansion in the equity markets has been driven by lower interest rates and lower tax rates. The biggest beneficiaries, if you just look at the effect of tax rates, has been these tech companies that are the best at sort of rerouting their profits through low tax areas like the Cayman Islands like Ireland. So, to the extent that these things at least stop becoming tailwinds or possibly become headwinds, some of the first places you're going to see that is going to be the top of the market here. There's a lot of risks given the valuation that we're seeing, those risks aren't placed in right now.

Lara Rhame (22:27):

I think one of the key takeaways for me is the passive investing, which has just been such a no-brainer, just is overstretched at 40 year levels from valuation, from concentration, and from an increasing lack of diversification with your bond portfolio. I think to me, those are the key takeaways. You know, again, these are, these are not bubble stocks, but they're not bargains. I think that is going to be one of the issues that investors were going to really be having to navigate in the second half of the year. It's not necessarily going to be easy.

Andrew Korz (23:02):

I would leave it with this. It's hard to talk about these things and to be a contrarian because right now it seems so obvious what you should be doing. But I think that is the best time to talk about what's coming not only over the next three or six months, but over the next two to three years. I think the starting point today is vastly different than it's been over the past five or ten years.

Lara Rhame (23:29):

Thank you so much, Andrew. This was great.

Lara Rhame (23:39):

This episode was recorded at the FS investments headquarters in Philadelphia's historic Navy Yard. It was produced by the investment research team. It was edited and engineered by Aaron Sherman. Special thanks to show coordinator Ellie Zhang. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.