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ASSET MANAGEMENT

March 2024

# Passive to Active:  Words of Wisdom from Ted Lasso

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## Executive summary

- *Historically, there are have been two environments in which active US equity managers have tended to outperform: when index concentration has declined, and during bear markets.*
- *As a result of an exceedingly narrow market environment in 2023, S&P 500 Index concentration in the top five stocks has reached an all-time high.*
- *For earnings and valuation reasons, we believe index concentration will decline.*
- *We believe US equities appear priced to perfection from a valuation perspective. Given active managers' track records of outperforming during bear markets, this may be a good time to switch from passive to active strategies in order to limit potential downside risk should market volatility increase.*

## The stage could be set for active managers to outperform

In the television series Ted Lasso, Ted says to the captain of the soccer team, "You know how they say, 'Youth is wasted on the young?'  Well, I say, 'Don't let the wisdom of age be wasted on you'."  Passive strategies have generally fared well over the past decade, which has made it easy to forget the long periods during which active managers outpaced passive approaches.

As shown in Exhibit 1, more than half of US large cap core managers outperformed their benchmarks in 7 of the 11 calendar years from 2000-2010. The years 2000-2002 were particularly favorable, with more than 60% of active managers outperforming their benchmarks. What conditions existed that favored active managers during that decade?

**Exhibit 1: More than half of active managers outperformed after the last peak in S&P 500 market concentration**
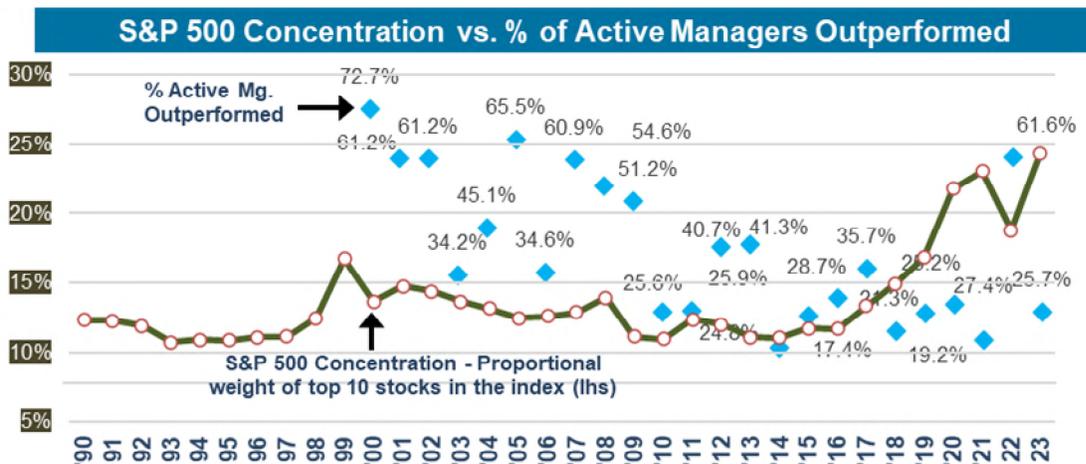


Source: Amundi US and Bloomberg, as of Dec 31 2023. Percent of active manager outperformance is based on Lipper Large Cap Core Universe 12/19/00 – 12/31/23. Source: Strategas. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index. Past performance does not guarantee future results.

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### *S&P 500 Index concentration plummeted*

At the end of March 2000, five stocks accounted for 18% of the S&P 500 index. After the dot-com bubble burst, index concentration fell, with the top five stocks representing less than 11% of the index a decade later. Moreover, only two stocks among the top five at the end of 1999 were still in top five at the end of 2009. And only one, Exxon, had a higher weighting than it did at the beginning of the decade.

Put another way, four of the top five stocks in the S&P 500 at the end of 1999 underperformed for an entire decade!  At the end of every decade since the end of 1989, there have never been more than two stocks in the top five that had also been in the top five at the beginning of the decade. In short, market leadership has historically changed from decade to decade.

Why does index concentration matter for active managers?  Because they are typically underweight the largest stocks during periods of extreme concentration.  During the 2000-2010 period, for example, active managers outperformed as market concentration fell because they were underweight the top five stocks.

**Exhibit 2: Top five stocks in S&P 500 in 1999 and 2009**

| Top 5 stocks in S&P 500 | Dec 31 1999 |
|---|---|
| Microsoft | 4.89% |
| GE | 4.12% |
| Cisco | 2.84% |
| Wal-Mart | 2.50% |
| Exxon-Mobil | 2.26% |

| Top 5 stocks in S&P 500 | Dec 31 2009 |
|---|---|
| Exxon | 3.26% |
| Microsoft | 2.37% |
| Apple | 1.91% |
| Johnson & Johnson | 1.79% |
| Proctor and Gamble | 1.78% |

Source: Bloomberg, Dec 31 1999 and Dec 31 2009.

### *There were two bear markets*

Historically, active managers have outperformed during bear markets. As shown below, more than half of US active large cap blend managers outperformed the S&P 500 during bear markets dating back to 1987 in which the S&P 500 fell more than 20%. During the bear market from 2000-2002, 61% of large-cap blend managers outperformed. During the Great Financial Crisis from 2007-2009, 65% of large-cap blend managers outperformed. We believe the outperformance of active managers during bear markets is due to their focus on risk control.

**Exhibit 3: More than half of active managers have outperformed during bear markets**

| Start Date<br>(beginning of month as proxy) | End Date<br>(beginning of month as proxy) | % of Morningstar Active Large-Blend Managers Outperforming |
|---|---|---|
| 8/25/1987 | 12/4/1987 | 77% |
| 3/24/2000 | 10/9/2002 | 61% |
| 10/9/2007 | 3/9/2009 | 65% |
| 2/19/2020 | 3/23/2020 | 55% |

Source: Morningstar, Bernstein Analysis. Note: Active manager performance is monthly. Periods are rounded to the nearest month-end. Past performance does not guarantee future results.

## What are potential catalysts for an active management revival?

### *The first potential catalyst is earnings*

Market concentration increased sharply in 2023 as 68% of the return of the S&P 500 Index came from the ten largest stocks**.** Seven of the ten are known as the Magnificent Seven[1].  We believe the reason these stocks

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[1] Source:  Strategas, 12/31/23. The Magnificent Seven are Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVDIIA, and Tesla.

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performed so well last year is that, in addition to being beneficiaries of developments in artificial intelligence, the Magnificent Seven also delivered earnings growth (shown in Exhibit 4) during a period in which earnings declined for the rest of the index.

Consensus earnings estimates for 2024 and 2025, however, suggest the earnings advantage of the Magnificent Seven is shrinking**.** As earnings recover for the broader universe of S&P 500 companies, investors looking for earnings growth may have more stocks to choose from than they did in 2023.

**Exhibit 4: The earnings advantage of the top seven stocks in the S&P500 is shrinking**
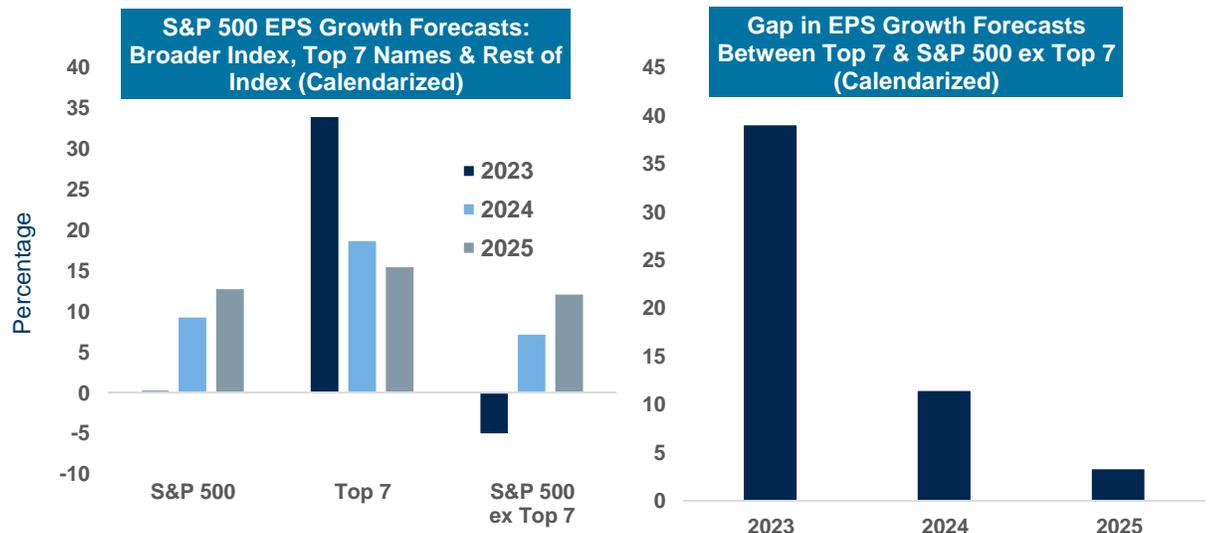


Source: RBC Capital Markets, Feb 5, 2022. Data is based on past performance, which is no guarantee of future results.

*The second potential catalyst is valuation*

The top ten stocks in the S&P 500 Index are trading at their highest price-to-earnings (P/E) multiples (apart from during the COVID-19 pandemic) since the end of the dot-com bubble. The P/E multiple of the S&P 500 Index minus the largest ten stocks, by comparison, is well off of its recent highs, and is only modestly higher than its long-term average. Given the valuation discrepancy, investors may increasingly favor stocks that are not in the top ten – especially as the earnings growth (barring a recession) of these companies recovers.

**Exhibit 5: The top ten stocks in the S&P 500 are near their peak valuation levels since the dot-com era**



Source: RBC Capital Markets, Feb 22, 2024. Data is based on past performance, which is no guarantee of future results.

*The final potential catalyst is a market drawdown*

Current S&P 500 valuations reflect, in our opinion, a "Goldilocks" scenario in which inflation fully retreats to the US Federal Reserve's target of 2%, the economy grows at a healthy pace, there is no escalation in geopolitics, the US presidential election proceeds smoothly and the outcome is accepted by all, and corporate profit margins stay at elevated levels or move higher.

While this outcome is possible, it is not certain. A recession, even a mild one, would cause earnings estimates to plummet. Stocks would likely follow. Though a recession as of the publication date of this piece does not appear imminent, investors historically have not done a good job of predicting them. As a result, markets have not discounted recessions until after they have begun. In a market drawdown, the biggest decliners are likely to be the ones most widely held – the Magnificent Seven. Since active managers can be underweight the Magnificent Seven, they can potentially mitigate downside risk relative to indices such as the S&P 500.

## Conclusion

We end this article with more words of wisdom from Ted Lasso, who said, "Living in the moment, it's a gift. That's why they call it the present."  At this moment, active managers are struggling to keep up with passive approaches due to the recent dominance of the largest stocks in the S&P 500 Index. History suggests that active managers can outperform passive ones for sustained periods under two conditions:  1) When index concentration declines; and/or 2) There is a bear market.

The reasons we believe market concentration will decline include (1) a shrinking earnings advantage for the top ten companies, and (2) seemingly unsustainably high valuations relative to the broader market. While we cannot predict the timing of when market concentration will decline, leadership historically has changed from decade to decade. Because the timing is unpredictable, we do not believe investors should avoid the Magnficient Seven completely, but that they may benefit from investing with active managers that thoughtfully select their exposure based on the earnings and valuation profile of each stock.

## Index and Term Definitions

- Average price/equity ratio: The current price of a stock divided by the estimated one-year projection of its earnings per share.

- Beta: A measure of the contribution of an individual asset to the risk of the market portfolio.

- Compound annual growth rate: The mean annual growth rate of an investment over a specified period of time longer than one year.

- Global Financial Crisis: The period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

- Megacap stock: A designation for the largest companies in the investment universe as measured by market capitalization; a common measure is those with a market capitalization above $200 billion

- Price-to-earnings (P/E) ratio: The ratio of a stock's price over its per-share earnings.

- The Russell 1000® Growth Index: measures the performance of the large-capitalization growth sector of the US equity market. Indices are unmanaged and their returns assume reinvestment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index.

- S&P 500 Index: A stock market index that tracks 500 publicly traded domestic companies and serves as the foundation for a wide range of investment products.

## Important information

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