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US equity market concentration presents both risks and opportunities

INVESTMENT TALKS

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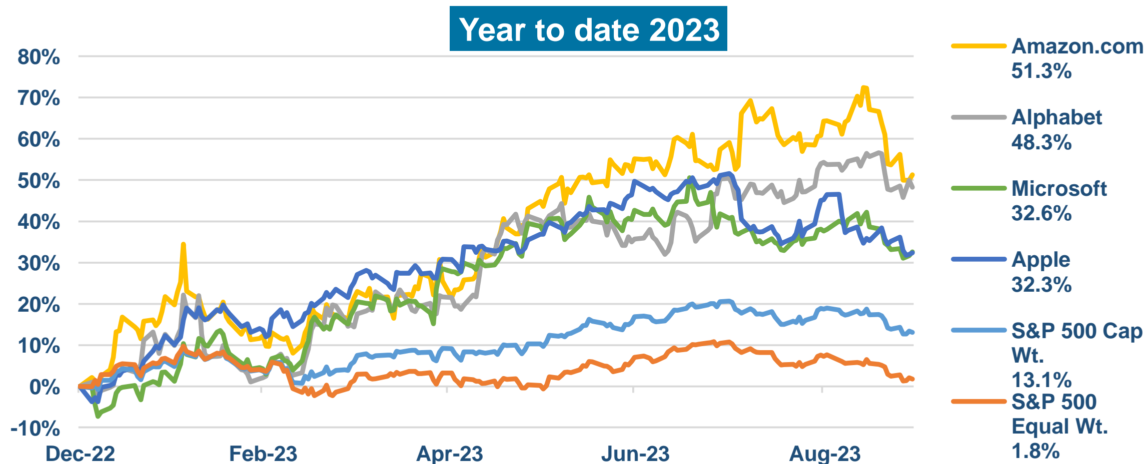
Executive summary

- *Throughout 2023, US equity returns have been driven by a narrow group of stocks, with the top 10 stocks by market capitalization accounting for 96% of S&P 500[1] returns.*
- *Historically, periods with significant increases in concentration have been followed by sharp reversals. For instance, after reaching a peak in 2000, S&P 500 concentration plummeted as the largest stocks underperformed.*
- *Apart from the megacap stocks, US valuations appear reasonable, with the S&P 500 Equal Weight Index trading at a 16x P/E ratio, in line with historical averages.*
- *We believe investors could be rewarded for underweighting megacap stocks and overweighting average stocks, including value and reasonably priced growth stocks.*

The largest stocks in the S&P 500 have driven returns in 2023

Year-to-date, 96% of the return of the S&P 500 Index has come from the index's 10 largest stocks[2]. Investors have flocked to these stocks due to enthusiasm for artificial intelligence and because their earnings have increased at a time when overall corporate profits have been under pressure. Notably, in no calendar year since 1990 have the largest 10 stocks driven a higher percentage of the positive overall S&P 500 return than they have in 2023. By comparison, the average stock as represented by the S&P 500 Equal Weight Index has lagged the megacaps and the capitalization-weighted S&P 500 Index significantly.

Exhibit 1: The S&P 500 Equal Weight Index is well behind the S&P 500 Index and the megacaps



Source: Bloomberg. Past performance is no guarantee of future results. Securities listed are not meant to represent any current or future holding of an Amundi US portfolio, and should not be considered recommendations to buy or sell any security.

[1] Year-to-date through Nov 2023.

[2] Microsoft, Apple, Amazon, NVIDIA, Alphabet, Meta, Tesla, Berkshire Hathaway, UnitedHealth, Eli Lilly.

Due to its underperformance, the S&P 500 Equal Weight Index is trading at a 4x discount (16.6x) to the S&P 500 Index (20.6x) as measured by price/equity (P/E) ratio[3]. As shown in Exhibit 2, the P/E ratios of the two indices have historically been similar. Assuming consensus earnings estimates are accurate, this would suggest that the average US stock is attractively valued, while the S&P 500 Index appears modestly overvalued.

Exhibit 2: The "average stock" trades at the biggest discount to the capitalization weighted Index in more than 10 years

Source: Bloomberg and Amundi US. Last data point 30 Nov 2023. See appendix for more information on indices.

Historically, what has followed an extremely narrow market environment?

Years in which the 10 largest stocks in market capitalization drove more than half of the S&P 500 returns[4] have always been accompanied or followed by significant stock market volatility. In 2007, for example, the 10 largest stocks accounted for 78% of the S&P 500 Index return. The Index plummeted 37% in 2008 during the Great Financial Crisis. In 1999, 54% of the S&P 500 Index return came from the 10 largest stocks. The Index fell 9% in 2000 as the dot-com bubble burst. In each of these cases, market concentration reversed sharply, creating a fruitful environment for active equity managers as the largest 10 stocks underperformed. From 2000-2002, for example, more than 60% of active managers outperformed as the largest stocks declined and index concentration dissipated[5].

[3] Source: Bloomberg, calendar 2023 earnings estimates as of 5 Dec 2023.

[4] Years in which there has been a positive return. There have also been years when concentration has been high and returns have been negative.

[5] Source: Bloomberg, 5 Dec 2023.

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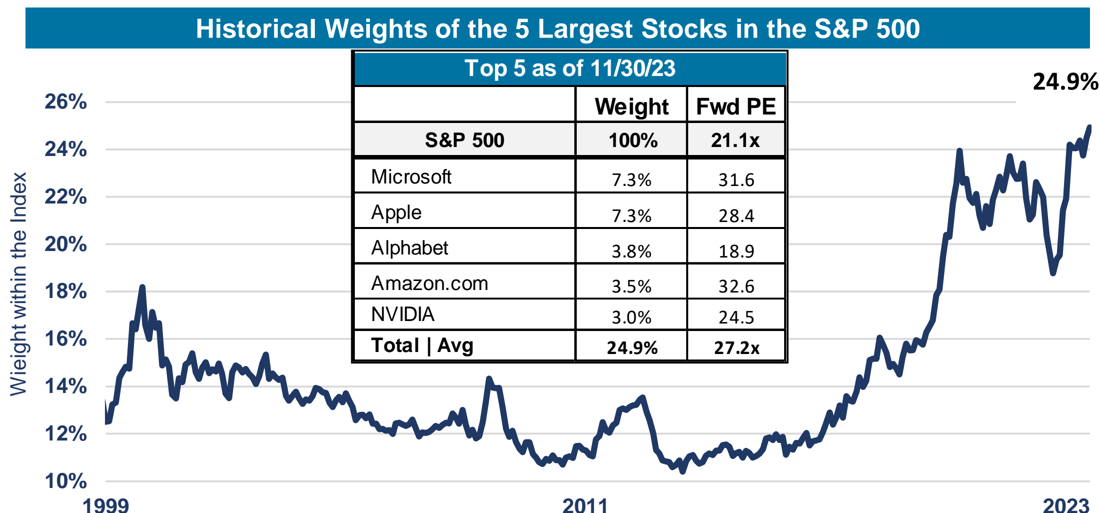
Exhibit 3: The S&P 500 is highly concentrated in the megacaps



Top 5 as of 11/30/23		
	Weight	Fwd PE
S&P 500	**100%**	**21.1x**
Microsoft	7.3%	31.6
Apple	7.3%	28.4
Alphabet	3.8%	18.9
Amazon.com	3.5%	32.6
NVIDIA	3.0%	24.5
Total | Avg	**24.9%**	**27.2x**

Source: Bloomberg and Amundi US. Securities listed are not meant to represent any current or future holding of an Amundi US portfolio, and should not be considered recommendations to buy or sell any security.

How can investors respond to the highest concentration of the S&P 500 in more than 30 years?

We believe investors can reduce concentration risk in their portfolios by cutting exposure to the megacaps and selectively adding exposure to non-megacap stocks. One way to facilitate this outcome is to reduce exposure to growth stocks and add value stocks, most of which have lagged the megacap stocks significantly and trade at much lower valuations. The Russell 1000 Value Index, for example, traded at 14.4x estimated 2024 earnings-per-share compared with 25.9x for the Russell 1000 Growth Index[6]. The 11.5 difference in P/E multiple between the two indices is nearly twice the historical average of 6x. Growth historically has traded at a premium to value due to its superior growth and profitability, but typically not at a premium this wide.

Value stocks, however, have more cyclical exposure and thus could falter if there is a recession in 2024. For this reason, we suggest maintaining exposure to reasonably valued growth stocks while underweighting exposure to the pricier megacaps. As shown in Exhibit 4, the top decile stocks in market capitalization in the Russell 1000 Growth Index traded at a higher P/E relative to rest of the Russell 1000 Growth Index than they have since the dot-com period. Not all of the growth universe in richly priced, in our view. Active growth managers who underweight the megacaps in 2024 may be well rewarded.

[6] Source: Bloomberg, 30 Nov 2023.

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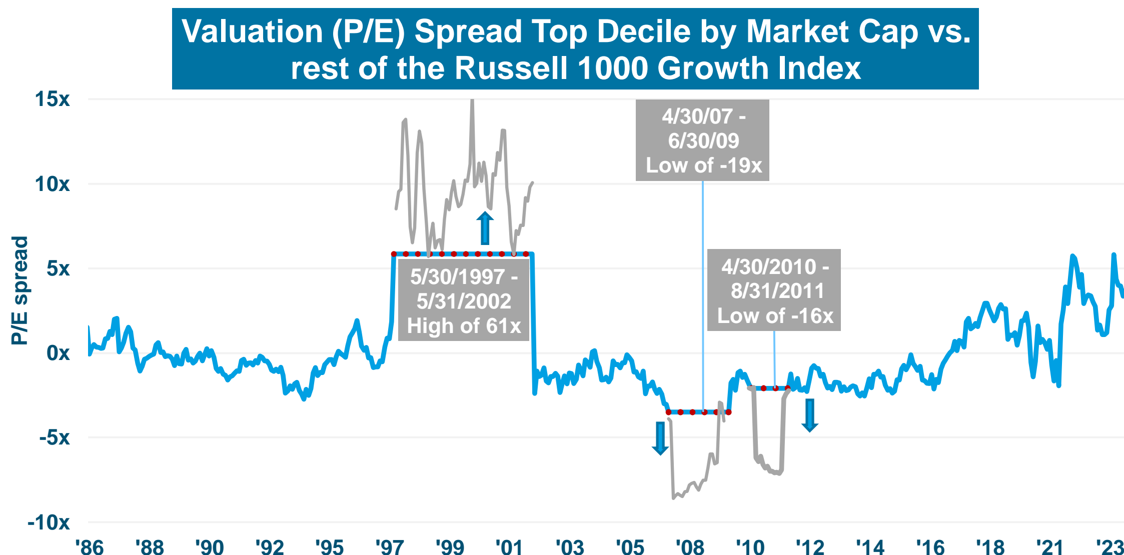
Exhibit 4: Valuation spread by market cap of top decile of Russell 1000 Growth Index vs remainder of index



Source: Bank of America (BofA). Last data point October 31, 2023. The Russell 1000 Growth Index is a market-capitalization-weighted index of US growth stocks. P/E = price-to-earnings ratio. See Appendix for more information on indices.

Conclusion: To reduce concentration risk, consider investing with active managers who diversify

Megacap stock have delivered nearly all of the performance in US equity markets in 2023. We believe the performance of these stocks relative to the rest of the equity markets is unsustainable. As we enter 2024, we think investors will be best-served by diversifying away from megacap stocks into value stocks and reasonably priced growth stocks.

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Index and Term Definitions

- **Average price/equity ratio (estimated):** 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.
- **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.

Important information

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