

02.18.2021

Gresham's Views on the Narrowness of U.S. Equity Market Leadership

Executive Summary

Over the last decade, U.S. stocks appear to have outperformed international stocks. And while the performance of major indices appear to support this argument, the truth is not as clear. The S&P 500 Index, the primary index by which investors measure U.S. equity market performance, has been disproportionately influenced by the unprecedented concentration of the five largest stocks within the index (Facebook, Amazon, Apple, Microsoft and Google or "FAAMG") and their recent performance. When we strip away the performance of these companies, we are left with a very different perspective on equity market performance.

In addition to providing a different perspective on the relative performance of U.S. equity markets, this increased concentration has increased the risk to investors. These five companies now comprise an historically unprecedented amount of the S&P 500 Index. Worse, while high valuations do not presage a market decline, all of these companies are trading at historically elevated levels when compared to their own history and that of the overall market.

While higher valuations have historically implied greater downside risk to investors, defenders of these companies will correctly note that these risks are mitigated by their strong revenue and earnings growth. History has shown that these index leaders struggle to maintain their leadership position often due to the weight of their own success creating unrealistic expectations for future growth. Further, it is the unknowable risks, such as regulatory pressures that are more often the deflating pinprick.

At a minimum, investors should understand the historically high concentration of these companies in the S&P 500. Further prudence would suggest rebalancing this risk back toward more traditional levels or international, emerging market exposures or even other stocks in the U.S. whose exposure has been reduced by this phenomenon.

Global Equities Performance: A Historical Perspective

The S&P 500 is the default index for many investors who want to own a piece of the American economy. Over the last ten years, the S&P 500 has outperformed its non-U.S. developed markets counterpart by over eight percentage points per year and its emerging market equivalent by over ten percentage points per year. Put differently, if one had invested a dollar in U.S. stocks at the beginning of 2011, today it would be worth \$4.22, compared with \$1.84 and \$1.70 for developed international and emerging markets, respectively.

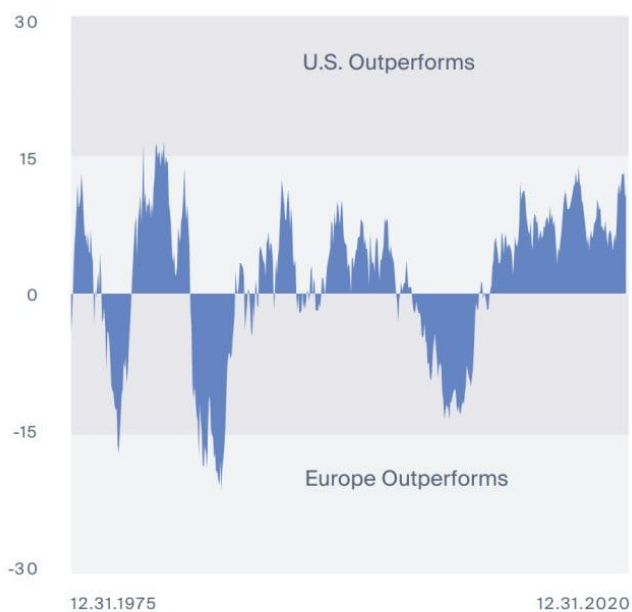
Historically, the performance of U.S. markets relative to world equity markets, or other major

geographies such as Japan, has been cyclical. The chart below illustrates these long-cycle rotations through a comparison of the S&P 500 to the MSCI Japan and MSCI Europe indices. During the 1970s and 1980s, the Japanese stock market was much stronger than its American or European counterparts, besting the US by 250% cumulatively in the seven years ending in 1989. This trend reversed in the 1990s, with the US market beating the Japanese market by close to 200% over this decade.

The rally in U.S. stocks after the Global Financial Crisis is also clear in these charts, and the gap of outperformance has been one of the longest and cumulatively largest divergences in history. However, there is no reason to believe that this pattern represents a long-term structural shift nor that the mean-reverting tendency of these relationships will cease to exist ... it's simply a question of when the reversal occurs. We are not suggesting that an unwind is around the corner, but rather want to ensure that investors understand the drivers of recent U.S. market performance and are aware of the changing risk profile of U.S. equity market indices.

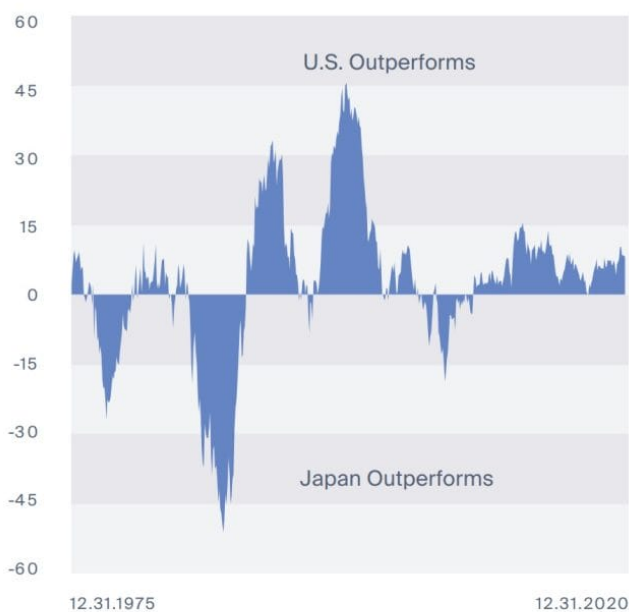
Chart 1. U.S. vs International Performance

S&P 500 vs MSCI Europe Rolling 3 Yr. Ann. Excess Performance (%)



Source: Bloomberg

S&P 500 vs MSCI Japan Rolling 3 Yr. Ann. Excess Performance (%)



Source: Bloomberg

Investment flows suggest that the “herd” is once again chasing performance. This behavior is typical in the later stages of a market cycle. Most investors suffer from recency bias, which favors recent events over historic ones, causing them to extrapolate current trends into the future. One common manifestation of this bias is that it often causes investors to chase performance for fear of being left behind. These behaviors have exacerbated recent performance trends in favor of U.S. stocks and specifically for a small number of highly appreciated companies. Further, they have created some interesting distortions within capital markets and equity indices that have elevated investor risk.

Drivers of Recent S&P Index Performance

The S&P 500 Index is comprised of a large number and wide variety of stocks. Taken as a whole, it is intended to represent a broad cross-section of U.S. corporations and provide a balanced measure of U.S. equity market performance. However, the index, based on its own simple construction rules and the strong performance of a few stocks, has become unbalanced and potentially riskier than investors may realize. Further, recent relative outperformance appears to be more representative of these few stocks rather than the broader U.S. market. To a historically unprecedented degree, U.S. equity market performance has been dominated by a handful of stocks whose performance has been so strong that it exaggerates S&P 500 Index performance and distorts comparisons to other markets.

In 2020, the largest five stocks in the S&P 500 Index (Facebook, Amazon, Apple, Microsoft and Google or “FAAMG”) returned 56%, while the remaining stocks in the index returned 11%, far less than the actual index return of 18% for the year, and interestingly, a level nearly identical to the 10.7% return of global equities when U.S. stocks are excluded. This differential is not only driven by the strong performance of the FAAMG stocks, but the high weighting of these stocks in the index, which has reached an unprecedented level of concentration. While the strong performance of U.S. equities and increasing levels of concentration have benefited investors, they also have increased downside risks for investors going forward.

Chart 2. Narrowness of U.S. Equity Returns



Source: FactSet and Goldman Sachs Global Investment Research

“ While the strong performance of U.S. equities and increasing levels of concentration have benefited investors, they also have increased downside risks for investors going forward.

Contrast this situation with non-U.S. indices. The MSCI Europe and MSCI Pacific indices were surprisingly more concentrated at the beginning of the millennium than they are now. Europe’s Nestle, Roche, Novartis, SAP and ASML make up about 12% of the index currently as opposed to about 17% in 2001. For the Pacific market, the top five are Toyota, AIA, Softbank, Sony and CSL, which account for about 10% of the index. Concentration in this

index is down similarly from about 22% in 2001, and off the subsequent peak in 2012 of 15%

Concentration in the U.S. Market

The concern around concentration is most acute in capital-weighted indices such as the S&P 500. Under this methodology, capital flows disproportionately into the larger stocks comprising the index, increasing their stock prices and market values, which then forces the index to rebalance by buying more of these companies. This self-reinforcing cycle increases the concentration in the index to these larger companies. It is important to understand that increasing weights, on their own, are not tied to corporate performance, but rather are simply a function of a company's stock price and valuation moving higher. Essentially, a capital-weighted index perpetually buys high and sells low, violating a fundamental rule of investing. This process can work in an investor's favor until some fundamental aspect of a business changes, causing non-index based investors to sell and the process begins to work in reverse.

Chart 3. Index Concentration Unique to the U.S.

Market Cap of 5 Largest Companies as Share of Total Index (%)



Source: MSCI, Bloomberg

Chart 4. Technology Sector Has Been a Driving Force

Cumulative Performance (%)



Source: Bloomberg

In addition to increased index concentration, we are also seeing growing sector concentration. The FAAMG stocks are all technology stocks, and the primary contributor to the performance of the IT sector, as shown in Chart 4. The equal-weight index avoids the individual stock concentration concern of the cap-weighted S&P 500 Index, and one can see the performance differential that has occurred over the last few years. However, this pales in comparison to the performance gap that has been created between the performance of the technology sector and that of broader equity market indices.

In contrast to U.S. equity markets, international equities have experienced less sector concentration with leading firms from different sectors. The top five companies in the MSCI

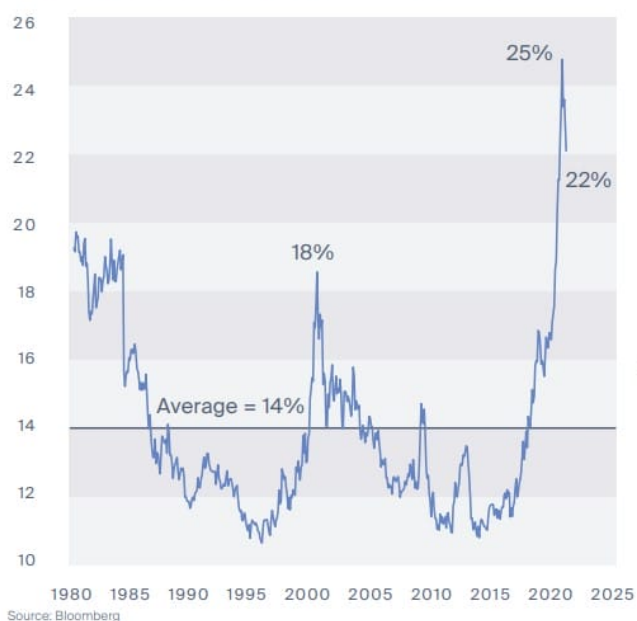
Europe Index are Nestle (Swiss food and drink firm), Roche (Swiss healthcare company), Novartis (Swiss Pharmaceutical firm), SAP (German software company) and ASML (Dutch semiconductor maker). The Pacific index is also more diverse with its top five companies being Toyota (Japanese automotive company), AIA (Hong Kong-based insurer), Softbank (Japanese conglomerate including technology, energy and finance), Sony (Japanese technology and entertainment) and CSL (Indonesian shipping).

Historical Comparisons

Similar periods of imbalance and concentration historically suggest that this trend for U.S. equities is not sustainable and that some form of correction is likely to occur. The most recent prior example occurred during the Tech Bubble, when a handful of stocks (Microsoft, Cisco, Exxon Mobil, GE and Intel) dominated the S&P 500 Index with an 18% weighting. Recently, the top five stocks (Apple, Microsoft, Amazon, Alphabet and Facebook) reached nearly 25% of the index, far exceeding the prior period of excess concentration. And all of the current index stalwarts are tech stocks, a phenomenon that did not occur even during the Tech Bubble.

Chart 5. Concentration of Top Five Near an All Time High

Market Capitalization of 5 Largest Companies as share of S&P 500 (%)



Market leaders rarely retain their dominant industry or index positioning for long, as larger firms have difficulty sustaining their growth rates amid increasing competition, disintermediation and/or regulation.



Market leaders rarely retain their dominance for long, as larger firms have difficulty sustaining their growth rates amid increasing competition, disintermediation and/or regulation. The group of five companies that collectively peaked at 18% of the index in the early 2000s represents only 8% of the index today. Microsoft is the only remaining top-five company from the prior period and it is the one company in the current group that is not facing government antitrust probes, although it ironically faced such a challenge in 2001. It is also worth noting that in 2000, Amazon and Google were in their infancy, Facebook did not

yet exist, and Apple was a marginalized personal computer maker.

High Valuations Increase Risk

Typically, in these periods of increased index concentration, large, highly valued companies tend to trade at elevated multiples as investor flows push stock prices beyond what business fundamentals support. The current environment is no exception as is shown in the chart below. The largest companies in the S&P 500 Index are becoming very expensive on a price-to-earnings (“P/E”) basis. While these valuations have not yet exceeded the record levels witnessed during the Tech Bubble, the gap compared to the other index constituents has clearly widened over the last few years. Why should this concern investors? Typically, higher valuations, while they don’t presage a market correction, exacerbate the downside risk and potential losses when such a correction arrives. In the case of these large market leaders, investors’ recency bias creates increasingly unrealistic growth expectations, which these companies will inevitably fail to meet.

Ironically, these valuations, while elevated, may be more appropriate when compared to similar periods from the past. Goldman Sachs estimates that average annual revenue growth over the next two years for the five largest companies in the S&P 500 will be 15% compared with only 6% for the remaining 495 companies. Further, when we examine the three-year period 2020-2022, annual revenue growth estimates are 16% vs 3%. However, current P/E ratios for these two groups are 34x and 21x, respectively, so one might argue that investors are simply paying higher prices for the higher growth rates of FAAMG and thus the elevated valuations may be partially justified.

Chart 6. Concentration and Highly Valued Companies

Forward Price/Earnings



Source: Goldman Sachs



Typically, higher valuations, while they don't presage a market correction, exacerbate the downside risk and potential losses when such a correction arrives.



Historically, when market concentration increases, it tends to unwind suddenly and powerfully. The 1998 market correction of 19% followed a period when the top five companies in the S&P 500 accounted for more than 15% of the index. In 2000, the top five stocks represented 18% of the index and the bursting of the Dot-Com Bubble saw markets drop by 41% over the ensuing three-year period.

Regulatory Risk

In some cases, a company's future prospects are not undone by the extrapolated weight of unrealistic expectations but rather by exogenous events such as increased regulation. Most free-market oriented governments will attempt to balance the positive effects of free-market enterprise with a need to protect the consumer against monopolistic powers and other corporate behaviors that restrain open competition. Today, a quick glance at the news will tell you there is genuine regulatory risk to the FAAMG cluster. The Democrats now control both houses of Congress and the Presidency. They are traditionally more welcoming of regulation and anti-trust actions than Republicans, but in the current environment both parties seem to have reason to take issue with the increasing influence of these tech giants.

Further, many of these companies were direct COVID-19 beneficiaries as shelter-in-place orders encouraged further adoption of online shopping, increased use of technology to work from home and social media as a tool for communicating with family and friends. Many people are frustrated that their old lifestyles are not possible right now, and when the vaccines are wide-spread enough to allow restaurants, malls, theatres and arenas to reopen, consumers will shift their consumption patterns to the detriment of FAAMG stocks; it's only a question of how far and how fast.

For example, Apple, which recently reported record revenue and earnings, took 30 years to achieve a valuation of \$1 trillion, hitting that level in August 2018. This period of astounding innovation included the development of the Mac, iPod, iPad, iPhone and several other devices that are sitting in our homes. Two years later, by simply upgrading existing products, the company is valued at well over \$2 trillion. Apple trades at over 30x forward earnings, yet annual growth rates for its earnings and revenues are projected to be less than 10%. On the positive side, earning-per-share growth has been seemingly better at 12%, but only because the company has used its enormous cash hoard to buy back its stock.

Investment Implications

While capital markets, particularly as represented by large capitalization-weighted indices such as the S&P 500, have developed a number of imbalances, we are not calling for a collapse in FAAMG or the U.S. stock market more broadly. History suggests that these imbalances will last far longer than people anticipate. We believe this period is no exception,

as zero interest rates and limited growth opportunities may continue to drive investors toward the allure of these well-known and growing franchises. Our goal is to highlight several capital market dynamics that are not readily apparent on the surface:

- U.S. market out-performance relative to international peers is partially an illusion driven by the performance and increasing weight of a handful of stocks in the S&P 500 Index.
- As a result, the concentration of this index in these top five holdings has now far exceeded prior periods of excess concentration, such as the Tech Bubble.
- These large tech giants are also expensively valued. Investors may take comfort as these valuations on a P/E basis have not yet approached Tech Bubble levels and may be partially justified by good earnings-per-share growth.
- Expensive stocks and markets typically don't foretell a decline but simply exacerbate losses when one inevitably arrives.

It is important to remember, though, that it is the unforeseen risks that typically prove decisive.

If investors explicitly want to own the FAAMG group of stocks in a disproportionate manner, the S&P 500 Index provides this exposure. However, investors should, at a minimum, be mindful of this concentrated exposure with the accompanying elevated valuations and increasing potential for regulatory risk.

Others may want to rebalance their recent gains from this exposure toward equal weight indices in the U.S. or to more reasonably valued international equity or emerging market equity exposures.

The statements made in this article are the opinion of Gresham Partners and were developed from market research and data. Nothing in this article is intended to nor should be implied to be intended as any offer or solicitation for the purchase of securities or investments. No representation or warranty expressed or implied is made as to the accuracy or completeness of the information contained herein. Nothing contained herein should be relied upon as a promise or representation of future performance or as being intended to be investment advice.

**Approximate AUM and client families as of 12/31/19*



Gresham Partners LLC

February 18, 2021

Copyright © 2026 Gresham Partners LLC. All rights reserved.

May not be reproduced or distributed without permission.