Too much of a good thing?

The juggernaut that is the S&P 500 has been a fantastic investment for investors over the past 10 years, especially the large cap names. How many times have we seen journalist/strategist and economist come out and publish articles citing that this outperformance is leading to a bubble that will bring forth a lost decade for equity investors.

Interestingly, this level of outperformance has a side effect on the market make-up leading to a curious phenomenon that has taken hold: concentration. By certain metrics, it has reached seemingly unprecedented levels, prompting some worries.

This concentration poses several challenges. Firstly, it reduces? diversification, the bedrock principle of investment risk management. When a handful of mega-cap companies dominate, investors find themselves with fewer options to spread their bets. The result? A market that tilts perilously toward a few giants, leaving others smaller shares in their shadow.

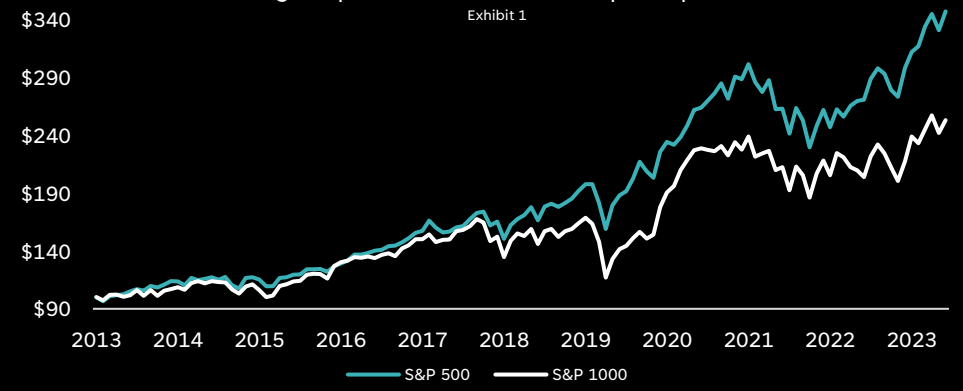
Secondly, ~~the~~ concentration fuels speculation. As these market titans surge, whispers of bubbles grow louder. Are we witnessing irrational exuberance, or is this a new normal? The answer remains elusive, but we try to take a deeper look into this phenomenon and whether investors should be worried at all.

Exhibit 1 shows the total return of the 500 largest U.S. listed companies and the next largest 1,000 companies. It is clear to the naked eye that over the past 10 years, there has been a considerable performance gap growing between these two indices. To try and answer the above question, we look at the largest stock markets in the world and the market capitalisation percentage that their top 3, 5 and 10 companies represent. The answer is quite astonishing. Exhibit 2 depicts the results. The most concentrated country by far is Switzerland with the U.S. being the 4th most diversified from this perspective, with only India, Japan and China having lower concentration in their top 10 companies as measured by the MSCI country indices.

Now of course the U.S. is by far the most important country within this arrangement of countries as the U.S. represents more than 63% of the MSCI All Country World index as at the end of May 2024. The U.S. stock market, even after a decade of increasing concentration, remains one of the more diversified markets in the developed world.

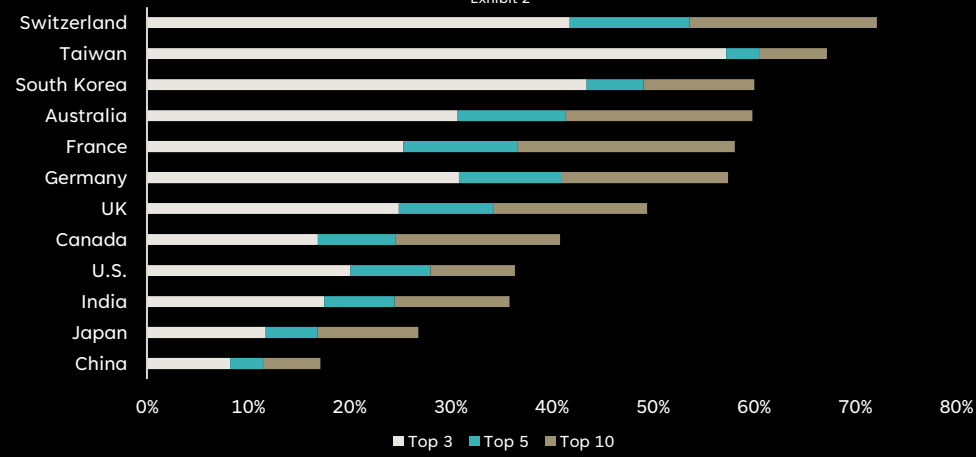
Large cap versus small & mid cap companies

Exhibit 1



Stock Market Concentration in the Largest Global Equity Markets

Exhibit 2



The country stock market concentration is from the MSCI country methodologies.

Too much of a good thing?

When pondering stock market concentration, consider the essence of value creation. Companies experience fluctuations in their prospects over time—sometimes improving, sometimes faltering. Stock prices, in turn, reflect expectations about future value. If market capitalizations align with these value prospects, concentration may be justified.

Enter economic profit—a yardstick for measuring value magnitude. It's calculated as the difference between return on invested capital (ROIC) and the weighted average cost of capital (WACC), multiplied by invested capital.

For instance, a company with an ROIC of 15% and a WACC of 10%, with $1,000 in invested capital, yields an economic profit of $50. This metric not only gauges value creation, but also accounts for the opportunity size via invested capital.

The spread between ROIC and WACC hints at the right enterprise value to invested capital multiple. Multiply this by invested capital, and voilà—an estimate of equity market capitalization emerges. There is a reasonable link between economic profit and equity market capitalization.

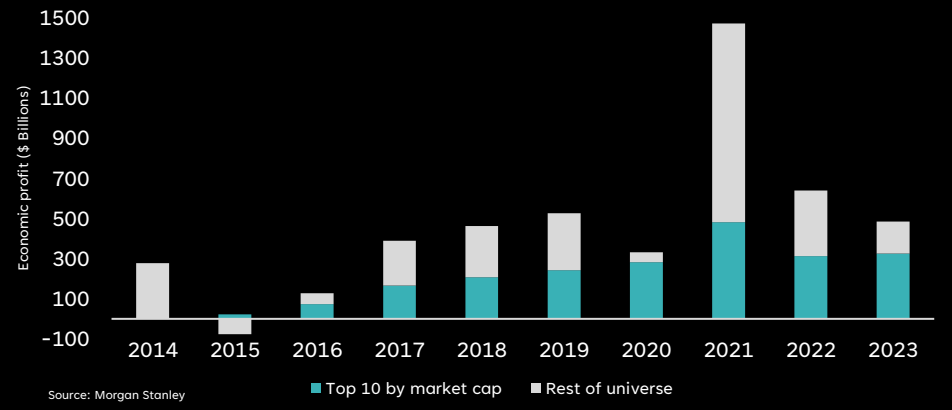
In 2023, U.S. public companies collectively generated $481 billion in economic profit. The top 10 market cap giants contributed $331 billion, representing a whopping 69% of the total economic profit that was generated. In contrast, the top 10 companies only represented 27% of the index as per the market capitalisation methodology. Behind the scenes, economic profit weaves the fabric of market concentration.

Another reason for the outperformance of the large cap names could be as simple as the disparity in fundamentals. Looking at exhibit 4, the large cap companies (represented by the Russell 1000) has a clear competitive advantage when it comes to profitability relative to the small caps (represented by the Russell 2000). Per exhibit 4, the gap between the ROIC (return on invested capital) has grown the past couple decades with the average expanding by 0.4% from the 2000's to the 2010's. Since the start of the 20's this has already expanded another 1.7%.

Over the last decade, stock market concentration has surged, meaning a small number of stocks now make up a significant portion of the overall market capitalization. This has some practical implications: Unease arises due to potential loss of diversification; overvaluation of large stocks; and the impact of index fund flows. While it's hard to quantify these concerns, historical data shows that only a few stocks consistently dominate the market and are responsible for the majority of shareholder wealth creation*. Calculations suggest that theoretical concentration was higher than actual concentration and that fundamental factors justify rising concentration, with top companies contributing significantly to profit. If history is anything to go by, it can be anticipated that shareholder wealth creation is likely to be concentrated in relatively few firms during future decades as well.

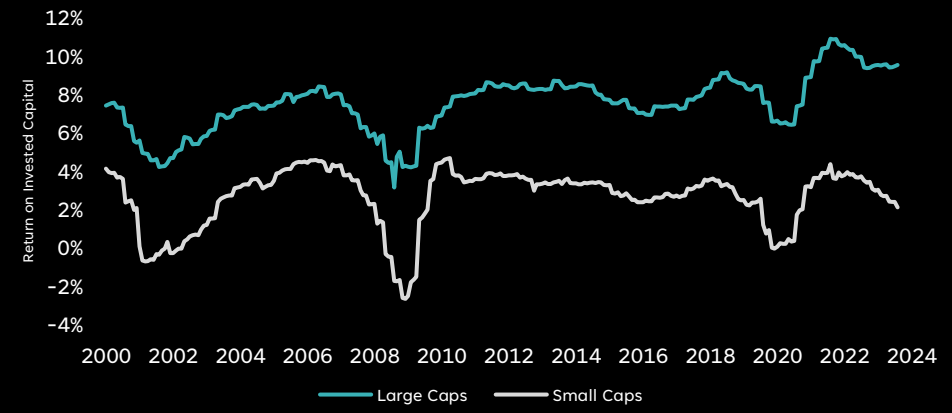
Economic Profit of Top 10 by market cap vs the rest of the universe

Exhibit 3



ROIC for Large and Small cap companies in the U.S.

Exhibit 4



Hendrik Bessembinder, "Wealth Creation in the U.S. Public Stock Markets 1926-2019,"
Large caps: Russell 1000, Small caps : Russell 2000

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