DISTILLATE CAPITAL

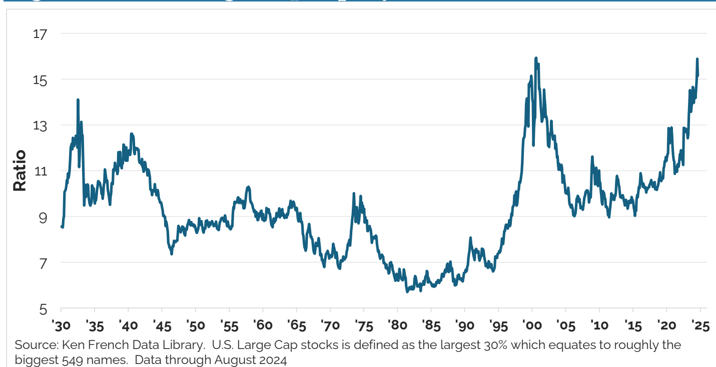
Equity Market Concentration – What Comes Next

The stock market is enormously concentrated at present. By one measure, the largest 10 stocks' share of the largest 500 U.S. stocks, at 35.8%, is at highest level in recorded history going back to 1875[1]. The figures make for catchy headlines but miss the bigger story that valuation extremes can reach well beyond the top 10 stocks, and likely have an impact on market dynamics and future relative returns more generally.

To take a deeper dive, we look back historically and segment the large cap market into three parts using the Ken French data library. The top three deciles of the U.S. equity universe currently numbers 549 stocks and roughly coincides with the S&P 500 -- the most commonly used index of large U.S. stocks. Within this group of large stocks, we can compare the average market cap of the biggest third and the smallest third to gauge concentration more thoroughly. When we create that same comparison historically in Figure 1, it confirms that the current level of concentration is nearly unprecedented going back to the Great Depression, and was only eclipsed once during that history – at the peak of the TMT bubble in early-2000. At the lowest level in the early 1980's, the biggest third of large cap stocks in aggregate were only about 6 times larger than the smallest third, versus the current situation where the largest stocks are nearly 16x the size of the smallest group.

The weighted average market cap of the largest third of U.S. large cap stocks is very high relative to that of the smallest third.

Figure 1: U.S. Large Cap Equity Concentration

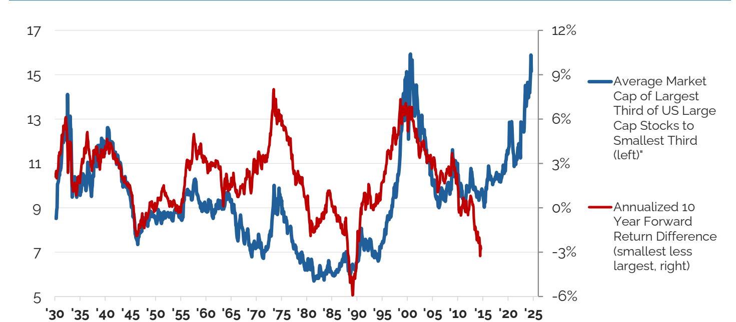


Source: Ken French Data Library. U.S. Large Cap stocks is defined as the largest 30% which equates to roughly the biggest 549 names. Data through August 2024

Using that same definition of large stocks with the same segmentation into three groups sorted by size, we can take the analysis a step further to get a sense of how returns follow. The blue line in Figure 2 is the same measure of concentration shown in Figure 1, but overlaid on top in red is a measure of forward returns that shows the annualized returns for the smallest third of large U.S. stocks versus the largest third over the subsequent 10-year periods. While the two lines do not lay on top of one another perfectly, it seems there is a clear (and intuitive) return pattern. When small stocks are priced at their highest level vs. the largest stocks, as was the case in the 1980s, subsequent relative returns are poor for the smaller subset of large U.S. stocks. But the opposite is also true with the extreme case being the peak of the TMT bubble in early 2000, where the smallest third of large cap U.S. stocks subsequently outperformed the largest third by roughly 7% annually for the next decade.

Equity concentration has been a good indicator of future outperformance among the smallest third of large cap stocks.

Figure 2: Equity Concentration & Future Relative Returns by Size

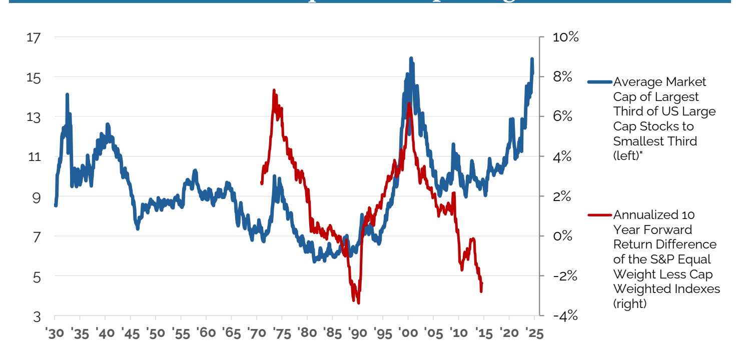


Source: Ken French Data Library. U.S. Large Cap stocks is defined as the largest 30% which equates to roughly the biggest 549 names. Data through August 2024

Another and perhaps even more intuitive way to examine the impact of concentration on future returns is by comparing large cap stock concentration to the future returns of an equal weighted S&P 500 relative to the more traditionally quoted capitalization weighted version. The only disadvantage of this analysis is that data is limited with the history beginning in 1970. Figure 3 shows the results of this comparison with the blue line illustrating the same relative market cap differences between the top and bottom thirds of the largest stocks, while the red line now compares the returns of the capitalization versus equal weighted S&P 500. The relationship between starting concentration levels and subsequent relative returns remains very tight with high concentration levels corresponding to outperformance of the cap weighted S&P 500 and the very low 10-year forward relative return of the equal weighted S&P 500 being explained by the sharp rise in concentration recently.

Concentration, as measured by the average market cap of the largest third of large U.S. stocks relative to the smallest third, has historically offered a good indicator of future outperformance of the equal weighted S&P 500.

Figure 3: Equity Concentration & Future Relative Returns for Equal vs. Cap Weighted S&P 500



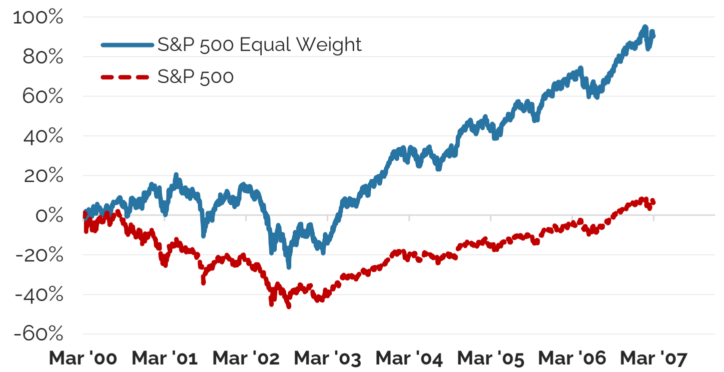
Source: Ken French Data Library. U.S. Large Cap stocks is defined as the largest 30% which equates to roughly the biggest 549 names. Data through August 2024

[1] Concentration of top 10 as a share of the S&P 500 at record: https://globalfinancialdata.com/s-p-market-concentration-hits-a-new-all-time-high

concentration was roughly the equivalent to today's situation. Following that March peak, a sharp equity correction followed as rich valuations compressed and two years later the cap weighted index was down over 40%. The equal weighted index also declined as the gravitational pull of the largest and most expensive companies weighed heavily, but it fell much more modestly. But most notably, while it took nearly seven years for the capitalization weighted index to fully recover, the equal weight index was up a rather stunning 80% over that same period. So, despite the rich overall starting valuation for the large cap U.S. stocks, and the broader market correction that followed, good opportunities were prevalent and solid returns were available in the smaller subsegment of that space.

While it took seven years for the cap weighted S&P 500 to recover from the TMT bubble, the equal weight index was up over 80% in that time.

Figure 4: Equal vs. Cap Weighted S&P 500 Post TMT Bubble



Source: FactSet

Finally, while the current concentration levels suggest that a broader sample of stocks, like the equal weighted index, may outperform the standard capitalization weighted version in the coming years, the path in unknown. And there is risk to being led to lower quality stocks if lower concentration is the sole driver of stock selection. Table 1 shows that while the equal weight S&P 500 may be less expensive, it comes with higher levels of financial leverage among a group of companies that have exhibited more operational variability than the averages.

No two market episodes are alike and we do not claim any ability to predict the future—as Yogi Berra wisely said, "it's tough to make predictions, especially about the future." What we do know is that investors get in trouble two ways. One is paying too much to avoid the fear of missing out. History and valuations suggest we are seeing that happening again now. The other relates to ignoring risks hidden in lower-priced stocks where expected future cash flows erode amid an unforeseen economic or business shift. It is the first risk that looks especially acute for the broader S&P 500, but the second that could pose a challenge to an equal weighted version.

But just as investors need not own a cap-weighted version of the S&P 500, they do not need to own the lower quality components of an equal weight S&P 500 either. We believe an active approach focused on a combination of fundamental quality and normalized free cash flow valuation may provide investors the "best of both worlds" for U.S. large cap equity exposure versus the passive strategies we have studied here.

As of 9/30/2024, the S&P 500 equal weight has a FCF yield advantage over the cap weighted S&P 500, but the cap weighted S&P 500 has lower leverage exposure and better FCF stability, making it appear to be higher quality given the mega-cap concentration.

Table 1: Quality & Valuation Stats for Large Cap Indexes

		S&P 500 ETF	S&P 500 Equal ETF	Russell 1000 Value ETF
Valuation	Free Cash to Mkt Cap	3.9%	4.7%	4.9%
	Free Cash to EV	3.5%	3.8%	4.0%
	NTM P/E	21.6	17.4	16.8
Quality	Leverage	1.1	2.0	2.1
	Cash Flow Stability	0.70	0.59	0.58

Source: FactSet, as of 9/30/24

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The investment management fee schedule for the strategies discussed are as follows: 0.39% for U.S. Fundamental Stability & Value; and 0.55% for U.S. Small/Mid Quality & Value.

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Methodology Notes for ***Portfolio Characteristics Tables (Appendix)****:* ***Free Cash Yield to Market Cap and Enterprise Value (EV)*** *are based on the next-twelve-month free cash flow estimates relative to market capitalization and EV, which adds Distillate's proprietary measure of indebtedness. Stocks without estimates in the are excluded and the remaining names are reweighted based on those exclusions.* ***P/E*** *is based on consensus estimates for next-twelve-months and excludes P/Es over 250 and under 0 to avoid the distortion from outliers.* ***Leverage*** *is based on Distillate Capital's proprietary measure of indebtedness which looks at the ratio of adjusted net debt to an adjusted measure of forecast Earnings Before Interest, Taxation, Depreciation, and Amortization (EBITDA.)* ***Fundamental stability*** *is Distillate Capital's proprietary measure of through-cycle cash flow stability with a higher value indicating greater stability.* ***Negative FCF weight*** *is measured as the weight of stocks with negative free cash estimate as a share of those with any estimate.*

The ***S&P 500 Index*** *is an index of roughly the largest 500 U.S. listed stocks maintained by Standard & Poor's. The* ***S&P 500 Equal Weight Index*** *is an index of the same stocks as the S&P 500 Index, but weights the constituents equally.*

Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs, which would reduce returns.

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