

Concentrate. Hard.

(first of three part series)

This will be the first installment of a series of short pieces, which holistically seek to frame the current state of equity markets. From there, we strive to continue to offer novel viewpoints on equities, options, and macroeconomic themes through additional research. Our core aim in adding value is through connecting the dots we see in the mosaic. Access to data, chartbooks, and superlatives are ever-present, while attempts at making sense of it all is less common. We believe starting with our view on the current lay of the land will provide guidance as to how we think as a firm and how we intend to differentiate for investors.

It is widely cited that key stock market indexes are the most concentrated they have been in history. The top 25 stocks in the S&P 500 comprise ~55% of the market capitalization of the index with the top 10 accounting for ~40% (chart 1). The largest public corporations are predominantly in the same industry with core growth prospects tied to the same AI thesis. In many cases, they are each other's largest customers and/or suppliers. These statistics are the tip of the concentration iceberg. U.S. household ownership of stocks as a percentage of total assets has reached a record high and stands at least 10-25% above peaks going back to the dotcom era (chart 2). Broken down by age, those 55+ and particularly those 70+ make up the overwhelming majority of stock owners – a record share.

It is equally, if not more important, to understand how the aforementioned concentration figures are related. Within the past several years, passive investing has overtaken active management. More than 55% of total mutual fund and ETF assets are in passive strategies with their share growing by the day. ETFs (predominantly passive AUM) have increased in popularity and index returns have been both abnormally strong and consistent over the past ~15 years making arguments against the passive approach increasingly difficult to defend. Given the dramatic and ongoing shift away from active, many managers in the space have moved closer to “closet indexing” in which they closely align their holdings with the respective benchmark out of fear of underperforming and becoming victim to the trend. This is not a knock, but rather a reality of the investment landscape.

The stock market is highly concentrated in a narrow group of companies levered to the same growth strategy. It is funded by the most aggressive equity asset allocation by the public in history, arguably by the cohort with the least ability to tolerate a substantial drawdown. Meanwhile, the bulk of existing investments and the ever increasing majority of incremental flows are agnostic to company fundamentals.

Implications

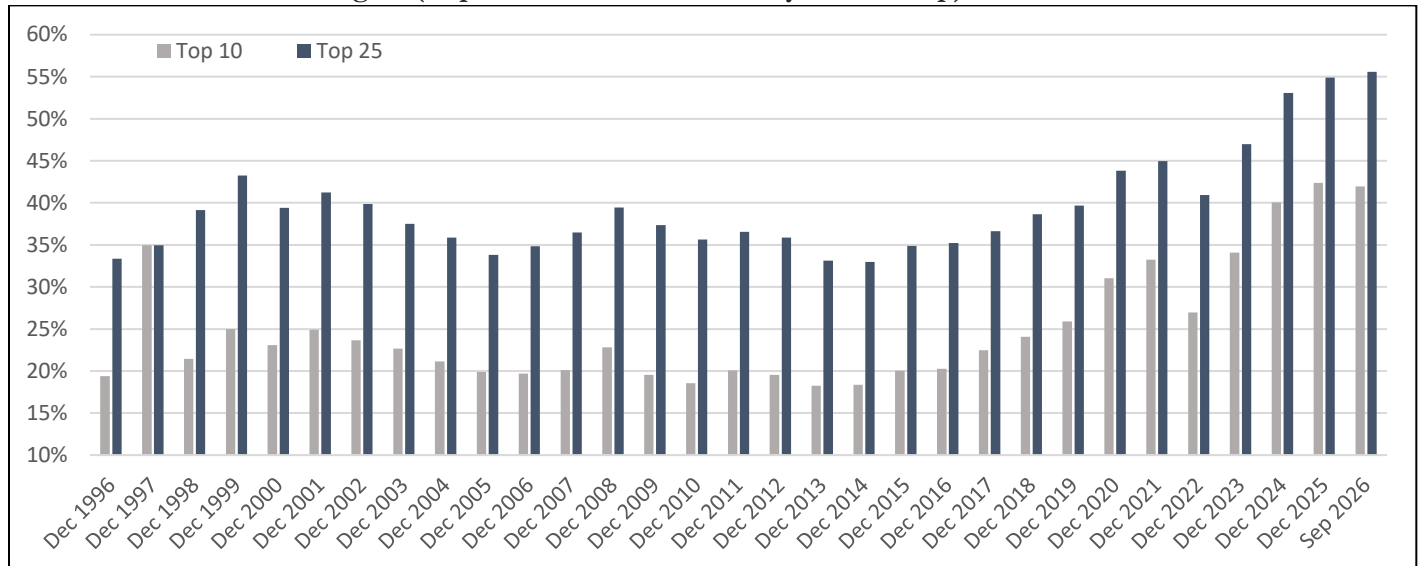
With relation to the broader economy, the state of the U.S. stock market is arguably the most systemic it has ever been. The AI trade has subsumed the broader indices and the associated capital expenditure is a material contributor to headline GDP figures. Domestic and foreign investor allocations to U.S. equities are at or near all-time highs.

What does this mean for risk taking?

In our view, the market could continue its upward climb as long as liquidity is ample and credit metrics stay in check. With the dominance of passive flows, it is difficult for a meaningful drawdown at the index level to arise regardless of valuations or idiosyncratic shocks to single stocks. Passive flows in retirement accounts are sticky. Fiscal and monetary support has been at the ready at each sign of trouble since the financial crisis training more active investors to buy even modest dips. The concentrated, systemic framework simultaneously reduces the probability of moderate drawdowns beyond a few percent, while dramatically amplifying the potential for a severe drawdown. Absent a “v-shaped” type recovery in prices as we saw in the past two years, a sustained correction in equity markets may enlist passive selling. By definition, it will be equally indiscriminate on the way out as it was on the way in bringing the concentration risk to the forefront.

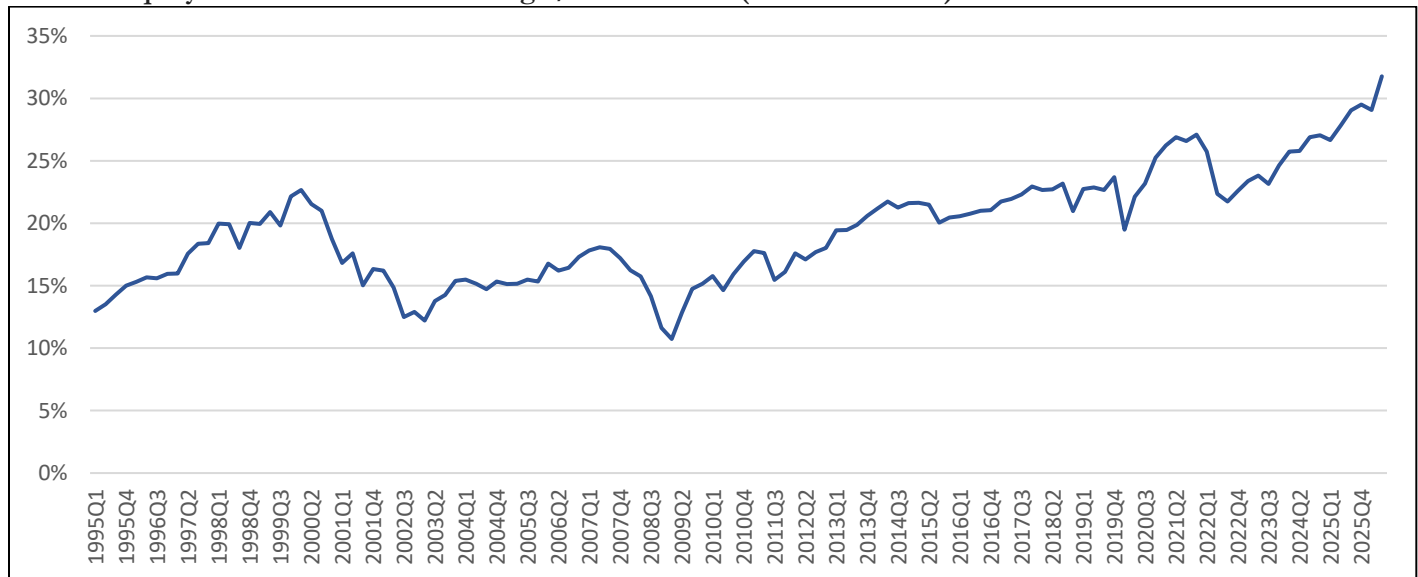
A Few Charts:

Chart 1: S&P 500 Index Weights (Top 10 and 25 Constituents by Market Cap)



Source: Bloomberg, Core Alternative Capital Research

Chart 2: Equity and Mutual Fund Holdings / Total Assets (US Households)



Source: Federal Reserve, Core Alternative Capital Research

The views expressed herein are presented for informational purposes only and are not intended as a recommendation to invest in any particular asset class or security or as a promise of future performance. The information, opinions, and views contained herein are current only as of the date hereof and are subject to change at any time without prior notice.