The Impact of Concentration on U.S. Equity Investing

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As a handful of tech stocks have come to dominate the S&P 500 and, more importantly, the Russell 1000 Growth Index, active U.S. growth equity managers operating under the Investment Company Act of 1940 are facing serious challenges with real-world implications for investors.

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By now, most investors are familiar with the moniker "Magnificent Seven," which refers to a collection of large, primarily tech-oriented companies whose stock prices have seen a meteoric rise over the last 18-24 months. Through September 30, 2024, Apple, Microsoft, NVIDIA, Tesla, Alphabet (Google), Amazon, and Meta (Facebook and Instagram) are collectively up almost 300% since the beginning of 2023. As their share prices have exploded, their overall size and representation within the U.S. stock market also has grown dramatically.

As of the end of September 2024, these seven stocks accounted for almost one-third of the S&P 500 Index and over half of the Russell 1000 Growth Index. The current level of concentration in U.S. equity markets is unprecedented and has real-world implications on how U.S. equity managers, specifically large-cap growth managers, can and should build portfolios and manage risk.

Nobel laureate Harry Markowitz famously asserted that diversification, or the idea of owning a broader range of stocks or other assets, is the only "free lunch" in investing. He claimed that over time, diversified portfolios will achieve superior risk-adjusted returns. Diversification is such a central concept in the world of investing that it has been codified in a number of legal and regulatory constructs, such as the Uniform Prudent Investor Act and the Investment Company Act of 1940 (aka "The 40 Act") which regulates mutual funds.

For a 40 Act fund to market itself as a "diversified company," the Act states that individual holdings of 5% of total fund assets or greater cannot exceed 25% of the fund's assets in aggregate at the time of purchase. In other words, **if the total of a fund's positions that carry 5% or greater individual weights exceeds 25%, the fund manager can no longer purchase more of those positions** until it comes back into compliance with the rule. Based on these guidelines, the Russell 1000 Growth is not a diversified index, and if the current trend continues, the S&P 500 could also be at risk of no longer being considered diversified. It's likely that the original authors of the regulation couldn't have imagined an environment like the one we find ourselves in today.

Undoubtedly, the massive earnings potential of the artificial intelligence (AI) boom has been the primary driver behind these stocks' impressive gains over such a short period of time. NVIDIA's stock, for example, has gained over 700% since the beginning of 2023. While many investors have benefited from the rapid rise in share prices, portfolio managers in certain areas of the market are quite constrained in their ability to actively manage their funds.

Consider the Russell 1000 Growth Index. As of September 30, 2024, the weights of the top 10 holdings within the index are below:

1. **Apple Inc. 12.27%**
2. **Microsoft Corporation 11.60%**
3. **NVIDIA Corporation 10.30%**
4. **Amazon.com Inc. 6.27%**
5. **Meta Platforms Inc. 4.55%**
6. **Alphabet Inc. 3.53%**
7. **Alphabet Inc. 2.98%**
8. **Broadcom Inc. 2.84%**
9. **Tesla Inc. 2.63%**
10. **Eli Lilly and Company 2.57%**

Clearly, the index itself is not even close to being considered diversified. The top 10 stocks account for almost 60%, with the four stocks with a 5% or more weighting totaling a shocking **40.44%** of the index. For a portfolio manager of an active U.S. large-cap growth fund managed to this benchmark, this creates a very challenging situation.

Let's assume a "diversified" fund manager holds all of these stocks in the same weight as the index. In this example, the Diversified Fund Rule effectively prohibits that fund manager from buying any additional shares in Apple, Microsoft, NVIDIA, and Amazon until their aggregate weight is below 25%, or about a 40% decrease in their current weight in the index. **Effectively, the only option a fund manager has with respect to these stocks is to sell.** But what incentive does the fund manager have to sell? How does the manager determine which stocks to sell? Should the manager sell portions of all the concentrated positions, or just the least-favorite? If they sell, they know they can't buy back the stock if it were to drop in price.

Virtually every active fund investor manages a portfolio relative to a benchmark index. Active managers judge performance and justify higher fund fees based upon their ability to outperform the benchmark. Any deviation of portfolio positions vs. the benchmark represents an active decision that introduces risk to fund performance. If the fund breaches the position limits outlined in The 40 Act while its benchmark remains highly concentrated, a portfolio manager may struggle with a potentially paralyzing decision: 1) Sell some portion of concentrated positions to fall back below the 25% level, or 2) Maintain concentrated holdings in the portfolio. Option 1 is an active decision that the sold stock will not continue to outperform the benchmark index. Option 2 is an implicit bet on the status quo – that concentrated stocks will continue to outperform.

These are huge risks for the fund manager relative to their benchmark, and **the risks will ultimately be felt by investors in active funds.** If 40% (or more) of the portfolio can't really be actively managed, investors should consider the value in paying full active management fees for a portfolio that can only be half-actively managed due to constraints. Investors would do well to stay informed of these issues and to consider the pros and cons of the new dynamic of concentration within actively managed equity funds.

In response to this unique market dynamic, the Securities and Exchange Commission issued a No Action Relief for index-based funds in 2019. Effectively, this exempts index funds from the diversification parameters and allows them "to continue to invest in accordance with their investment objective and strategy" without any shareholder approval required. **Unfortunately, for active managers, they are now playing with a different set of rules than the indices they are trying to outperform.**

We believe this dynamic has created an environment where investors in this particular area of the market need to reconsider their priorities. In order to provide true diversification, a fund manager has to be willing to materially deviate from the fund's benchmark, but this risks significant underperformance if the biggest stocks continue to lead the market. **It seems as though diversification is no longer a free lunch.**

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