Portfolio Perspectives

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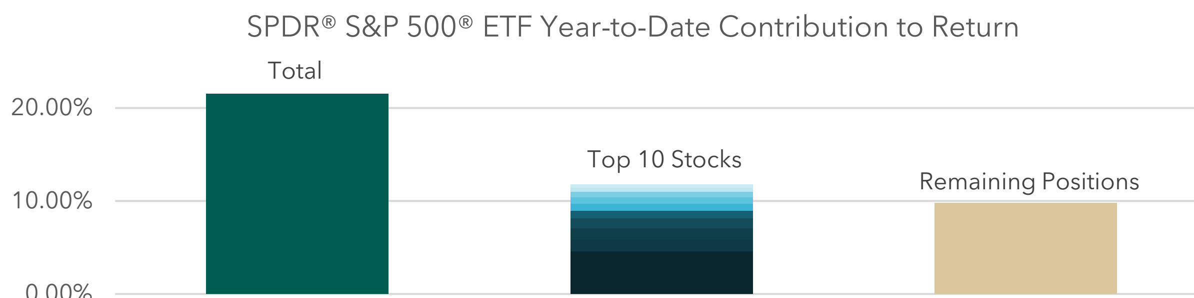
Exploring the Risks of Top-Heavy Markets

Concentration has become a defining feature of today's financial markets, with just a handful of companies surging in both value and influence, propelling the market to all-time highs. While recent performance in these indices has been very strong at the headline level, it may be important to evaluate associated risks which go beyond simple weightings within indices, including concentrated revenue streams, operational overlap, and reliance on similar secular trends.

Index Concentration

According to a study by J.P. Morgan Research (jpmorgan.com), current levels of concentration in the S&P 500® Index are at its highest levels in over 50 years. As of the end of September 2024, the 10 largest companies in the SPDR® S&P 500® ETF represented close to 35% of the total fund and accounted for over half (11.8%) of the 2024 year-to-date performance of the fund (21.5%). Nvidia alone contributed 4.6% to the fund's year-to-date returns as the stock rallied a blistering 142%. We also see concentration at the sector level. For instance, within the Consumer Staples sector, the top 5 companies have contributed over 87% of the sector's year-to-date returns and they represented over half of the sector's total weighting as of the end of September. The current degree of concentration highlights just how reliant entire indices can be on the fortunes of relatively few companies.



Source: Bloomberg , as of September 30, 2024

Platform Risk

Companies in the "Magnificent 7" such as Apple, Amazon, Microsoft, Alphabet, and Meta, have significant overlap via each of their platform ecosystems. This commonality can prove risky as such large portions of their businesses are reliant on one another. For instance, in 2022 Apple made an update to its iOS software, limiting companies' ability to track user activity. As a result, the privacy policy change was estimated by many to reduce Meta revenues by up to $10 billion as it was anticipated a majority of iPhone users would not opt for Meta to be able to track their activity, dramatically affecting their ability to use targeted advertisements.

In addition, some of the largest companies' revenue streams and operational functions are highly dependent on their market peers. For example, an estimated 40% of Nvidia's current revenue comes from four companies (Amazon, Meta , Microsoft, and Alphabet.) This narrow revenue stream could prove risky as competition strengthens, hyperscalers pull back in Artificial Intelligence (AI) spending, or proprietary custom chips rival the performance and costs of Nvidia's GPUs.

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Secular Trends

Adding to the complex web of risks associated with market concentration is the relation each of the largest companies have to secular trends in the market. These trends characterize markets and industries over lengthy periods of time, rewarding the best innovators and strongest competitors, while punishing those that miss out. For example, AI has been significantly influencing markets since late 2022, when Open AI unveiled the impressive AI chatbot, ChatGPT. Since then, mega-cap technology companies have poured billions of dollars into AI, engaging in fierce competition with one another in an attempt to come out as a winner in this hot new trend. With such large investments into AI, risks loom with any changes to expectations, timelines, and regulatory scrutiny surrounding AI, and can have profound impacts on companies and thus markets as a whole.

Regulatory Concerns

Another downstream risk of market concentration is heightened regulatory scrutiny. Anti-Trust laws aim to foster competition by limiting the power and influence individual companies can have within the marketplace. When regulators key in on concentrated markets, risks to investors increase as intensified scrutiny often leads to lengthy investigations, hefty fines, and can potentially change a company's business structure or model. These potential actions can increase stock volatility as uncertainty mounts surrounding a company's revenue streams, business practices, and potential growth. The current concentrated market is no different, as evidenced by Nvidia's recent anti-trust probe with the government suspecting the chipmaker of limiting customer's ability to do business with other chip makers and potentially employing price favoritism to customers who exclusively use their AI chips. This caused significant volatility in the stock and as a result entire indices given Nvidia's weighting in many indices.

Time to Circle Back?

As active managers, we vigorously vet these risks with the intent to maximize risk awareness for our clients and strategically position portfolios for attractive long-term returns. While concentration is not a new concept and has recently driven markets to all-time highs, we believe it is critical to fully appreciate the underlying risks in this environment, especially as they relate to client risk tolerances and portfolio construction. We also believe further interest rate cuts should relieve some market concentration pressures and bode well for broader equity performance as sectors and companies hit particularly hard by higher rates begin to recover.

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