Trends & Ideas

PRIVATE CLIENT SOLUTIONS

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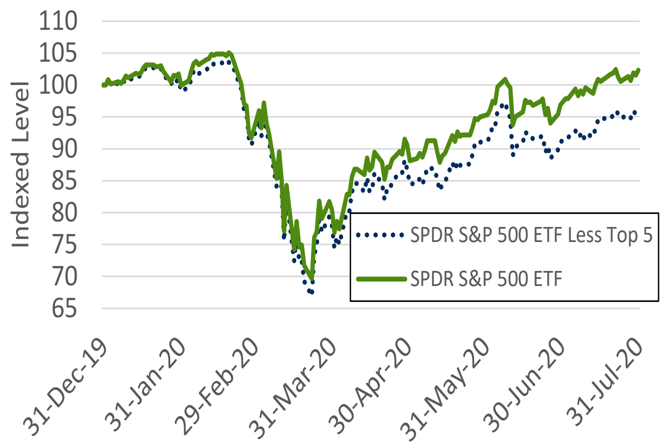
Market Concentration

Markets have strongly rebounded off their March lows, recovering from the hit they took as a result of the economic lockdown in response to the coronavirus pandemic. While the market, in this case represented by the SPDR S&P 500 ETF (SPY-US), is in the positive, up 2.3% as at July 31, many have raised concern that the index has been driven higher only by a handful of technology names. In fact, looking at SPY's performance without the top five members, the market is actually down 4.7% year-to-date (YTD), showcasing that the main contributors to return have largely been a select few companies. A market being driven by only a few stocks demonstrates lack of breadth, or broad market participation. Canadians who invested during the early 2000s may recall when Nortel represented 35% of the S&P/TSX and therefore was responsible for a significant percentage of the daily changes in the index. A market being driven by one or two stocks heavily reduces the diversification benefits an investor receives from holding a broad-based index product.

Top Five = Strong Contributors to Performance



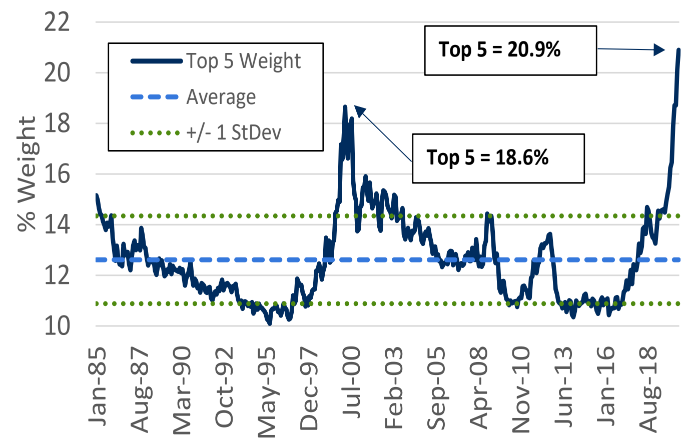
Source: FactSet, Raymond James Ltd.

Today, in the US market, the top culprits include tech behemoths such as **Facebook (FB-US)**, **Amazon.com (AMZN-US)**, **Apple (AAPL-US)**, **Microsoft (MSFT-US)**, **Alphabet (GOOGL-US)**, also known as FAAMG. As at last month's end, the collective weight of the top five hit 20.9%, well above the 35-year average of 12.6%; and skyrocketing past levels not seen since the dot-com bubble when the top five index members comprised 18.6% as at March 2000. Collectively, FAAMG have returned 41.8% YTD as at July 31. In normal market times, we prefer to see broad market participation where many issues are contributing to the overall market return. Since these are not normal times, in this publication, we will attempt to understand the potential implications of a concentrated market, and whether today's top five deserve the returns they've been experiencing.

In Comparison

First, let's begin with the latter. At the height of the dot-com bubble, the top five SPY members included **Microsoft (MSFT-US)**, **General Electric (GE-US)**, **Cisco Systems (CSCO-US)**, **Intel (INTC-US)** and **Walmart (WMT-US)**. Three of these names were within the tech sector and the remaining two in industrials and consumer staples. Given the strong presence by big tech within today's top five, some are quick to attribute today's robust returns to speculative flows as had been seen two decades ago.

Market Concentration at All-time Highs



Source: FactSet, Raymond James Ltd.

However, in stacking up today's top five against their dot-com counterparts, we find that today's names are actually in better shape across many metrics:

EPS growth. Today's historical growth eclipses that from the top members of the 2000s as well as the rest of the index.

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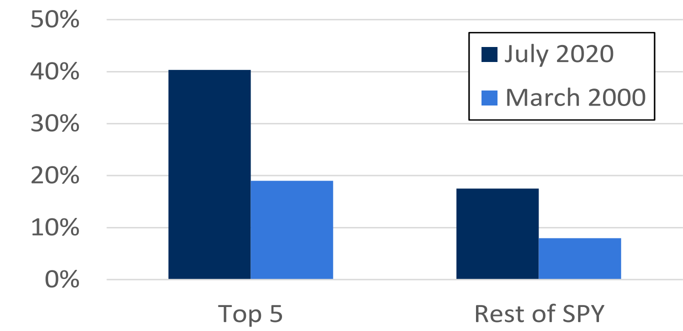
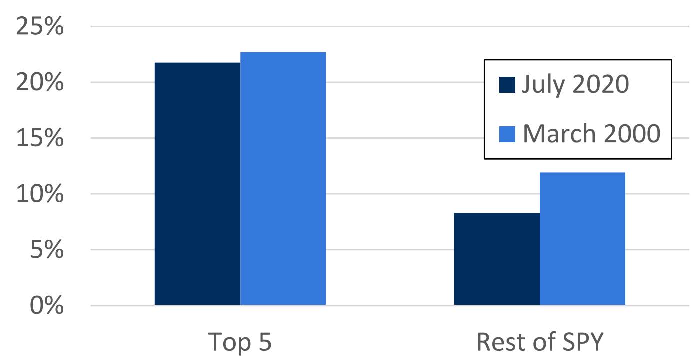
Average Historical 3-yr EPS Growth in Better Shape



Source: FactSet, Raymond James Ltd.

Sales growth. Average historical sales growth of FAAMG is almost 1,347 bps greater than the remaining members of the index, making them more attractive than their counterparts on a relative basis.

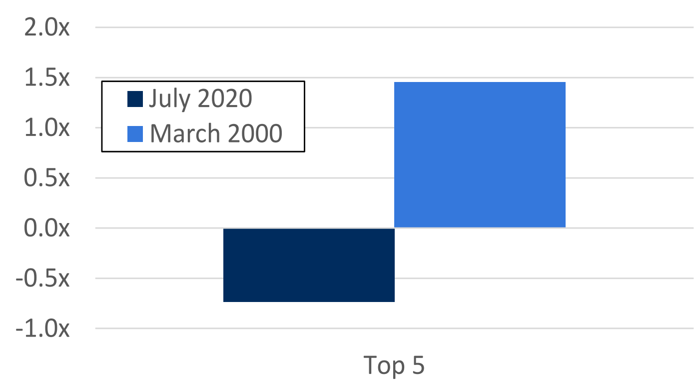
Average Historical 3-year Sales Growth > Rest



Source: FactSet, Raymond James Ltd.

Balance sheets. Average leverage today is drastically better with today's top five in a net cash position.

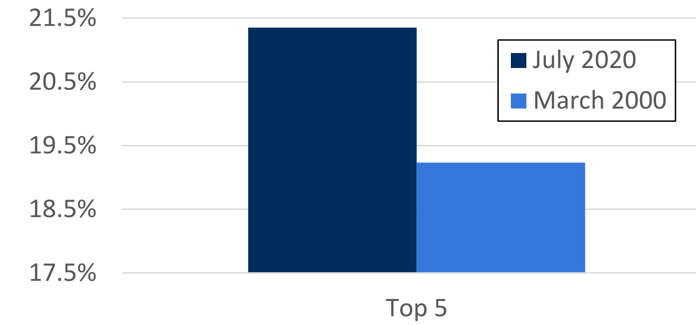
Average Net Debt/EBITDA = Net Cash Position



Source: FactSet, Raymond James Ltd. Not enough data for Rest of SPY.

Margins. Net margins for today's top five also happen to be healthier, meaning they contribute more to the bottom line than their counterparts did 20 years ago.

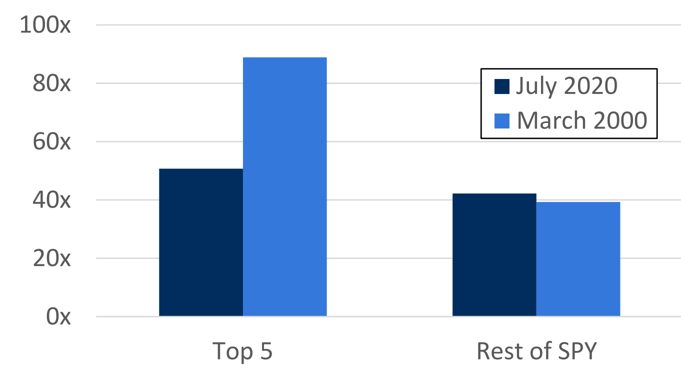
Superior Net Margins



Source: FactSet, Raymond James Ltd. Not enough data for Rest of SPY.

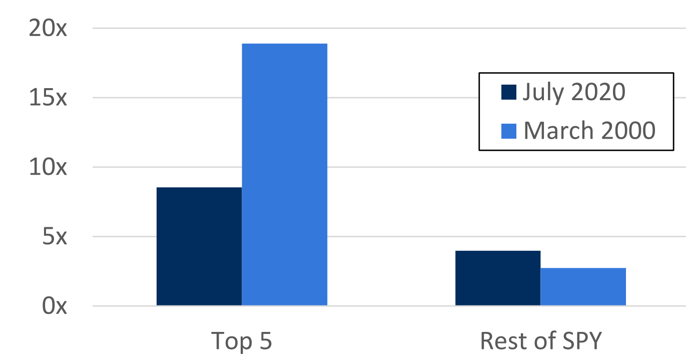
Valuation. While by no means are the top five "cheap" on an absolute basis, valuation levels today look more favourable, especially when considering historical top and bottom line growth, margins and balance sheets. It's worth noting that the average multiples shown below are a simple average across the members of the market and are not market-weighted. As an example, while SPY is actually trading at a forward PE of 22x, the simple average forward PE across its members as at July 31 was 59x.

Average Price/Earnings more Attractive Today



Source: FactSet, Raymond James Ltd.

Average Price/Sales also more Attractive



Source: FactSet, Raymond James Ltd.

Big Tech Deserving of Returns

Premium for quality. In past publications, we have discussed our preference for quality companies. As showcased above, we see that the top five have not only demonstrated that they are in good shape, but have displayed key characteristics of quality companies, including having wide moats, solid balance sheets and improving fundamentals. Valuations, while at a premium to the overall market, reflect investors' preference for quality. Big tech also offers superior growth prospects, which is an attractive attribute in an environment where growth is scarce.

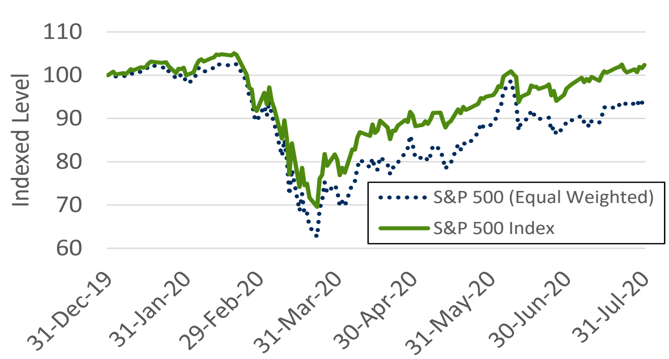
Sector rotation. The pandemic caused investors to rotate out of sectors that were more prone to uncertainty brought on by the pandemic, such as airlines and energy, and into the "safety" of companies that had better earnings visibility and growth prospects. The largest beneficiary here was the tech sector, which has been the best performing sector YTD.

Tech adoption. Structural changes that were expected to happen over multiple years began taking place in months. As we wrote in our June 2020 Insights & Strategies titled *Post-COVID Themes*, COVID-19 accelerated the adoption of technologies across sectors and industries and furthered trends from robotics and automation to ecommerce.

Implications for Mr. Market

Weak breadth. Market breadth indicates the number of stocks that are participating in a broader market move of an index. While there are many market breadth indicators such as advance-decline or new highs-lows, a market is also considered to have weak breadth when it is performing well, but only due to participation from a few names (as we are seeing today). Such weakness can lead to greater idiosyncratic risks for the broader market, particularly attributed to the technology sector in today's case. Looking at the performance of the equal-weighted S&P 500, which is down 6.4% as at July 31, we can further see the lack of participation across a broad set of companies.

Equal-weighted S&P 500 Shows Weak Breadth



Source: FactSet, Raymond James Ltd.

Interconnectedness of FAAMG. Not only do the big tech companies represent a large chunk of the S&P 500, but they have also become more correlated with each other. According to our data provider, pairwise correlation (correlation on how each stock moves with one another) is up from a low of 0.2 in 2013 to 0.78 as at April of 2020 (a correlation between 0 and 1 indicates they move in the same direction with a value of 1 meaning a strong linear relationship, or perfect positive correlation). With this, a negative event with one company may have similar effects across the top five, leading to weakness in the broader market.

Conclusion

Today's top five companies by market capitalization have proven to be healthier and more deserving of their premiums compared to their dot-com era counterparts as they have not only strongly benefitted from today's environment, but have also been a safe haven for investors looking for quality growth. While there are many reasons to be bullish or bearish on the market today, market breadth and concentration are only some of the many indicators investors must be aware of.

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