INVESTMENT NOTE

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THE INCREASING CONCENTRATION OF THE US EQUITY MARKET

EXECUTIVE SUMMARY

The stock market outperformance of a narrow group of large US companies – the so-called Magnificent-7 – has highlighted the concentration[1] in the US equity market. This has become a topic of significant interest. Here we explore the implications of this concentration, its historical context, and the potential future trajectory of market concentration. We conclude that although concentration in the US market is now as high as during the 1960s, remarkably, the valuations of the largest stocks in the US market do not appear much higher than those of the rest of the universe. This is because the increase in their net income has kept pace with the rise in market capitalisations. It is thus difficult for us to see how the concentration levels should decline from here without a trigger that could significantly compromise the ability of these large-cap companies to earn yet higher net income. Could reports of a newly developed, much faster and cheaper-to-train artificial intelligence model set off a correction?

BACKGROUND

The US equity market has seen a notable increase in concentration since 2014, particularly in major indices such as the broad S&P 500 or the tech-heavy NASDAQ. This trend has been driven largely by the exceptional performance of a handful of large-cap stocks commonly referred to as the Mag-7: they are Apple, Meta, Tesla, Microsoft, Nvidia, Amazon, and Alphabet. Here we analyse the current state of market concentration, its historical evolution, and the potential for future changes.

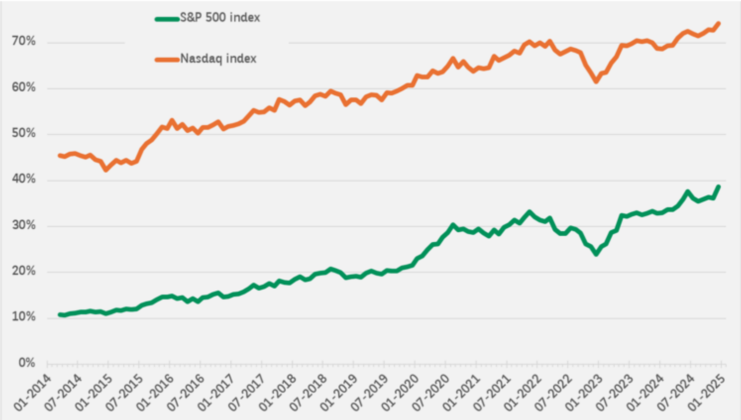
WHY IS THIS IMPORTANT

The high concentration in the US equity market has made it challenging for managers to construct high-conviction portfolios without underweighting the largest-cap stocks relative to benchmarks to fund investment ideas. And even if they were positive about these large stocks, overinvesting in them was often not possible because of diversification rules. As a result, these large stocks have been dominating the contributions to excess returns, complicating efforts to outperform benchmarks.

[1] Market concentration: a small number of firms account for a large percentage of the total market capitalisation. A high concentration reduces diversification benefits, making portfolios vulnerable to sector-specific downturns or company-specific issues

Exhibit 1

Percentage float[1] of the Magnificent-7 stocks in the US S&P 500 and NASDAQ indices over time



For illustration purposes only. Past performance is not indicative of future performance. Source: BNP Paribas Asset Management, Bloomberg, S&P Global, NASDAQ; 16 January 2025

PERFORMANCE OF THE MAG-7

In 2023 and 2024, the Mag-7 companies significantly outperformed the broader market, with an aggregate net return of 155% over the two-year period. Returns in 2024 were smaller than in 2023 but still much higher than those of the S&P 500 or the Nasdaq index.

In contrast, in the same two-year period, the S&P 500 and NASDAQ excluding the Mag-7 gained only 23.7% and 0.6%, respectively. The share of the Mag-7 in the NASDAQ has increased from 45.4% in December 2014 to 74.2% currently, and their share in the S&P 500 has risen from 10.8% in early 2014 to 38.6% recently.

Exhibit 2

Historical performance, volatility and Sharpe ratio of the S&P 500, NASDAQ and Mag-7 stocks over selected periods

	S&P 500	NASDAQ	MAG-7	S&P 500 excluding MAG-7	NASDAQ excluding MAG-7	APPLE	META	TESLA	MICROSOFT	NVIDIA	AMAZON	ALPHABET
IPO date						12-Dec-80	18-May-12	29-Jun-10	13-Mar-86	22-Jan-99	15-May-97	19-Aug-04
Net returns (full period)												
2023	26%	55%	74%	9%	22%	49%	194%	102%	58%	239%	81%	58%
2024	25%	26%	47%	13%	-17%	31%	66%	63%	13%	171%	44%	36%
2023 + 2024	58%	95%	155%	24%	1%	95%	388%	228%	79%	820%	161%	115%
Sharpe ratio												
2023 + 2024	1.6	2.2	3.0	0.5	-0.1	1.7	3.7	1.7	1.5	4.7	2.3	1.8
May-12* to Dec-22	0.9	1.0	1.0	0.6	0.4	0.9	0.6	1.2	1.2	1.4	0.9	0.9
Volatility (annualised)												
2023 + 2024	13%	16%	18%	14%	20%	21%	32%	61%	20%	45%	25%	24%
May-12* to Dec-22	14%	17%	22%	15%	17%	28%	38%	65%	21%	42%	30%	23%

* Meta IPO

Based on monthly net returns in USD calculated on 16 January 2025. For illustration purposes only. Past performance is not indicative of future performance. Source: BNP Paribas Asset Management, Bloomberg, S&P Global, NASDAQ

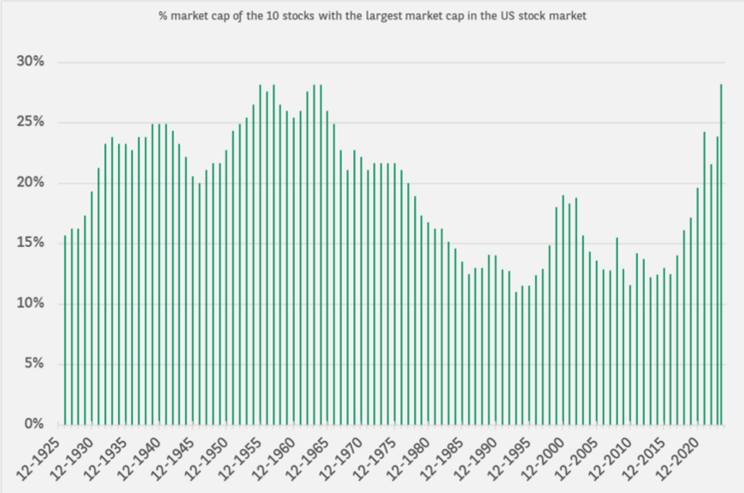
HISTORICAL CONTEXT

Historically, the concentration of the top-10 largest cap stocks on the US market has fluctuated. Going back 100 years, we realise that the current level of concentration of the US stock market is at an all-time high, higher than it was during the dot-com bubble of the late 1990s, and as high as during the 1960s. That period was dominated by the 'Nifty Fifty' stocks, an informal designation for a group of roughly fifty large-cap stocks on the New York Stock Exchange.

One difference between now and the 1960s is the smaller diversification in terms of drivers of concentration. Today's group of leaders is dominated by seven companies active in tech and artificial intelligence.

Exhibit 3

Percentage share of market cap of the largest 10 stocks in the US market, rebalanced annually



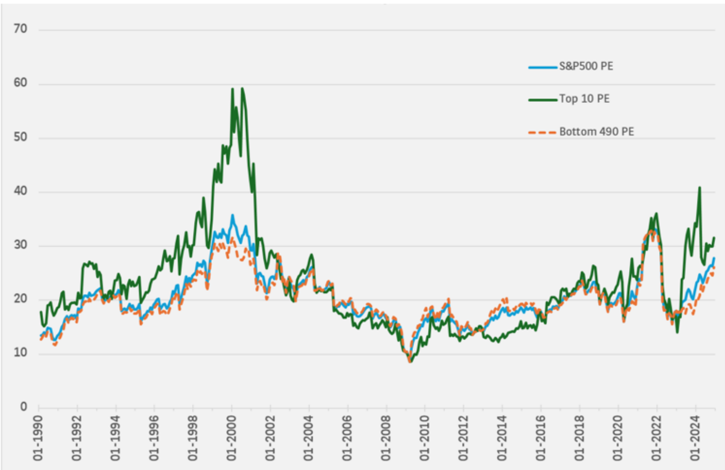
Calculated on 16 January 2025. For illustration purposes only. Source: BNP Paribas Asset Management, FactSet, World Bank, Global Financial Data, Morningstar.

VALUATIONS

The net income of the top 10 largest cap stocks has generally kept pace with their market cap growth. However, there have been periods when their valuations became high relative to the rest of the market, such as in 2000 and 2020. Currently, the valuations of the top 10, while not cheap in absolute terms, are comparable to those of the other 490 stocks in the S&P 500 index. And while current valuations of the top 10 may not look cheap by historical standards, they are clearly not as high as in 2000.

Exhibit 4

Price to earnings calculated as the sum of market cap divided by the sum of net income



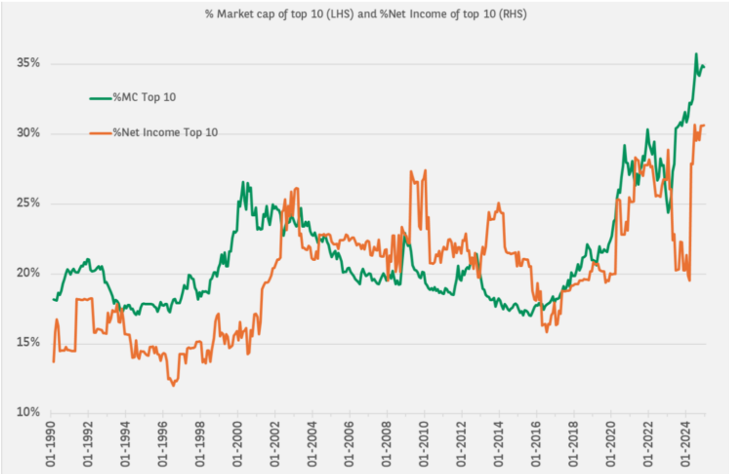
Net income was set to zero whenever it was negative for a given company. This smooths the price-to-earnings in some periods such as in May-02 for the Bottom 490 when net income of Lucent Technologies Ltd., Nortel Networks Corp and JDS Uniphase Corp was negative, and in Jun 2008 when a few stocks had negative income, in particular AIG and Citigroup. It also impacts the PE of the top 10 stocks in periods like March 2023 to March 2024 when net income of Berkshire Hathaway and Amazon was negative. Calculated on 16 January 2025. Based on monthly market cap and net income in USD. For illustration purposes only. Source: BNP Paribas Asset Management, FactSet, S&P Global, Worldscope

As seen in exhibit 4 above, valuations of the top 10 did become high relative to the remaining 490 stocks in 2000, but not in 2008. All valuations rose in 2020 due to the fall in net incomes. Valuations of the top 10 were high in March 2023 through March 2024 due to the fall in net income of Berkshire Hathaway and Amazon, but have corrected now after the most recent release of net income figures for these companies.

As seen below, the percentage share of market cap of the top-10 stocks in the S&P 500 has been somewhat correlated with their percentage share of net income.

Exhibit 5

Comparison of percentage share of market cap of the 10 largest market cap stocks in the S&P 500 index with the percentage share of net income of the same stocks

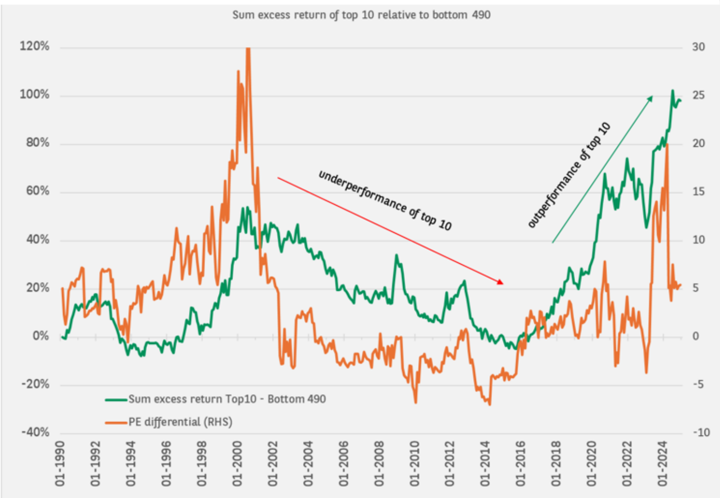


Net income was set to zero whenever it was negative for a given company. Calculated on 16 January 2025. The drop in the percentage of net income from March 2023 to March 2024 is explained by the drop in net income of Berkshire Hathaway and Amazon. Based on monthly market cap and net income in USD. For illustration purposes only. Source: BNP Paribas Asset Management, FactSet, S&P Global, Worldscope

As shown below, in the formation of the dotcom bubble in the late 1990s, the top 10 stocks in the S&P 500 became increasingly more expensive relative to the remaining 490, which was accompanied by an outperformance of the top-10 stocks. From 2000, the top-10 stocks underperformed until about 2015, reducing their relative valuations. This time, the outperformance of the top 10 stocks was not accompanied by an expansion in their valuations relative to the remaining 490 stocks, except for the period March 2022 through March 2023 when net income of Berkshire Hathaway and Amazon was negative. In the meantime, valuations of the remaining 490 stocks caught up with those of the top 10.

Exhibit 6

Excess returns of the 10 largest market cap stocks relative to the remaining 490 stocks in the S&P 500 index



Summed over time and plotted against the differential of respective PE ratios. Net income was set to zero whenever it was negative for a given company. Calculated on 16 January 2025. Based on monthly net returns in USD. For illustration purposes only. Past performance is not indicative of future performance. Source: BNP Paribas Asset Management, FactSet, S&P Global, Worldscope

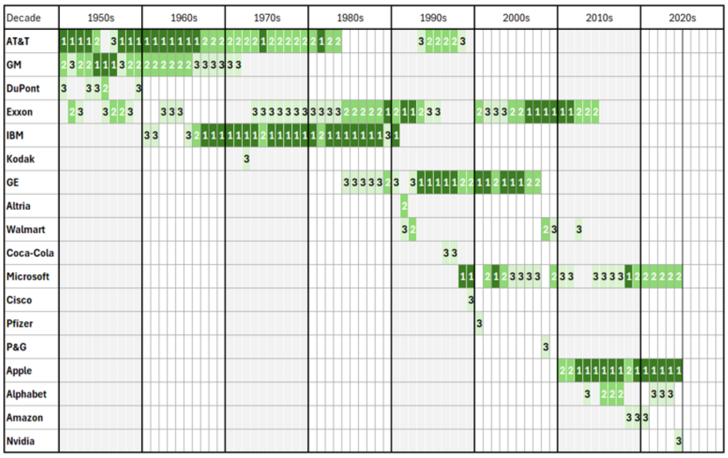
ROTATION AT THE TOP

Historically, the three largest US companies by market cap have rotated over time but can remain dominant for many years. Thus, AT&T was in the top three for 33 years between 1960 and 1983 and then again for six years between 1983 and 1998. Exxon was in the top three since 1960 for a total of 47 years and IBM for a total of 28 years.

In the meantime, looking at the recent market cap leaders, Microsoft has been in the top three since 1998 for 23 years, while Apple has been in the top three for 15 years and Alphabet for only 7 years. The current largest caps have been leading for a shorter period than some of the previous market leaders.

Exhibit 7

Top-3 US stocks ranked by year-end market capitalisation



Company names have changed throughout time. GM = General Motors, P&G = Procter & Gamble, Exxon = ExxonMobil, IBM = International Business Machines, GE = General Electric, Altria was previously known as Philip Morris. Calculated on 16 January 2025. For illustration purposes only. Source: BNP Paribas Asset Management, Morgan Stanley

CONCLUSION

Mainly driven by the recent outperformance of the Mag-7 stocks, the current market concentration levels are at their highest in the last 100 years, matching those seen in the Nifty Fifty era and well ahead of those of the dotcom bubble. Although somewhat high in absolute terms, valuations of the 10 largest stocks by market cap in the S&P 500 are not much higher than for the remaining index components as net income growth has kept pace with the growth in market cap. We note that, historically, the largest companies have remained at the top for many years, even decades. However, the current largest caps have not held their leading positions as long as some of their predecessors.

Investors holding exchange-traded funds (ETFs) that replicate market capitalisation-weighted indices such as the S&P 500 or MSCI USA have benefited from the growth of large-cap stocks in recent years. These investors may now face risks as the likelihood that these large companies maintain their exceptional net income growth becomes increasingly smaller. Triggers that raise questions about the outlook for their net income are likely to create market volatility. This could end up bringing down index concentration.

To protect against overexposure to these large companies, investors may now consider buying an actively managed fund and delegating the timing of reducing the weight in large caps to the fund manager or ensuring portfolio diversification. An alternative could be to invest in an equally weighted ETF. That would decrease the exposure to very large stocks and increase the exposure to smaller companies in the S&P 500.

DISCLAIMER