Perspectives

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What Does Elevated Index Concentration Mean for Active U.S. Equity Managers?

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Indexing has risen in popularity over the last decade, particularly for U.S. equity investors. The fees are lower and indexing is perceived as less risky, with investors primarily seeking beta exposure to the market. However, these indices have evolved against an ever-changing economic and financial market backdrop. As a result, several unintended structural issues have emerged, particularly related to concentration risk. Understanding this evolution and how it could alter the overall exposures within a broader portfolio is critical, as these indices are not static. Notably, the composition of some indices alongside the increase in passive capital has created headwinds for active managers and helps to explain recent performance challenges.

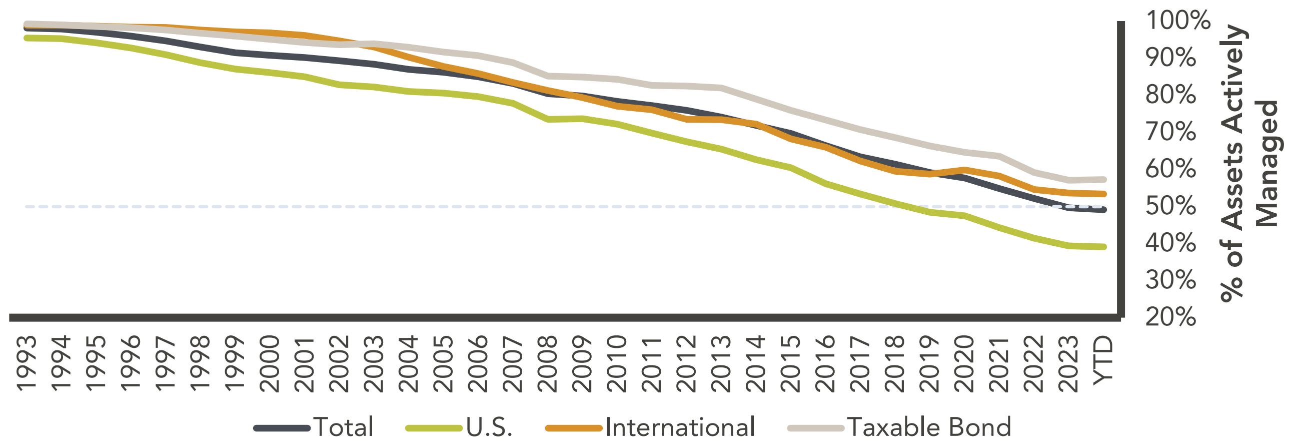
THE PROGRESSION OF PASSIVE MANAGEMENT

Since the early 1990s, the percentage of assets held in actively managed strategies fell from over 98% to under 50% by the end of 2023. Unsurprisingly, this move is most pronounced across U.S. equities. The downward trend has been driven by a variety of factors, including lack of consistent outperformance as well as growing sensitivity to fees on behalf of investors. This shift was exacerbated by significant outflows from actively managed strategies in 2022, as shown in Exhibit 2 on the following page. 2022 was marred by a historic rise in interest rates that ignited market turmoil, as the S&P 500 and the MSCI ACWI ex-U.S. plunged over 18% and 16%, respectively. Amid market downturns, investors typically expect their active managers to better protect capital but this proved challenging in 2022, which further softened sentiment towards active management. Looking ahead, the overall shift towards indexing U.S. equity exposures is expected to continue.

At a high level, the movement towards passive U.S. equity exposure makes sense from a fee and risk control perspective — tracking error is eliminated and return expectations are consistent with overall market performance. However, the

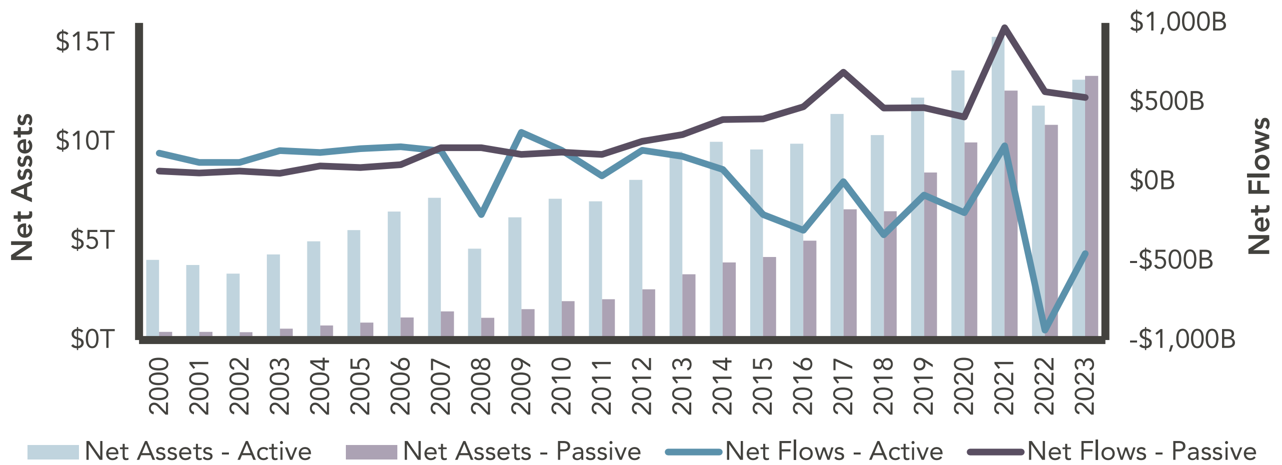
evolution of indices – particularly from an index concentration perspective — has created newfound risks that investors must understand.

Exhibit 1: Historical allocation to actively managed strategies



Source: Morningstar as of June 30, 2024

Exhibit 2: Assets and flows for active and passive strategies

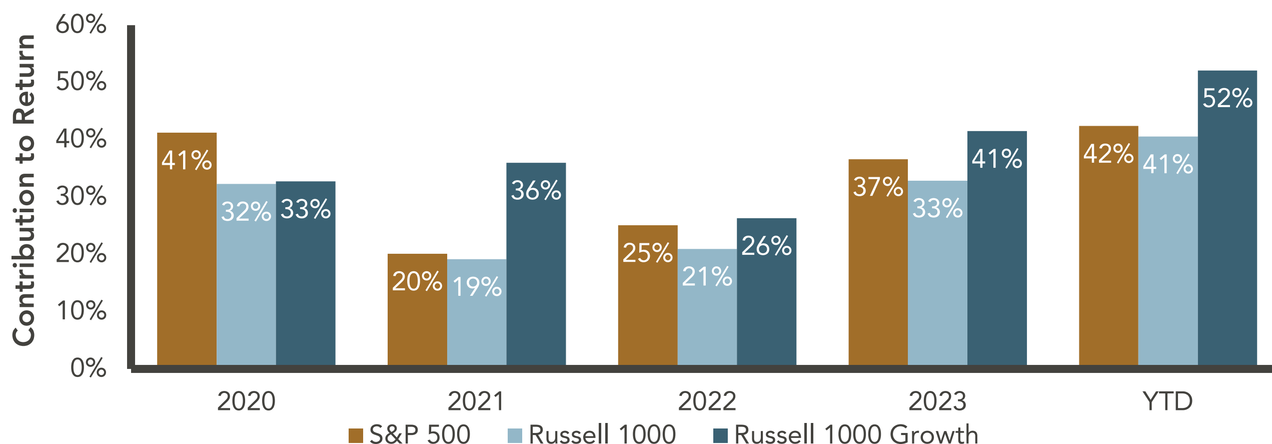


Source: Morningstar as of June 30, 2024

INDEX CONCENTRATION TAKES OFF

Coming off a tough year for active managers in 2022, markets grew increasingly more concentrated, reaching extreme concentration levels in 2023. As a result, the composition of the indices emerged as a hot button topic, with the rise in concentration of U.S. large-cap indices a prevalent storyline. Entering 2024, investors saw intermittent signs of growing market breadth, a potential tailwind for active managers. The narrative from 2023, however, looks poised to repeat itself, as the largest technology companies continue to propel the market higher in 2024. Amid the artificial intelligence frenzy that emerged in early 2023, a market long dominated by two technology companies — Microsoft and Apple — has witnessed the rise of a third player, NVIDIA. Through June 30, these three companies have contributed over 42% to the S&P 500 return in 2024. This effect is more pronounced in the growth indices, as these companies contributed over 52% to the Russell 1000 Growth return during the first half of the year.

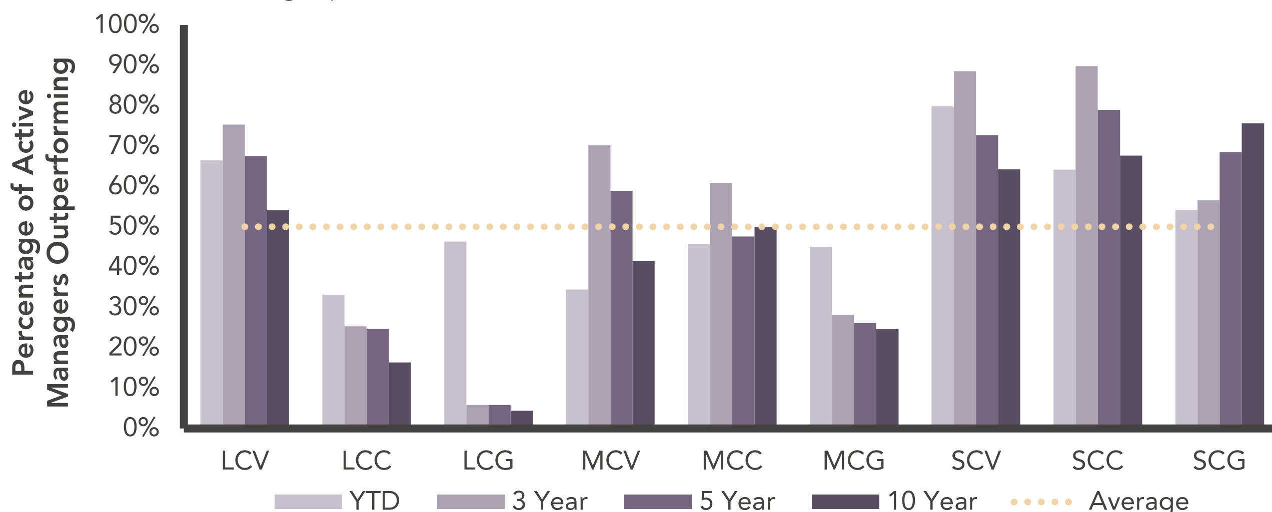
Exhibit 3: Contribution to return from Apple, Microsoft, and NVIDIA



Source: FactSet as of June 30, 2024. SPY, IWB, and IWF utilized as ETF proxies for the S&P 500, Russell 1000, and Russell 1000 Growth Indices, respectively.

Consequently, markets are increasingly narrow and index strategies are thus exposed to greater concentration risk, with some indices only offering the appearance of diversification. The Russell 1000, which historically has benefitted from a mid-cap effect as it offers exposure to a broader range of companies, has seen its performance driven by a similar number of companies as the S&P 500, with the top three companies contributing 41% to the return of the index in 2024. Portfolio construction guidelines restrict active managers from matching the exposures of the largest constituents in select indices, especially U.S. large-cap growth indices that are dominated by these technology heavyweights. As these indices continue to violate diversification guidelines — including a limit on the cumulative weight of stocks with at least a 5% weight — active managers may face further headwinds as market breadth struggles to assert itself. Notably, as shown in Exhibit 4, U.S. large-cap growth managers reflect the greatest struggles over multiple trailing time periods.

Exhibit 4: Active manager performance



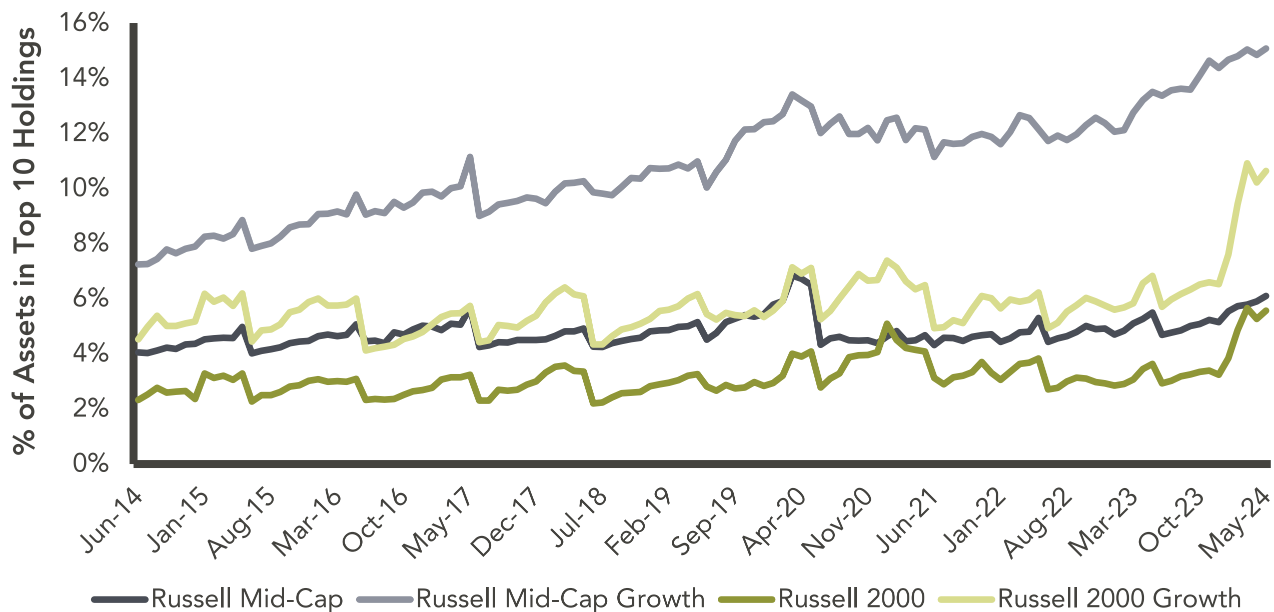
Source: Morningstar as of June 30, 2024

Although large-cap equities dominate the headlines, similar trends present further down the market capitalization spectrum. Historically, the Russell Mid-Cap Growth Index has not frequently held multiple

positions greater than a 1% weight. As of July 1, more than 20 holdings carry a weight of at least 1% and the percent of assets held in the top 10 positions exceeds 15%, an all-time high *(Exhibit 5)*.

Furthermore, greater index concentration has impacted the underlying valuation of the index, with knock-on effects for active managers. As a matter of background, the Russell indices rebalance on June 30 each year, and at the rebalance following the onset of COVID-19 in 2020, Russell dropped the number of holdings by over 70 companies. While this clearly increased the concentration, it also pushed the valuation multiple of the index — as measured by price to earnings — higher. Hypergrowth companies that trade at lofty valuations became more prominent in the index. This progression has further challenged active managers because many of them adhere to a valuation discipline and focus on profitability which tends to underweight — or avoid altogether — the most expensive companies in an index. Following the reconstitution in June 2024, the number of holdings fell to under 300 companies[1] and only 28% of active managers outperformed over the trailing three-year period.

Exhibit 5: Percentage of assets held in the top 10% for small- and mid-cap indices



Source: FactSet as of June 30, 2024. IWR, IWP, IWM, and IWO utilized as ETF proxies for the Russell Mid-Cap, Russell Mid-Cap Growth, Russell 2000, and Russell 2000 Growth Indices, respectively.

Small-cap stocks have seen an even faster spike in index concentration, with the Russell 2000 radically narrowing over the last 12 months. This phenomenon follows the strength of the two largest constituents in the index at the time, Super Micro Computer and MicroStrategy. Not unlike the mid- and large-cap growth indices, the Russell 2000 achieved historic levels of concentration, breaching 10% of assets in the top 10 positions as of March 2024. Similar to U.S. large-cap equities, technology-related companies have driven this trend in small- and mid-cap equities. Unlike the Russell Mid Cap Growth Index, however, the Russell 2000 reflects the reconstitution, as shown in Exhibit 5. Although the percentage of assets in the top 10 holdings may increase throughout the year, at the reconstitution these companies graduate out of the index, better aligning the overall composition with historical levels.

[1] The Russell Mid Cap Growth Index held 401 companies at the end of 2022.

While index concentration emerged as a potential risk across the market capitalization spectrum, small-cap equities have encountered additional headwinds. As the makeup of the Russell indices evolved, the percentage of unprofitable stocks reached historic levels in 2021, which explains the quality erosion in the Russell 2000. This trend can be attributed to multiple factors, but the low interest rate environment that encouraged companies to enter the public markets earlier in their business life cycle may be the most logical explanation. Albeit the number of unprofitable companies has declined since then, it still hovers near 40% of the index. Not surprisingly, concerns around small caps' higher debt burdens have contributed to their underperformance versus large-cap stocks.

Although the asset class has struggled on a relative basis, this environment has actually been a tailwind for active managers, who focus on high quality companies with less reliance on capital markets to fund growth opportunities. Consequently, small-cap active managers across the style spectrum have posted a more attractive record of outperformance, as 90% of small-cap core active managers outperformed in the trailing three-year period, with an average excess return of almost 4%.

Exhibit 6: Small-cap active manager performance

Source: Morningstar as of June 30, 2024

CONCLUSION

Index providers make active decisions on how to construct indices, so when considering a passive equity allocation, the composition of the underlying index cannot be ignored. Although these indices are rebalanced periodically as markets evolve, index exposures may deviate from style expectations prior to the next rebalance, which can have unintended consequences on portfolio allocations. 2023 presented several unique dynamics across the market capitalization spectrum that challenged active managers and shed light on the potential risks of index construction. Following the Russell reconstitution last month, some of these dynamics are likely to persist, especially among growth equities. As the economic backdrop continues to evolve, understanding how these indices are constructed may highlight potential opportunities for active managers to outperform, including those instances when index construction poses unaddressed risks, such as overconcentration and deteriorating quality. A passive approach may still win favor as an effective, low-cost alternative across more efficient asset classes but can also present challenges that are worth monitoring.

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