Goldman Sachs Exchanges: The Markets

Why the Nasdaq 100's rebalancing matters for investors

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John Detrixhe: A handful of tech companies have powered US stock market returns this year. As market cap shifts, the NASDAQ 100 index will undertake an unusual rebalancing this week, which raises the question: What will that mean for equity prices for these companies? This is The Markets.

Hi, I'm John Detrixhe, filling in for Sam Grobart. Today, I'm joined by David Kostin, chief US equity strategist at Goldman Sachs Research. David, welcome to the show.

David Kostin: Thank for you inviting me.

John Detrixhe: Let's start off with the NASDAQ 100 rebalancing. On July 24, the index will undergo a special rebalance, which is meant to curb the high concentration in the index of a handful of tech stocks. Can you give us some background on this rebalancing?

David Kostin: You are correct. On Monday morning, July 24th, the NASDAQ 100 index, widely followed as a measure of growth stocks, is going to be rebalanced. So the largest seven stocks in the market today are comprised at the start of this month about 56% of the NASDAQ 100 index, 56%, which is an extraordinary level of concentration that seven companies comprise such a heavy weight in the index. And as a result, they are rebalancing the index to reduce the weight of those largest stocks. And so those seven largest stocks will now be around 44% of the index. Still a very significant part of the index but less than 50%.

John Detrixhe: Which companies are going to be most impacted by this?

David Kostin: So you can look at it two different ways, John. The first is: Which companies will have their weightings diminished? NVIDIA will go from seven and a half to four and a half, approximately. Microsoft will go from 13 to 10%. Those are two prominent examples with the largest dimension in their weighting in the index.

And so on the other hand, what are some of the other securities which will increase their weightings? And you'll see, for example, within technology, Adobe, Cisco, Intel, Qualcomm. These are tech companies that will be increasing their weight in part to supplant the diminished weight of some of the largest companies as that rebalances the index.

John Detrixhe: And what's the purpose of this? Why is the NASDAQ 100 doing this for a second time?

David Kostin: Well, the reason is that some companies have been growing their sales so rapidly, in some cases also having a PE multiple expansion. And they've become larger and larger components of an index. And there's so much passive dollars that are invested to track the indexes that, at some point, they become unbalanced. And while on the one hand, this is a function of the market. On the other hand, if you're investing in an index in a passive way, to have some reflection of the broader indication of what's happening economically, there's some desire to have them re-weighted.

The S&P 500, probably the most widely watched index here in the United States, also has some high degree of concentration. And if we look at the seven largest stocks in the S&P 500, they are about 25-30% weighting right now, which is extremely high relative to history. Really is something that we didn't experience until the tech bubble in 2000. So very high level of concentration that still exists in the S&P 500 right now.

NASDAQ is even more concentrated because it is just 100 stocks, and they are primarily growth-oriented stocks.

John Detrixhe: And the NASDAQ 100 index is an index of non-financial companies. How is this going to shake up the sectors within that index?

David Kostin: So the sectors themselves won't actually see much of a change. The technology sector will continue to be roughly 50% of the index capitalization once the rebalancing takes place on Monday. The other large sector will be communication services. And while companies like Google -- Alphabet's the parent company -- or META will see their weightings diminished, you'll see other companies within the communication services area increase their weighting. Netflix and Comcast, for example, would be increasing their weightings in the index.

So there'll be some intra-sector changes but not at the sector level. It won't be so dramatic.

John Detrixhe: Just to summarize, based on what you've seen historically, do you think the rebalance will impact the prices of these high-flying tech companies in the index?

David Kostin: I don't necessarily believe that it will have an impact on the prices of the index, but it will have is a significant impact on the way portfolio managers are measured versus the benchmark. The reason I emphasize this is right now only about 20-30% of mutual funds are beating their benchmarks. And one of the reasons for this is that these largest stocks comprise such a significant part of the index, and most fund managers, in an attempt to actually run a diversified portfolio, do not have an index weight in these largest positions.

And so if the largest positions really outperform as they have this year, then it basically destines most of the mutual funds to lag their benchmark. And so I think it will make it, in some ways, an index that is more reflective of the way portfolio managers approach managing money and, arguably, make it slightly easier to beat the benchmark. It's always difficult but perhaps slightly easier in an environment where these stocks have had a reduction in their weightings.

John Detrixhe: If the rebalance doesn't necessarily influence the prices of these individual stocks, what do you think will be influencing the prices of these individual stocks going forward?

David Kostin: So from a fundamental perspective, it's generally growth, valuation, and some of the macroeconomic dynamics. So at the present time, the expectation of many market participants is there's likely to be a recession in the next 12 months. That is decidedly not the view of Goldman Sachs economics. And as a result, in a growth -- extended growth environment, the idea of revenue growth, sales growth, and valuation have these companies is likely to be a key driver of their performance.

To the extent that their sales continue to be stellar -- and again, one of the reasons these large stocks have become larger over time is because their sales are growing so much more rapidly than the rest of the market -- to the extent that those sales are generated and delivered, their valuations are likely to stay at a premium to the market. And they're likely to continue to do well and, in many cases, outperform the broader benchmark. They're just starting now from a reset lower weight in that index.

John Detrixhe: And when it comes to this market breadth question of a relatively small number of stocks driving a lot of the index returns this year, do other stocks catch up to the high fliers eventually? Or do these high fliers sink? Or what is the outcome do you think?

David Kostin: Well, the experience of what has happened is that the high fliers, if you will, can maintain their market leadership and position, provided they deliver on the expected results that investors and research analysts are anticipating. And so to the extent that these companies continue to generate their really, really strong sales growth and, you know, continue to consolidate their market positions, these stocks can maintain a high level of valuation.

The seven stocks that we've been talking about, the largest companies in the market, currently trade around 32 times forward earnings. The overall market is around 19 times, and so, if you exclude those leading stocks, the median stock or the rest of the companies in the index are around 17 times. And even though they have been reduced in weighting, they're still likely to be a really, really significant contributor to performance going forward.

John Detrixhe: Quarterly earnings are coming out now. From what you've seen so far this week, are you getting a sense that the valuations are justified by the results?

David Kostin: So it's very early in the earnings season. Many companies have actually been beating expectations for the second quarter results. And to put that in some context, the expectation coming into the quarter was that year-over-year earnings-per-share growth would be down 9%. And to put that in some perspective, last quarter it was expected to be down 7%, and the results came in -2%. So better than was feared.

And so this quarter, thus far, people are expecting, again, -9% earnings growth year over year. The very early reporters so far have actually had a pretty good result. Now, that's been skewed towards certain sectors, and the number one peak week of earnings season will be next week between July 24th and July 28th when roughly 50% of the US equity market in terms of market capitalization, those companies will report.

And what we'll be focusing on in particular is corporate margins, and corporate margins have been decelerating and declining for the last four quarters. And we'll continue to see if that downward trajectory is arrested or accelerating. So that's a big area of focus. All eyes are on earnings season next week.

John Detrixhe: David, thanks so much for joining us.

David Kostin: Thank you very much.

John Detrixhe: That's it for another episode of The Markets. Be sure to subscribe to our feed on Apple Podcasts, Spotify, or wherever you get your podcasts. I'm John Detrixhe. Thanks for listening.