Are the largest US stocks too dominant?
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Allison Nathan: A handful of tech stocks have driven the eyepopping performance of the US stock market in recent months. So just how concentrated is this performance? And should investors be worried?

Ben Snider: "Extreme" is the word I've been using. By some measures, actually, you could argue this is the most concentrated market we've seen in almost 100 years since the 1930s.

Allison Nathan: I'm Allison Nathan, and this is Goldman Sachs Exchanges.

For today's episode, I'm sitting down with Ben Snider, a senior strategist on the US portfolio strategy team in
Goldman Sachs Research, and Peter Callahan, who covers the US technology, media, and telecommunications markets business. We'll be talking about the investor and broader implications of high equity market concentration. Ben, Peter, welcome back to the program.

**Ben Snider:** Good to be here.

**Peter Callahan:** Thank you.

**Allison Nathan:** So let’s kick off. The US stock market has performed exceptionally well, I think much better than anyone expected, especially heading into 2024. US indices are hitting record highs. But this is really thanks to the performance of a handful of stocks, these mega cap stocks that we hear so much about, the Magnificent Seven. Ben, just give us some context first on just how concentrated this performance has been.

**Ben Snider:** There’s really two things going on. First is the concentration of the market. So, for example, if you look at the top 10 stocks in the S&P 500, they currently account for about a third of the market cap. That is exceptional relative to history. And then on top of that,
those stocks tend to be performing very well. They're outperforming everything else, so performance is also very concentrated.

So just to give you a sense, year to date, the S&P is up about 10%, more or less. And the top ten stocks have accounted for over 50% of that. So that's 2% of stocks and more than 50% of the returns.

**Allison Nathan:** So just to emphasize, this is very unusual relative to history?

**Ben Snider:** "Extreme" is the word I've been using. You can look at other periods that investors think about when they think of very high concentration. The first that comes to mind for a lot of investors in the tech bubble in the late '90s and 2000. Concentration today is higher than it was back then. Another period people look at is in the early 1970s, the Nifty Fifty Period it's called. Likewise, concentration today is higher than it was back then. And by some measures, actually you could argue this is the most concentrated market we've seen in almost 100 years since the 1930s.
**Allison Nathan:** What measures, by the way, are you looking at when you assess that?

**Ben Snider:** You can look at the top five stocks, the top seven stocks, the top 10 stocks. To go back a century, what I'm looking at is the market cap of the largest stock in the market compared to the 75th percentile in the market. And that ratio today is very, very extreme relative to history.

**Allison Nathan:** So as you said, the market is highly concentrated, but these mega cap stocks are also driving all of this performance because they're doing so well. Ben, what's driving the stellar performance of the Mag Seven? There's so much talk about bubbles these days. Is this just investor enthusiasm? Or do fundamentals support the price action?

**Ben Snider:** Yeah, the word "bubble" means different things to different people. The way a lot of investors use it in conversations that I'm having is price application that is unanchored from fundamentals. And what's really interesting today is that has not been the case at all. These stocks have been outperforming, they've been getting
larger, they've been becoming a larger share of the equity market, but this is happening because their earnings are also outperforming the rest of the market.

There are times in the past, for example, like the late '90s and 2000 where that wasn't the case, but today, even though prices are rising quickly, they're moving hand in hand with earnings.

**Allison Nathan:** These companies are very profitable, but at this point, given how much they've run up, just a quick question on valuation because is valuation getting to a point where you might be concerned that they're stretched, even relative to that strong profit performance?

**Ben Snider:** Well, valuations are another way to gauge whether something is a bubble or not. And of course these stocks are trading at higher multiples than the average stock in the S&P. Think about the top ten companies trading generally about 25 times PE, that's price-to-earnings ratio, compared to about 18 or 19 times for the rest of the market. Certainly higher, but if you look back at a time like 2000, that gap was much, much wider, about twice as large as it is today. Even if you look in the
middle of last year, the valuations of the top stocks were higher than they are today, and that's because, even though their prices are rising, their earnings are rising more quickly and so their valuations have actually been declining.

Allison Nathan: That is actually something I did not know. Very striking. Peter, let me bring you into the conversation. You sit on the trading desk. Are there any signs of a bubble that you're seeing from your seat?

Peter Callahan: This has certainly been the topic du jour among investors lately. And to Ben's comment earlier, I think a lot of this ends up being driven by stock price, where investors say, "Those are up a lot, so that must be a bubble." And again, to comment to you earlier, the fundamentals are largely supportive of the outperformance of the largest stocks, or the Magnificent Seven. Let's use that term.

Are there pockets of euphoria? Yeah, I do think there are pockets of excitement in this market. I think one way to look at that might be the use of options and other sort of levered strategies to capture upside risk in single stocks
and at an index level. And so I think that might be one gauge of excitement that you've started to see come back into the market, both locally around the AI theme specifically and in tech broadly. But this has also become a tool for investors over the last year and a half, and so it's new and it's accelerated quite a fair bit year to date, largely concentrated in technology and AI-linked stocks.

**Allison Nathan:** And so you're seeing more of this options-driven activity today, maybe driving some of this performance. Ultimately, is that new? Or did we see those types of characteristics in past periods of high concentration?

**Peter Callahan:** Sure. No two cycles or periods are, of course, the same. Although maybe price performance could rhyme. Or you could get any chart to look like one in the past depending on what time frame you want to look at, so there's a lot of that comparison going on. But I do think the excitement might be similar to other levels; i.e., obviously the buildout of the Internet in the dotcom era. Use of options I think is a newer phenomenon. Part of that's driven by shorter day to call options, zero day expiry, that type of activity, which, frankly, was a toolset that
didn't really exist to the same degree back in, you know, let's use 2000 as a comparison.

But when I think broadly about tech, this cycle, again, we do want to come back to that point that the fundamental story has been very strong. The buy back story remains a real story for these stocks. They're highly profitable. And while there is some excitement, I think AI is the thing that's maybe fueled the fire lately and really opened up investors' imaginations about what could go right over the next couple of years. It doesn't quite to me, in my seat every day, looking at what we see in the screens, feel quite like 2000.

One thing that we have seen lately has been a little more appetite from investors to try to capture that right-tail risk in the market. So think about a lot of upside and upper momentum in stock prices that is often being captured on the backside of either exciting AI announcements or big earnings revisions. And the number of names that are up more than 20% this year, for example, really stands out and has captured people's imaginations. So that's definitely been a feature of this market. There's been more willingness to try to seek those out and lean into those.
**Allison Nathan:** All that said, when we think about the Mag Seven performance, it actually has been somewhat choppier of late, if I'm not mistaken. So what's really driving that? And what do you make of that choppiness?

**Peter Callahan:** You're right, Allison. I think an underused word this year has been "dispersion" because, while there is high concentration, there's also been an uptick in dispersion. That's been generally well received by the market, active managers in particular, that's a good outcome where you can find dispersion, whether it's alpha in idio-single stock selection. And I think part of this is, one, the starting place and then, two, the fundamentals story.

Coming off calendar '23, the Big Six all outperformed the S&P 500 last year. That was only one other team in the last ten years that happened. So last year, it was an everything up story. And if you weren't in the Big Six or Seven, it was actually hard to find performance anywhere. This year, it's a little bit different. While those big stocks are continuing to push higher and other stocks are struggling to keep up, you are starting to see dispersion. I
think the number one driver of that has frankly been earnings. META, Amazon, and Nvidia have had the biggest earnings revisions of the Mag Seven over the last three months. And those three stocks have outperformed the remaining names in the Mag Seven this year.

**Allison Nathan:** Interesting. And Peter, do you expect this outperformance of these mega cap tech stocks to continue? We've just come off of tech companies' recent earnings season. What were your key takeaways?

**Peter Callahan:** Yeah, I think the story remains good from an earnings perspective. The Mag Seven grew earnings about 15% in Q4, December quarter. If you looked forward expectations in the market, these seven stocks are expected to grow revenue double digits over the next couple of years. And so the forecasts remain upbeat for the Magnificent Seven.

One of the things the market remains very focused on is this tradeoff between their costs and revenue moving forward. You're starting to see CapEx increase for some of the largest companies in the world as they start to invest more and more in artificial intelligence. Because of that,
the market will need to see continued revenue outperformance to offset rising costs both on an OpEx and CapEx basis for the Magnificent Seven, so that will really be the key from here. But the story in Q4 was a good one, and at the moment the forward-looking story also remains a good one.

**Allison Nathan:** What's even more remarkable about the performance that we've seen out of the Mag Seven and in the tech sector more broadly is of course there's still a lot of questions about the underlying economy. It's held up, but there are concerns about growth this year as well. Ben, how does this macro backdrop impact Mag Seven over time?

**Ben Snider:** I think it's important to note that, if we're talking about concentration or outperformance, there's really two things going on. One is the earnings strength of the largest stocks that Peter was just talking about. But the other is widespread concern that in a way is hampering the rest of the market, or at least large parts of the rest of the market. And when I look over history at other periods of high momentum or increase market concentration, you tend to see that as a recurring theme.
Generally speaking, when market concentration is high, yes, there are a few stocks that are doing great, but there is something about the environment that's also holding everything else back. So for example, if you look at 2020, when we were still in lockdowns with COVID, at that time, too, we saw a really elevated market concentration. And ultimately what happened was the vaccines were announced, the market became more optimistic about economic reopening. That released the tethers on the rest of the market, and we saw of course the S&P rally but also concentration decline.

Today, I think part of what's going on is persistent fears of an economic recession, although those have come down quite substantially from where we were a year ago. But the thing that is still holding back large parts of the equity market today is concerns about, quote/unquote, higher for longer interest rates. One characteristic of the Magnificent Seven, or the largest stocks, is they tend to have very strong cash flows, very strong balance sheets, and so they're relatively insensitive to what the Fed is doing in terms of monetary policy. That is not the case for the rest of the market.
And so as we go forward, if we see investors worry a little bit less about the economy or worry a little bit less about the Fed, whatever is happening with the Magnificent Seven I think we'll probably see market breadth expand as the rest of the stocks catch up.

**Peter Callahan:** Yeah, to jump in here, I think from my perspective, it feels like the market struggled to see whether it can run all the way in the direction of cyclicals or all the way in the direction of defensives. And these large cap stocks that have quality compounding earnings growth with very strong balance sheets and capital return stories, not to mention a nice theme like AI to play, has really just been the safe haven for a lot of investors. And so to Ben's point, should things really shift hard on cyclical side or on defensive side, that may change investors' allocations. But at the moment, this sort of in between has been the right temperature for these large cap stocks.

**Allison Nathan:** I think that's such an interesting point because most people think, if we do have rates staying higher or even rising again, which is the new fear that has come into the market obviously more recently, you know,
normally you'd think that would be bad for tech companies where we've been thinking about these discounts and cash flows ahead, that's going to be bad for them. But you're really seeing the reverse, the strengths of their balance sheet, their profitability is making them a safe haven. And that's unusual relative to the past.

**Peter Callahan:** Yeah, and I think the thing that Ben and I will probably key on here is the volatility of rates. And if the market feels like it knows what level to price in from a discount rate, they can do a pretty good job figuring that out and managing these sort of exposures to duration or large cap tech stocks, which, frankly, aren't really that much of a duration asset to begin with. But I think we probably key in on volatility as much as we would say the absolute level, whether the 10-year is at 4% or 4.15% or something like that.

**Allison Nathan:** So sometimes we think about these big run-ups. Investors are just not there to take advantage of them. How have investors done in this period?

**Ben Snider:** When we look at institutional investors, it's actually been very favorable for them. The average
hedge fund that we look at is up about 6%, which is pretty great not even three months into the year. And likewise, we're seeing more mutual funds beat their benchmarks than average at this point in the year. So far, even though the degree of concentration has generated a lot of anxiety among investors, it's been very good for their performance.

**Allison Nathan:** So I think another key question and hits on that debate in the industry is, if investors can get outsized returns by owning a handful of stocks, what does that mean for the active versus passive debate? Peter?

**Peter Callahan:** Yeah, I think it's a good question, and I don't know if I know the answer for this specifically. But I guess I would say I do think it's important just to cut out that concentration can cut both ways, and we've been in an environment over the last 12 to 24 months where that's really been a good story to the upside at an index level. But of course the market rarely lets you get too comfortable. And I think it is important to think about that consideration.

**Allison Nathan:** Ben, let me come back to you because is this just a US phenomenon? Or are we setting this market
concentration in other regions?

**Ben Snider:** Certainly, the Magnificent Seven have gotten most of the focus from investors around the world, but the truth is this is a global phenomenon, albeit not to the same degree we're seeing in the US. So for example, if you look at Europe, the top ten stocks are not quite a third of the market like they are in the US, but they're about 20% of the market. And that's about the highest we've seen since the financial crisis around 15 years ago.

**Allison Nathan:** Ben, you had mentioned that, outside of this handful of stocks, we have seen lagging performance. What's the outlook for whether that can catch up, Peter, in terms of do we think this concentration's going to broaden on?

**Peter Callahan:** Yeah, you're starting to see some signs of this, Allison, in the market. I mentioned last year it was all six that outperformed the S&P 500. This year, you're definitely getting more dispersion at least among those six stocks. We're starting to see outperformance in things like semiconductors or industrials, pockets of Internet. So when we look at tech broadly, despite all of
the bubble and concentration conversation, on a day-to-day basis, it does feel like the universe of stocks that we're engaged with clients, talking about, writing about, seeing activity in has really broadened out. And so I actually think the day-to-day story is probably a little bit healthier than maybe that top-down splashy headline that we all see in front of our face every day about extremeness and narrowness of market. It does feel like investors have been more comfortable starting to move out a little bit beyond those six or seven stocks and try to find opportunity elsewhere.

**Allison Nathan:** I bet if you put that into the historical context, the work that you've done, do you typically begin to see this high level of concentration spreading out?

**Ben Snider:** None of this can last forever, right? The question is: When will it change? And when it changes, will that be good for the market and bad for the market? And I think most investors, particularly because there's so much anchoring on the 2000 experience of the tech bubble, expect that, when this ends, it's going to be very painful and the market's going to move lower.
But actually, if you look over the bulk of the historical examples, usually this ends with the market rallying, not falling.

**Allison Nathan:** Interesting. Okay. So I think my main takeaway from this conversation is we shouldn't be that worried about this concentration risk, but is that the right message? Ben?

**Ben Snider:** I don't think you can deny there's a risk here, right? By definition, elevated concentration means less diversification. Diversification generally is something that makes portfolios safer and less volatile. And we have to acknowledge that, when you're putting more weight in a smaller group of stocks, you are depending on those stocks to continue their strength.

On the other hand, it also tells me there's a lot of opportunity in the rest of the market. And as I mentioned, most often when these honeymoon phases of small concentration outperformance and you get a catch up, not a catch down. And so I think the outlook still looks pretty good.
Peter Callahan: Yeah, I agree. We could debate whether it's a feature or a flaw of the market that we're in, but to Ben's point, I think my antennas are up and they should be of course whenever you see concentration like this. But again, I think I do come back to some optimism about broadening out that we're starting to see play out. I come back to the strength in the earnings cycle that we've seen. I come back to the promise of artificial intelligence, which still feels relatively early days, and feel okay about the path forward from here. But again, it's good to have this conversation. It's good to recognize the environment you're in to know what pool you're swimming in, so to speak, and use history as a guide.

Allison Nathan: And the economy has to hold up decently well, correct?

Ben Snider: I think implicit in this whole conversation is a view that the economy's okay and that the Fed hiking cycle is over. And so we have to acknowledge, if we are wrong, if there's some shock and we dip into recession, I don't think investors are going to be areas focused anymore on AI or the Magnificent Seven. We're going to have much larger macro concerns.
But for the moment, the US economy looks very good. The inflation trajectory still looks like it's moving in the way it's supposed to move. And so we can focus on things like a handful of technology stocks outperforming everything else in a bull market.

**Peter Callahan:** Agreed. I don't think the tech sector can fully hide from the cyclicality of some of the earnings that are still there underneath the surface. So again, implicit in all this is hopefully the economy holds on, we are on the backside of the rate hiking cycle, and hopefully closer to the cutting cycle. And so if that doesn't materialize, we'll have to get back on for another podcast.

**Allison Nathan:** Indeed. Peter, Ben, thanks so much for joining us.

**Peter Callahan:** Thank you.

**Ben Snider:** Thank you.

**Allison Nathan:** Thanks for listening to this episode of Goldman Sachs Exchanges, recorded on Thursday, March
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