

Goldman Sachs Exchanges
Should investors worry about market concentration?
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Allison Nathan: A small number of stocks are driving most of the outsized gains in US equities this year. So, is that a problem for investors?

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

Each month, I speak with investors, policymakers, and academics about the most pressing, market-moving issues for our Top of Mind report from Goldman Sachs Research.

This month, I spoke to two prominent market-watchers—who are on opposite sides of this very relevant debate.

David Kostin, our chief US equity strategist in Goldman Sachs Research, believes that investors should be concerned about the high level of US equity market concentration today. That's because he finds that high concentration is associated with lower returns over the longer run.

But Owen Lamont, Senior Vice President and Portfolio Manager at Acadian Asset Management, disagrees. He says that current concerns about high US market concentration are overblown.

I started off by asking my colleague David Kostin just how unusual the level of market concentration is today. He discussed two measures he uses to determine this: the share of total S&P

500 market cap accounted for by the top 10 stocks, and the market cap of the largest stock relative to the 75th percentile stock.

David Kostin: One measure that's easy for people to comprehend, understand, track, follow, what have you is the weight of the S&P 500 market cap that is contributed by the top ten stocks. We have data going back 45 years and we have data on a daily basis. You can actually look at it very specifically and the specific number is those top ten companies today comprise around 36% of the market cap and if you go back over time, it's around 20%. At the peak of the dot com boom in 2000 it was about 25% and then we used another approach or time series that brought the data back 100 years. Today, 36% of the market cap is the top ten stocks. Using the other metric, we are at a level that we've never seen before since 1932.

Allison Nathan: How concerned should investors be about this high level of concentration today?

David Kostin: So, a critical observation is that a high concentration market has information about long term forward returns, not necessarily near term returns. So the way you posited the question was, how concerned should they be about it today? They should be concerned about it from a long term investment perspective, we'll take 10 years as a long term measure. So it doesn't tell you what's the risk of the market in the next week or month or six months or a year. It is informative about the long term return prospects and one of the reasons is that valuation and concentration are two distinct variables. They're not the same. They can be correlated at some points, but they are oftentimes not correlated. So over time, they're not correlated. By using concentration as a additional input in thinking about long term returns, it's an important variable. So your question, how concerned should they be, they should be concerned because it has impact on longer term returns and the

high level of concentration today would suggest that the returns going forward are likely to be lower than they might have otherwise been if you had a low concentration market. Obviously, there's no counterfactual, but looking backwards, that's the experience – a high concentration market is typically associated with a lower return going forward.

Allison Nathan: So in your analysis, market concentration is a *consistently* reliable indicator of future returns?

David Kostin: Well, in our model, it's statistically significant in terms of incremental adding value in explaining forward returns. What I mean by that is if you think about how to forecast longer term returns, the model looks at a variety of inputs, valuation being the most important informative variable about what the returns are likely to be going forward. The profitability of companies is another variable. Interest rate environment today would be important information content about forward returns and concentration similarly adds to the accuracy of our forecast. So, we can both model including concentration as a variable, or we can remove that, and I think that's an important point to understand.

The typical annualized 10-year return over any moving window over the last 100 years is about 11%.

So if you didn't know anything else, historical experience is you get 11 percent annualized total return in the stock market. The last 10 years has been around 13 and a half percent. So for the next 10 years, what should we expect?

Our conclusion is, even if we don't include concentration, we just use some of the other variables I mentioned, valuation, interest rates, profitability, some economic growth assumptions, that would suggest your return profile in the next 10 years is likely to be below average.

It's like three to eleven percent in that range, midpoint around seven. However, when we incorporate concentration as a variable, that shifts it lower, because, it does have statistical significance in making our model more accurate by including it.

So that leads us to a conclusion of somewhere between minus one percent, that would be extraordinarily low, to seven percent. Midpoint is around three. So, it shifts the goalpost by around four hundred basis points. So, from 7 to 3%.

Allison Nathan: If you think about what is driving that unique market concentration factor that is weighing on that 10-year average, what is the intuition behind why that drags on returns?

David Kostin: The intuition is, with high concentration, the forward realized volatility is likely to be greater because it's a narrow group of companies driving the index any portfolio, if you have a relatively few number of constituents, the return is going to be more volatile than in a broadly diversified portfolio. And investors are not being compensated because the valuation is not attractively valued for this expected higher realized volatility.

And the reason that we make that statement is the following. If you look at these leading stocks. They trade today with a negative risk premium. We have not seen that at all for 20 years. At 31 times earnings for these companies, the inverse of 31 times is about 3.2%. That's an earnings yield. Look at 10-year U. S. treasury yields today, that's like 4.2%. That's a negative risk premium. You get a earnings yield that's below the return that you can get on 10 year treasury yields. The rest of the market is trading at a positive risk premium.

That's one factor. And then the second is these stocks that are driving that high concentration are trading at very high valuations because the expectation is their growth is going to be really, really elevated for a persistently long period of time going forward.

These companies are expected to have 20% growth going forward. But history shows that the number of companies that can actually deliver 20% growth year after year after year after year fades dramatically and almost no companies can continue to do that over a decade.

Allison Nathan: So, how might you be wrong? In other words, if it turns out, ten years from now, that this argument was incorrect – that high concentration did not, in fact, drag on S&P 500 returns – where might you have gone wrong?

David Kostin: Obviously there's a lot of places we could be wrong. The first would be the idea of artificial intelligence being a contributor to more sustainable sales growth for these companies. And they can continue to maintain high valuations.

That's number one risk. And the second risk is when you forecast something out 10 years, the constituents of the market is an important observation, but about three and a half percent of the constituents of the index turn over every year.

So you run that out over a decade and roughly a third of the companies are going to be new in the 10 years and so we're forecasting something that is yet to be determined at the present time. So that's another source of potential risk and the third would be to the extent that you have incremental household allocation to equities, that would be another potential source of demand. We think that's less likely.

Because the allocation of household portfolios to equities is about 50 percent based on the Federal Reserve data going back to 1952, 70 years, we are at the highest level that we've been. You could say we have a more equity oriented investment culture for households.

So you could make a case, maybe it's going to go to 60%. Certainly a possibility. So I'd say those are three risks that could

create a scenario where returns will be greater than we're assuming.

Allison Nathan: So, what should investors do then?

David Kostin: We're not saying equities will generally do badly. We have a lower than average return for a capitalization weighted index. But the typical stock is likely to give you an 8% return, which has been an attractive return over history. And so our argument is, look, if you're going to be in the public equity market at this juncture with the high concentration that we're at right now, we would recommend non-taxable investors ought to be owning an equal-weighted benchmark as opposed to a cap-weighted benchmark. Now, we're forecasting on a 10 year horizon. The data in our model would suggest that that is a better way to invest 80 percent of the time over a 10 year horizon. An equal-weighted index does better than a cap-weighted index. 80 percent of the time.

Allison Nathan: Next I spoke to portfolio manager Owen Lamont, who sees all of this differently. I took the same approach as I did with Kostin and first asked him how concentrated the US equity market is today.

Owen Lamont: There are different ways to measure market concentration, but a simple way is just what is the weight of the top ten largest firms in the total market cap. So if you look at it that way, as of today in the US stock market, we're in the neighborhood of 30 percent, higher than it was in 1999, but not as high as it was in the 1950s and 60s or the 1930s. So I would say it's within historical norms for the United States. So that's the United States. If you compare it to other countries, the US is currently and has always been way more diversified and less concentrated than other countries. So as of today, most countries in Europe more concentrated than us by that metric. And in other countries around the world, like in Taiwan or in South Korea, there's just one company that's 20% of the market. So

compared to them, we're way less concentrated, way more diversified and historically like at one point there was one company that was 70% of the Finnish stock market. So compared to either historically or internationally, we're pretty well diversified. We're not alarmingly concentrated today.

Allison Nathan: There's obviously so much investor concern today about this so-called very high market concentration. So, do you think that that concern then is just overblown?

Owen Lamont: I do think that concern is overblown. I mean, it's a fact that concentration has gone up in recent years, but it's not an alarming fact. I think the driving reality is that the concentration of profits has gone up in the US in the past 10 years. So the reason the US stock market has gotten more concentrated is just because profits have gotten more concentrated.

It's as simple as that. The reasons to be alarmed would be if prices got out of line with fundamentals. And that may be a small part of the story here, but the main part of the story is just that the fundamentals got more concentrated. The percent of profits produced by the top 10 firms has gone up.

So, I would say that today's high stock market concentration is mainly just a mechanical function or mechanical byproduct of the fact that mega cap growth firms have had incredibly high profit growth in the past 10 years. And that is the main story. The second story is that growth firms, mega cap tech firms are somewhat more richly valued than they were 10 years ago.

Put those two facts together, and you've got a more concentrated market. So if you want to worry about something, worry about those things, don't worry about concentration.

Allison Nathan: But I think a lot of people perceive that concentration in markets increases the riskiness of markets. Is that true?

Owen Lamont: I'd love to talk about that. Okay, so I think that's confusing two concepts. One is when I choose what stocks to own, do I construct a concentrated portfolio and there, it's definitely true that smaller number of names or you know a bigger weight into one name in your portfolio generally increases risk, but when the market chooses portfolio weights that are more concentrated, I don't think that increases risk.

I don't think it's true, for example, that in the 1950s, the stock market was way riskier because it was more concentrated. The stock market was probably safer in the 1950s, less volatile, less risky.

Here's the two places where risks come from. They either come from fundamental risk, economic risk, or they come from prices that move away from fundamentals. And I don't think either of those are somehow necessarily increased because stock market concentration goes up.

And let me give you an example. In 1984, the Justice Department caused AT&T, the big monopolistic phone company, to split up into seven stocks, seven baby bells instead of one big ma bell. I don't think that increased or decreased the risk of the stock market. It changed measured concentration. I don't think it necessarily made the market safer just because there were seven stocks where before there were one.

Also, many of the stocks, let's just take the stocks in the Magnificent 7, many of those stocks are already super well diversified. They're doing different things. They're doing streaming movies. They're doing e-commerce. They're doing cloud storage. They're already pretty diversified. And if I take a bunch of very successful, profitable, pretty uncorrelated businesses and

put them in one big stock and that stock has a lot of weight, that's no big deal.

Allison Nathan: Is there any relationship between market concentration and returns?

Owen Lamont: I don't see a strong relationship historically between concentrated markets and subsequent performance. And let's just take 1999 as an example. There was a big tech stock bubble in 1999, peaking in 2000.

And it's also true that there happened to be higher market concentration then. But, the higher market concentration was not the causal effect. The causal mechanism was the market was expensive and there were a bunch of growth stocks that were super expensive and it doesn't really matter if there was 10 growth stocks that were super expensive or a thousand growth stocks that are super expensive.

The main thing to look at is valuation. I think there's lots of reasons to think the US stock market is overvalued today. Like the value spread, which measures growth stocks being expensive relative to value stocks. And that's more of a measure of whether growth stocks are overpriced, not the whole market.

But maybe it's a symptom of the market going crazy or getting too excited. So, there's lots of concerning measures to say the market's overvalued, but I don't think concentration is one of those measures.

Allison Nathan: I think people who are focused on this idea that concentration and returns are correlated are looking at research that has shown that it's very difficult for firms to maintain the outperformance and the profitability for sustained periods.

So over time, that performance will deteriorate, and returns will be lower in the future.

Owen Lamont: Is it true that when you have one or two big firms dominating the stock market, those one or two big firms subsequently do poorly? Yes, that is true. It's not because they're big relative to the rest of the stock market.

It's because they're expensive. So, it's true that expensive stocks, whether they dominate the stock market or don't, expensive stocks do poorly, both because their fundamentals subsequently disappoint and because they're just expensive and that price needs to go down relative to fundamentals.

So for those two reasons, generally we would call that the growth effect, or the value effect is that value stocks do well growth stocks do poorly. So, just due to the fact that they're expensive, I would expect the largest stocks in the US stock market to disappoint over time.

Okay, so that's like a constant through history. And maybe I shouldn't say it's a constant through history because one of the things that happened in the past 10 years is the big growth stocks 10 years ago did well, they didn't mean revert like they usually do. So that's one reason concentration has gone up, is because for reasons that are historically unusual, big growth stocks got even bigger.

But the stocks that were important to the US economy 30 years ago are not the stocks that are important today. So, I think 30 years from now we will have all kinds of firms you've never heard of that are important, that are generating jobs and generating profits and generating value for shareholders. And so it is an inevitable part of the American experience that we have creative destruction. We have old firms get smaller and new firms get born and they get bigger, so I think that's likely to happen. It would be very surprising to me if the Magnificent 7 of today are dominating the economy 20 years from now. So, I am not concerned about individual firms doing poorly, that's part of how our system works.

Allison Nathan: Interesting. So, do you have a forecast about what equity returns could be in the next decade?

Owen Lamont: Sure. I think that there's one bedrock math fact we know and that is things that are expensive generally have low subsequent returns. So, I would say based on the fact the US stock market is expensive today, that it's going to have lower returns in the next 10 years compared to the previous ten years.

Allison Nathan: So, what else should investors be concerned about?

Owen Lamont: Okay, so first of all, there are the obvious geopolitical concerns that everyone talks about, and those are big concerns.

The second thing is AI. AI is this very important innovation. And it's at least as important as the internet was. And it's probably more important. So, if we think about the internet that was introduced in the 1990s, that had all kinds of implications. It killed some firms like Blockbuster, it created some other firms like some of the biggest firms today could not exist without the internet.

And it created this huge bubble in 1999. And, looking forward, I see all kinds of upside and downside risk in AI. So, I could imagine that, one scenario is we relive the experience of 1999. We have this huge AI boom, or maybe an AI bubble. And maybe that's already started. I don't know. So that's one scenario.

You could also imagine a scenario in which AI is so transformative that it destroys the value of many existing firms, just like what happened to Blockbuster, but on a bigger scale and the whole stock market goes down. So, to me in the next five or 10 years, when I look at the US stock market, I see tremendous upside risk and tremendous downside risk.

Allison Nathan: You know, it's really interesting, because even though David and Owen have opposite views on whether investors should worry about market concentration, they do agree that US equities will likely deliver lower returns over the next decade than in the previous one.

Let's leave it there. Thank you for listening to this episode of Goldman Sachs Exchanges. I'm Allison Nathan.

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