PZENA Investment Management

FOURTH QUARTER 2024 COMMENTARY

For Professional Investors Only

Global equity markets have grown more concentrated, led by the U.S. and a few dominant stocks. Declining concentration could favor value stocks and active investment strategies over time.

Over the past decade, global equity markets have become increasingly concentrated, with the United States playing a central role in this trend. The share of the U.S. in global market capitalization has surged significantly, primarily driven by a handful of dominant companies. This concentration has become even more pronounced since the release of ChatGPT in November 2022; a small group of stocks accounted for a significant portion of U.S. market performance over the last couple of years, pushing market concentration levels to a 60-year high.

In this essay, we discuss

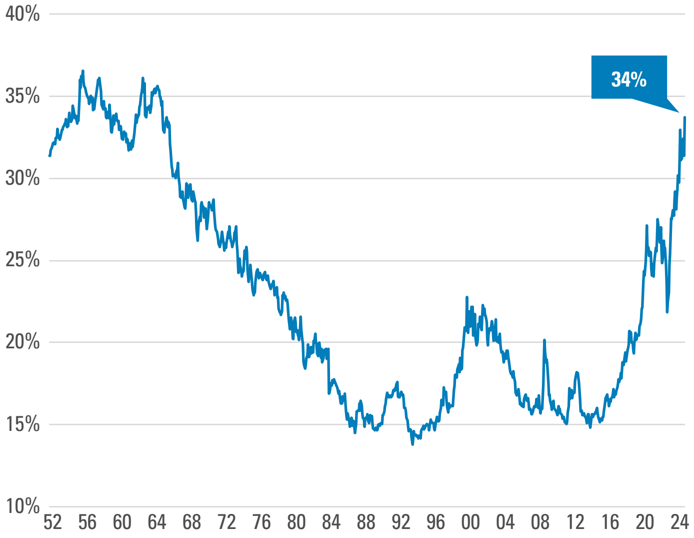
- The impact increasing concentration has had on investment styles and strategies
- Historical performance when market breadth widens (or expands)
- Why concentrated markets eventually broaden
- Forecasted earnings convergence in the U.S. market

INCREASING CONCENTRATION

U.S. market concentrations are at historic levels, with highs not seen for 60 years (Exhibit 1). Over the past two years, a mere 10 stocks have accounted for 62% of overall U.S. market performance. The level of concentration has become magnified since the release of ChatGPT in November 2022 and throughout the rise of investment in generative AI. Global equity markets have also become increasingly concentrated, with the U.S. acting as a major driver, as its share of the global market cap has grown to 66% from 44% since the Global Financial Crisis.

Exhibit 1: Market Concentration Has Been Increasing

US Large-Cap Stocks Share of Total Market Capitalization in the Top-Ten Stocks | 1952 - 2024



Source: Empirical Research Partners, Pzena analysis
Universe is the 1,000 largest US stocks ranked by market capitalization. Data from January 31, 1952 – December 31, 2024.

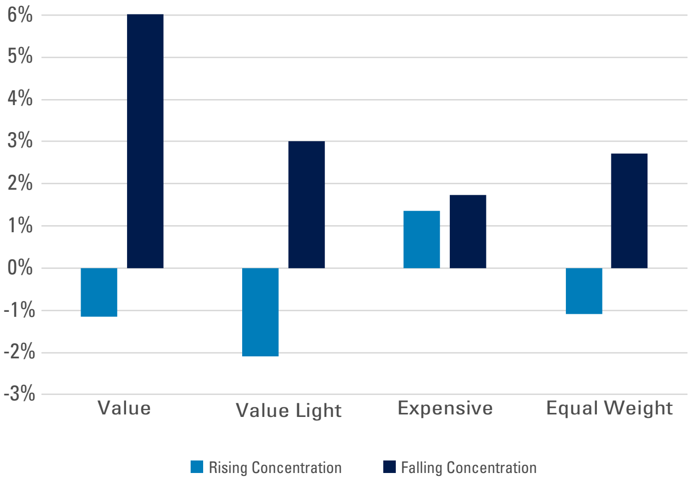
IMPLICATIONS OF CONCENTRATED PERFORMANCE

Since November 2022, the Russell 1000 Growth Index has outperformed the Russell 1000 Value Index by 54 percentage points, and the environment has been difficult for active investors[1], which is directionally in line with history (Exhibit 2). The historical performance is hardly surprising; as the largest, most expensive stocks perform well, market performance concentrates, thereby leading to value underperformance and poor alpha opportunity for active investors.

[1] We found a high correlation (.76 R-squared) between the alpha of active management and the relative performance of an equally weighted index relative to a cap-weighted index.

Exhibit 2: Performance In Concentrating Markets

Average 5-Year Annualized Alpha by Market Concentration



Source: Empirical Research Partners, Sanford C. Bernstein & Co., Pzena analysis
Rising/Falling concentration = change in concentration percentage of the top 10 largest stocks in the universe versus five years ago.
Value *= stocks within the cheapest quintile based on price/book of the 1000 largest US stocks (ranked by market cap).*
Value Light *= 2nd cheapest quintile.*
Expensive *= most expensive quintile. The quintiles are measured on an equally weighted basis.*
Equal Weight *= 1000 largest US stocks on an equally weighted basis. Alpha for Value, Value Light, Expensive, and Equal Weighted are calculated versus the cap-weighted market (1000 largest US stocks).*
Monthly rolling five-year data in US dollars January 1, 1960 – December 31, 2024. Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

However, periods of declining concentration have historically lasted twice as long as rising concentration. Once market performance broadens and concentration levels fall, the previous effects are more than offset; value stocks significantly outperform expensive stocks, and the environment becomes more favorable for active investors. Interestingly, value-light stocks underperform value stocks in markets with both rising and falling concentration levels.

CONCENTRATION LEVELS TURN

While we cannot predict when market concentration will turn or what may drive it, history offers some guidance. The last five years have seen markets concentrate at a greater pace than during any other five-year period. The only other five-year period during which the market concentrated at levels similar to today was during the dot-com bubble of the late 1990s. The subsequent five-year periods saw a dramatic swing, as value stocks outperformed expensive stocks by nearly 1,500 basis points per year.

Market concentration can reverse for a variety of reasons. The culmination of a bubble period, as seen in the post-dot-com bubble at the turn of the twentieth century, could cause such a reversal. A general broadening of performance could also cause a reversal, as seen in the post-Nifty Fifty period in the early 1970s. Most importantly, it is extraordinarily difficult for market leaders to maintain their dominance indefinitely due to the power of capitalism and competitive markets. An analysis of the decade-by-decade top 10 global market cap leaders shows how challenging it is to remain a market leader[2]. Underperformance is a likely result of this rotation of the largest companies[3]. A nearly 60-year study found that sector leaders subsequently underperformed relative to the rest of the sector by 3–4% per year. The impact was even more powerful for the overall market cap leader, which trailed the market by 5–6% per year (Exhibit 3). That level of underperformance would have turned $100, reinvested annually into the biggest stock in the market since 1950, into just $4 today[4]. Such has been the plight of the largest stocks in the index.

Exhibit 3: Too Big to Succeed

Average Forward Relative Return | 1952 – 2009

	1Y	5Y	10Y
Overall Market Leader[1]	-6.6%	-6.1%	-4.9%
Sector Leaders[2]	-3.5%	-3.9%	-3.3%

Source: Research Affiliates: Too Big to Succeed
https://www.researchaffiliates.com/content/dam/ra/publications/pdf/F_2010_June_Too_Big_to_Succeed.pdf

Universe is the 1,000 largest US stocks ranked by market capitalization.
1. The largest market cap stock in the universe versus the universe return.
2. The average alpha for all 12 sector leaders (the largest market cap stock in each sector versus the average return of the sector).
Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

While market leaders face fierce competition from existing companies, the biggest threat may come from companies that are not viewed as competition or ones that have not even been formed yet.

[2] https://www.visualcapitalist.com/how-the-top-sp-500-companies-have-changed-over-time/
[3] Q2 2023 Newsletter
[4] Mauboussin: Stock Market Concentration—How Much Is Too Much? https://www.morganstanley.com/im/publication/insights/articles/article_stockmarketconcentration.pdf

On average, the so-called Magnificent Seven largest stocks have only been publicly traded for 26 years. Compare them to the top 10 stocks at the turn of the century (Exhibit 4). Only one remains among the top 10 today, and half of the current list went public after 1996. Nobody would have predicted at the time that all but Microsoft would be surpassed by the rest of the Magnificent Seven.

Exhibit 4: Top 10 U.S. Market Caps In 2000

1. Microsoft
2. General Electric
3. Cisco Systems
4. Wal-Mart Stores
5. Exxon Mobil
6. Intel
7. Lucent Technologies
8. IBM
9. Citigroup
10. AOL

Soucre: Morningstar

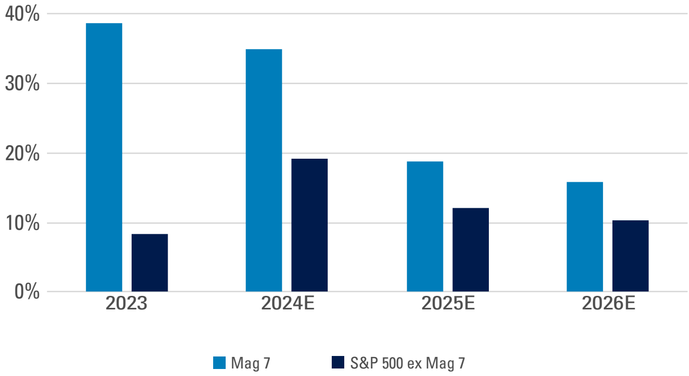
The NVIDIA-Intel rivalry is a great example of the brutal competitiveness of capitalism. At the turn of the century, Intel's market cap was $251bn, and it had a seemingly impenetrable competitive edge over NVIDIA, whose market cap was less than $1bn. Today, NVIDIA's $3.2tn market cap dwarfs that of Intel's at $86bn.

EARNINGS CONVERGENCE

The outsized recent performance of the Magnificent Seven stocks has been driven, at least in part, by incredible earnings growth. These companies have grown earnings by 37% per year in 2023 and 2024, which is approximately three times faster than the earnings of the rest of the market. The law of large numbers is catching up, however. Over the next few years, the earnings growth of these businesses is expected to decelerate and is only projected to grow a few percentage points more than the rest of the market (Exhibit 5), while trading at almost twice the valuation.

Exhibit 5: Earnings Convergence

Magnificent Seven Earnings Growth Is Moderating



Source: FactSet, Pzena Analysis
Magnificent Seven = Apple, NVIDIA, Microsoft, Amazon.com, Meta Platforms, Tesla, and Alphabet. Earnings data per FactSet as of December 31, 2024.

CONCENTRATION ONLY NEEDS TO ABATE, NOT REVERSE

As the law of large numbers looms, analysts are forecasting earnings growth of the Magnificent Seven to converge with the rest of the market, which may stem the tide of increasing market concentration. Historically, that's all that really needs to happen for style rotation to occur. The weight of the largest stocks does not need to reverse—it merely needs to stop going up. Once market concentration growth is relatively flat, value has historically outperformed the market by 460 basis points, beaten value-light strategies by 240 basis points, and outpaced expensive stocks by 370 basis points. Finally, as market concentration stops rising, equal weight (a proxy for active investing) has historically outperformed cap weight (a proxy for passive investing) by 150 basis points per year, even before market weights began to significantly diversify[5].

CONCLUSION

The rise of concentrated performance has had significant implications. Expensive stocks have consistently outperformed cheaper stocks over this period, creating a challenging environment for active managers. As the earnings growth of these dominant stocks begins to converge with the broader market, the tide may turn, which should benefit value stocks and create a more favorable environment for active investing strategies.

[5] Pzena analysis. See definitions in Exhibit 2.

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