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Investments

The case for active management in US equities

Mackenzie Bluewater Team

Summary

- Current market concentration of the mega-cap tech names has presented a very challenging environment for active managers.
- The combination of higher concentration in the benchmark indices and higher risk within the names that make up that concentration make this an especially questionable time to rely solely on passive strategies.
- Market-cap weighted indices have significantly underperformed equal weighted indices in severe market downturns such as 2000 and 2008.
- The Bluewater approach remains focused on owning durable, competitively advantaged businesses with underlying free cash flow that can outperform the market over the long-term. This results in a diversified high active share portfolio that provides favourable characteristics for long-term compounding, but in a more diversified way than the current market structure.
- The decision of “active versus passive management” in the US must consider these unique nuances of market structure, volatility and underlying risk, as true underlying risk is best defined as a “permanent impairment of client’s capital”, which is of utmost importance in the Bluewater investment philosophy.

Determining allocations between active management and passive management involves weighing several key factors that can significantly influence investment outcomes, most importantly risk and concentration. While the past two years have produced exceptionally strong equity returns, the combination of higher concentration in the benchmark indices and higher risk within the names that make up that concentration make this an especially questionable time to rely solely on passive investment strategies.

Risk mitigation

Active management involves taking a position in businesses based on fundamental assessments of the durability of free cash flow growth, balance sheet attributes and valuation, among other criteria, which can mitigate idiosyncratic risk and provide downside protection in large market drawdowns. In addition, active managers have the flexibility to adjust their portfolios based on market conditions, providing risk mitigation that passive strategies lack, such as diversification (by business model and exposures) and the ability to exit positions quickly when risks increase (potentially avoiding euphoric conditions where certain names can become a large part of the benchmark). This capability can protect investors during volatile market conditions and in the event of any economic dislocations (which would cause a drop in confidence).

Concentration on the rise

The past decade has witnessed a dramatic rise in stock market concentration. The weighting of the top 10 stocks in the S&P 500 Index has gone from 17% in 2014 to 36% today.* While this sort of concentration is not without precedent, it represents the highest level of concentration since the 1960s and is above the last spike in concentration that was experienced in the US in 1999.

To illustrate this level of concentration further, we provide the following stats:

- The worst year in over 20 years for equal weighted indices vs. market weighted indices was 2023.
- In 2023, the Magnificent 7 contributed 65% of the S&P 500 return. Three names (MSFT, AAPL and NVDA) contributed 37% of benchmark return with Nvidia up 239% in 2023 alone.
- This trend continued in 2024, and the level of concentration has continued to narrow around one specific name (Nvidia) that has appreciated ~200% YTD after being up +230% in 2023.
- Nvidia has appreciated from a 1.1% S&P 500 weight in December 2022 to 6.5%.*
- Before the emergence of the artificial intelligence theme in 2023, the top 10 weights in the S&P 500 included lower beta names such as Johnson & Johnson, United Health, Exxon and JPMorgan. Over the past two years these names have been replaced by names such as META, Tesla, Nvidia and Broadcom; names that historically carry significantly higher volatility and beta. This means that not only has the market become more concentrated after especially strong market returns, but that the composition of the top 10 names now carry more market risk.

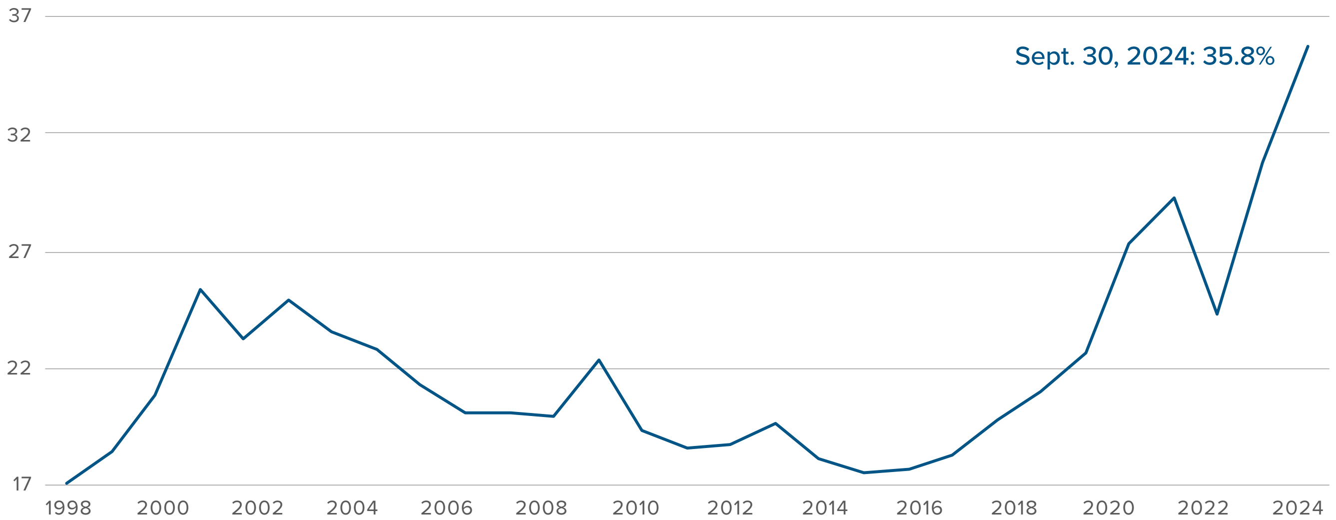
FIGURE 1: S&P 500 TOP 10 WEIGHTS AND BETA

(Dec. 31, 2022 vs. Sept. 30, 2024)

Dec. 31, 2022	Weight	Beta
AAPL	6.0%	1.16
MSFT	5.6%	1.10
GOOG	3.1%	1.25
AMZN	2.3%	1.18
BRK/B	1.7%	0.08
UNH	1.5%	0.72
JNJ	1.4%	0.56
XOM	1.4%	0.78
JPM	1.2%	0.98
NVDA	1.1%	1.67
TOP 10	**25.5%**	

Sept. 30, 2024	Weight	Beta
AAPL	7.3%	1.06
MSFT	6.6%	1.05
NVDA	6.1%	1.85
AMZN	3.6%	1.26
GOOG	3.6%	1.11
META	2.6%	1.22
BRK/B	1.7%	0.70
AVGO	1.6%	1.74
TSLA	1.5%	1.86
LLY	1.4%	0.75
TOP 10	**36.0%**	

* As at September 30, 2024.



Market weight vs. equal weight

The current market environment has led many investors to question the merits of active management, particularly given the strong performance of market indices. This questioning is understandable, as the market-cap weighted S&P 500 has delivered exceptional returns, driven largely by a small group of mega-cap technology companies.

A useful way to analyze the environment for active management is to compare the performance of the market-cap weighted S&P 500 (SPX) against its equally weighted counterpart (SPW). The equally weighted index assigns equal importance to all 500 constituent stocks, providing insight into how the "average" stock performs relative to the traditional index.

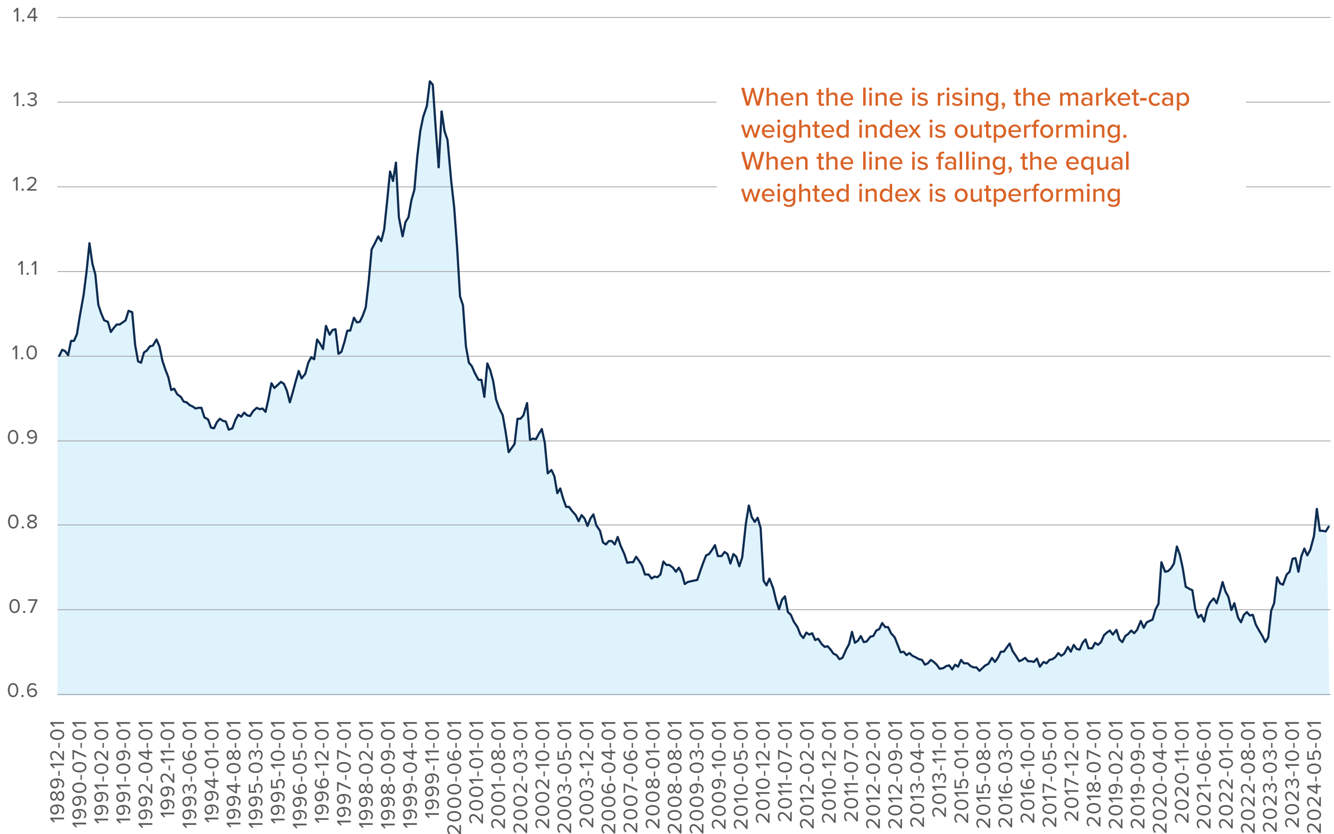
Markets that exhibit broader participation, where the average stock performs well relative to the largest names, typically provide a more favourable environment for active managers, particularly those maintaining high active share. This environment allows for greater opportunity in stock selection across the market capitalization spectrum.

As illustrated in figure 2 and figure 3, in early 2023, with the emergence of artificial intelligence and specifically a strong performance from industry leader Nvidia and other technology bellwethers, there has been a clear distinction between the "S&P market-weighted index" and the "S&P equal-weighted index", with the market-weighted index outperforming.

Key points:

- The market has experienced several multi-year cycles where either the market-cap weighted, or equally weighted approach has dominated.
- These cycles can persist for extended periods but typically reverse when market concentration reaches extreme levels.
- This divergence has been particularly pronounced over the last two years. Though the duration of this cycle remains relatively short by historical standards, the difference in annualized returns is one of the highest witnessed since the equally weighted index was launched in 1989.
- Current market optimism, particularly around specific sectors and companies, bears similarity to previous periods that preceded significant shifts in market leadership. While timing such transitions is challenging, maintaining exposure to skilled active managers can provide important portfolio diversification benefits when market dynamics shift.

FIGURE 2: SPX (MARKET WEIGHT) VS. SPW (EQUAL WEIGHT)



Source: Bloomberg, Factset

FIGURE 3: SPX VS. SPW

			Total return			Annualized total return		
Start	**End**	**Months**	**SPX**	**SPW**	**Diff**	**SPX**	**SPW**	**Diff**
Dec-89	Oct-90	11	-11.5	-24.1	12.6	-13.6	-28.1	14.5
Oct-90	Aug-94	46	75.6	94.2	-18.6	15.8	18.9	-3.1
Aug-94	Feb-00	66	218.9	98.1	120.7	23.5	13.2	10.2
Feb-00	Feb-07	85	15.5	86.7	-71.2	2.1	9.3	-7.2
Feb-07	Nov-08	21	-33.9	-43.5	9.6	-21.0	-27.8	6.8
Nov-08	Mar-15	76	164.5	233.4	-68.9	16.6	20.9	-4.3
Mar-15	Aug-20	65	88.9	52.9	36.0	12.4	8.1	4.3
Aug-20	Jan-23	29	20.8	42.2	-21.4	8.1	15.7	-7.6
Jan-23	Oct-24	22	43.7	20.1	23.6	23.0	11.0	12.0

Green denotes market-cap weighted outperformance, red denotes equal weighted outperformance

Source: Bloomberg, Factset.

Conclusion

The market concentration of the mega-cap tech names has presented a very challenging environment for active managers. The Bluewater approach is focused on owning durable, competitively advantaged businesses with underlying free cash flow that can outperform the market over the long term, resulting in a diversified high active share portfolio that provides favourable characteristics for long-term compounding, but in a more diversified way from the current market structure.

While calling an eventual top on names such as Nvidia is extremely difficult, what we do know from history is "extrapolating out current growth rates, specifically in technology is never linear," and when it normalizes (often rapidly or unexpectedly), the level of concentration can reverse while returns broaden out. These transition periods typically present significant opportunities for active managers who maintain discipline in their investment approach, creating a large tailwind for the Bluewater investment style.

The decision of "active versus passive management" in the US must consider these unique nuances of market structure, volatility and underlying risk, as true underlying risk is best defined as a "permanent impairment of client's capital," which is of utmost importance in the Bluewater investment philosophy.

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