THINKING WITH SENTIO

BEYOND THE BENCHMARK: UNDERSTANDING MARKET CONCENTRATION IMPACT

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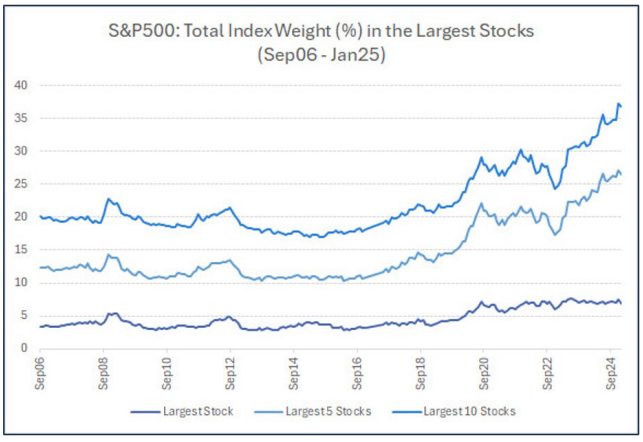
BEYOND THE BENCHMARK:
UNDERSTANDING MARKET CONCENTRATION IMPACT

In a world where technology is rapidly evolving, the rise of artificial intelligence (AI) has become a game-changer. Imagine a year where the equity market's performance is driven by groundbreaking innovations, much like 2024, just as in 2023, where the Magnificent 7 (Mag 7) contributed to 55% of the S&P500 returns, 2024 saw 45% of these returns coming from the same elite group. This concentration of returns to a select few stocks has ignited debates within the investment community about the relevance of benchmarks in such concentrated markets and the ongoing battle between active and passive management.

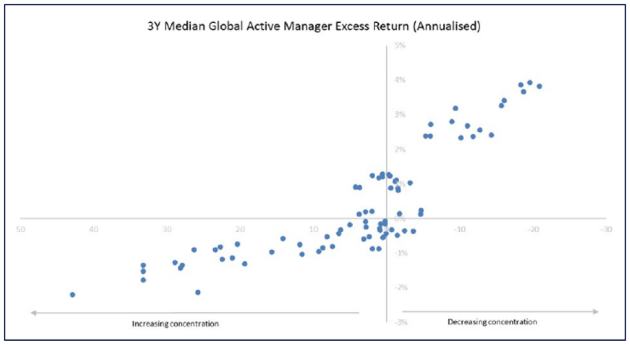
The COVID-19 and post-COVID eras heralded two key events that captured the world's imagination and supported the growth of the Mag 7 over traditional business models. These events were the 'work-from-home' winners and the advent of ChatGPT, or generative AI, which had a transformative influence on how work is done. These events catapulted the market capitalisations of tech-focused mega-cap stocks, creating increased stock concentration levels in the S&P500 index for these companies.



Source: *Sentio Capital Management.*

This has had profound implications for active equity market investing. It created structural challenges for active investment managers who typically build portfolio solutions that rely on diversification to reach their long-term return targets.

Historically, during periods of elevated market concentration, as measured by the Herfindahl Hirschman Index (HHI), active managers have struggled to generate excess returns, particularly for investment managers whose core skill set depends on stock picking.



Source: *https://russellinvestments.com/*

The underperformance of active managers in periods of rising concentration is partly explained by the narrowing of market breadth of opportunities accompanying these regimes. Studies have shown that the probability of picking big losing stocks relative to big winners doubles in regimes of narrow breadth. However, during periods of easing market concentration, these probabilities shift in favour of active managers as stock-picking opportunities are healthier than usual.

In the short term, the challenged performance of active managers is compounded by the influx of money into passively managed funds, which deliver the required returns of asset owners at significantly lower fees. This further reinforces the structural shift of the market toward these large benchmark-weighted stocks and calls into question the value proposition of active management.

Further questions are raised about whether there is an appropriate concentration level, for which there is no statistically robust answer to date.

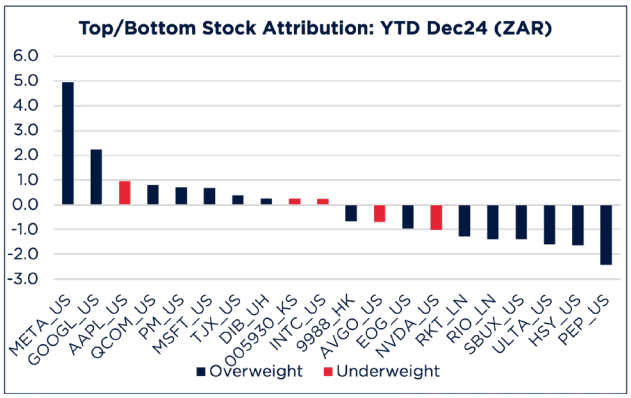
Market concentration does ebb and flow over the longer term, sometimes due to changes in the macroeconomic environment, government intervention or exogenous shocks. During the period from 1933 to 1964, the first Magnificent 7 (AT&T, General Motors, IBM, Standard Oil, General Electric, Du Pont and US Steel) emerged to dominate the equity market, resulting in concentration levels similar to the levels (30% of total market capitalisation) we see in today's market. The 3 decades following the 1960s saw rapid industrial innovation, which spawned the rise of the internet, semiconductors, fast food franchises and biotechnologies. This ultimately led to a broadening of value and reduced concentration levels to the old Magnificent 7.

However, three decades is well beyond many investment horizons, and the associated opportunity cost of being under-invested in emerging themes like AI can prove costly.

The key challenge that emerges is portfolio construction because the large benchmarked weighted companies reduce the active share of actively managed portfolios, making it difficult to distinguish between benchmark hugging and prudent portfolio construction.

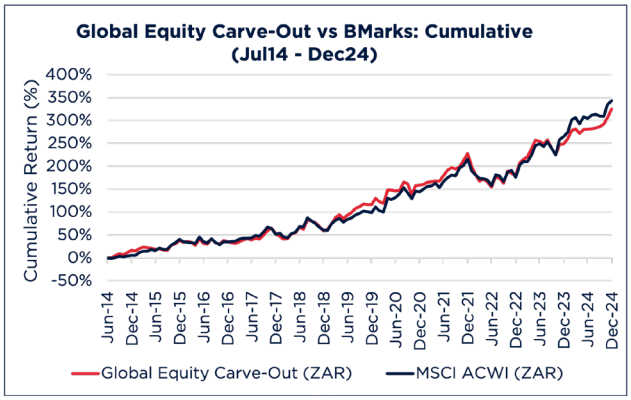
Therefore, the active management community's response tends to move in two directions. Active managers often bemoan concentrated markets and stick to their strategies but create less concentrated benchmarks similar to those seen on the JSE and Naspers/Prosus. Others remain hopeful for mean reversion, which can be costly, and the skew of excess returns is not in their favour.

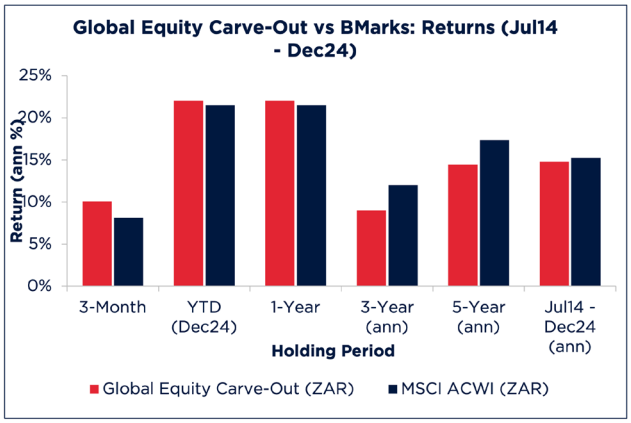
Sentio's approach to this problem is grounded in rigorous fundamental analysis and prudent portfolio construction. Our global process relies on an approach classified as the "Anchor-Satellite" approach. It is a style-agnostic approach to picking stocks; hence, our portfolio is not constrained to any one style. As seen in much of the available literature, no one style consistently outperforms the benchmark.



Source: Sentio Capital Management

We delivered a significant portion of our outperformance from Meta and Google, our two main holdings from the magnificent 7. However, we also added value from our old economy investments, such as tobacco, fashion retailers, and Middle Eastern banking exposures.





Source: Sentio Capital Management

Our balanced approach to style and themes has further allowed us to outperform the MSCI ACWI in 2024 despite the highly concentrated nature of the benchmark to the AI theme.

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