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Suffering from Bad Breadth?

A small group of stocks have led the US stock market meaningfully higher this year to date. These stocks tend to be considerably larger and more growth-oriented than the market.

Market indexes, and particularly large-cap growth indexes, are excessively concentrated.

This current period of weak market breadth, combined with excessively concentrated indexes, creates an attractive opportunity for active management.

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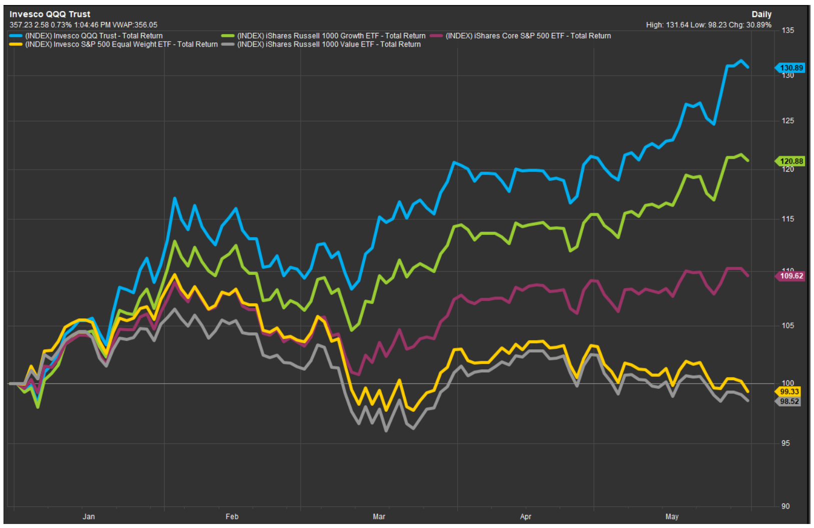
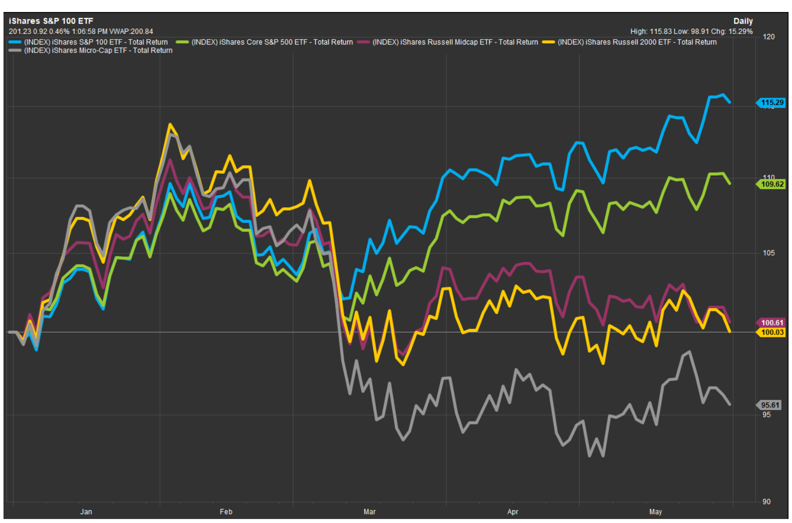
<u>Bigger is Better? Certainly it has been this year to date!</u>

The US stock market has rebounded in 2023 after a material decline of nearly 20% in 2022. While the headline S&P 500 index is up almost 10% through late-May, many stocks have not participated in this year's rally. The chart below depicts the year-to-date total return of multiple large cap indexes. This year's rally has clearly been led by growth stocks, as the NASDAQ 100 index has outperformed both the S&P 500 Equal Weighted and the Russell 1000 Value indexes by around 25 percentage points, which are merely flat this year to date.



Source: FactSet, Year-to-date through May 31st

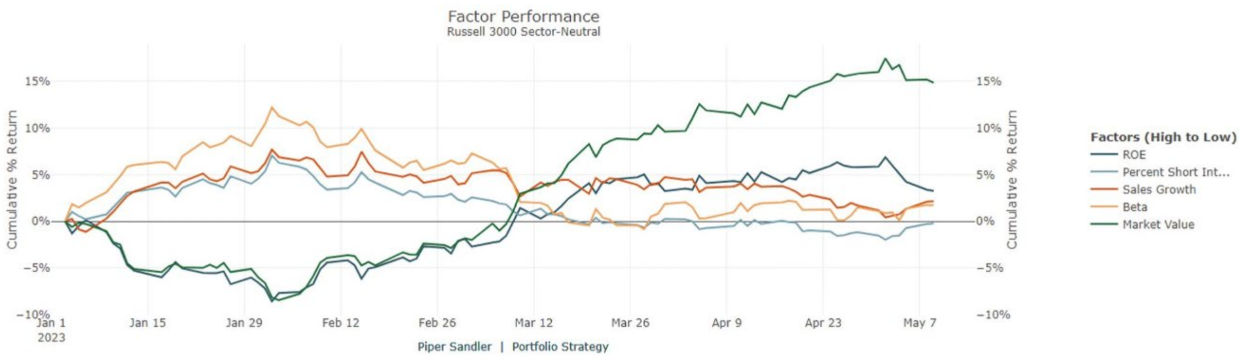
On the surface, it appears that growth stocks are back to their old tricks, leading the market higher as they have for most of the post-Global Financial Crisis era. Digging a bit deeper, however, suggests that market capitalization has instead been the material driver of performance thus far in 2023, with the largest companies faring far better than the smallest. The below chart illustrates the performance of various indexes by market capitalization from mega-caps to micro-caps.



Source: FactSet, Year-to-date through May 31st

Bigger has clearly been better this year. On a price return basis, if we take away the largest 10 stocks, the S&P 500 would give up approximately 80% of its upside this year through May 23rd.

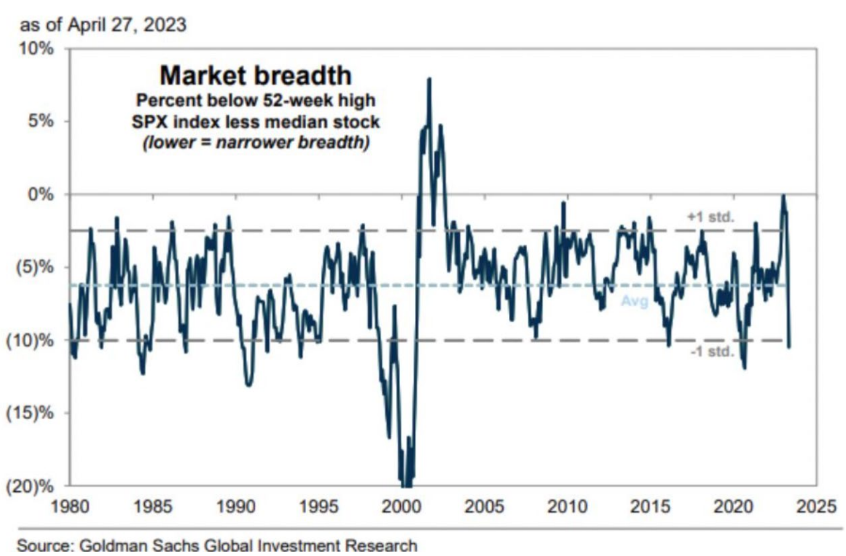
It's natural to ask whether different sector composition across the size indexes has driven the dispersion of year-to-date returns. However, the below chart suggests that, on a sector-neutral basis across the Russell 3000, size has been the dominant factor in performance this year, and particularly since the end of January.



Source: Piper Sandler

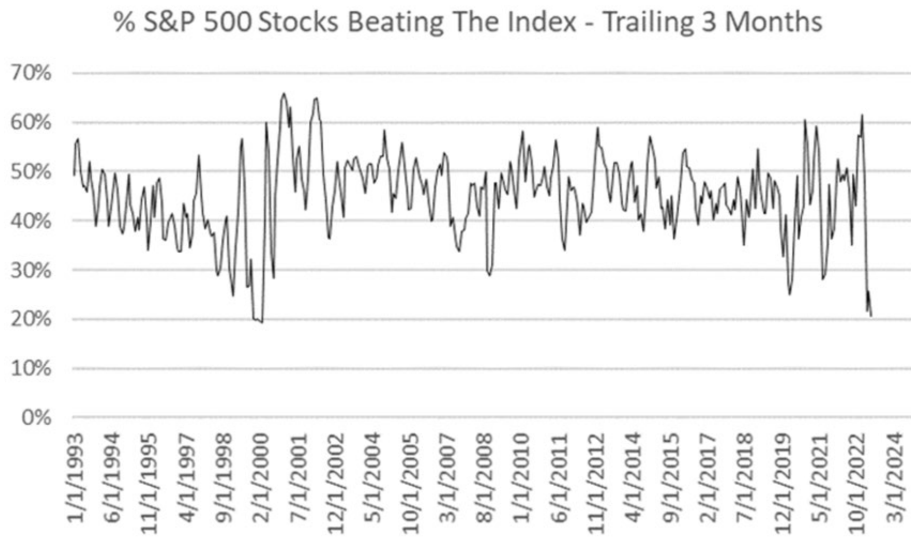
Narrow Leadership – A Market Suffering from Bad Breadth

The dominance of the largest stocks, which already represented a significant portion of market capitalization, this year-to-date has led to one of the "narrowest" markets in recent memory, with a tiny group of stocks driving the performance of the market through significant outperformance while most stocks are underperforming. The below chart compares the S&P 500's distance from its 52-week high to the average stock's distance from its 52-week high. A lower reading means a narrower market. This measure of breadth suggests that the market has only been this narrow four times in the past 20 years.



Source: Goldman Sachs

Alternatively, measuring breadth by examining the percentage of stocks outperforming the S&P 500 on a rolling three-month basis suggests that this is the narrowest market since March 2000, the peak of the internet bubble. Historically, the market has not sustained such weak levels of breadth for long, suggesting that weaker relative performance of the mega-cap stocks that have driven the market this year may be on the horizon.

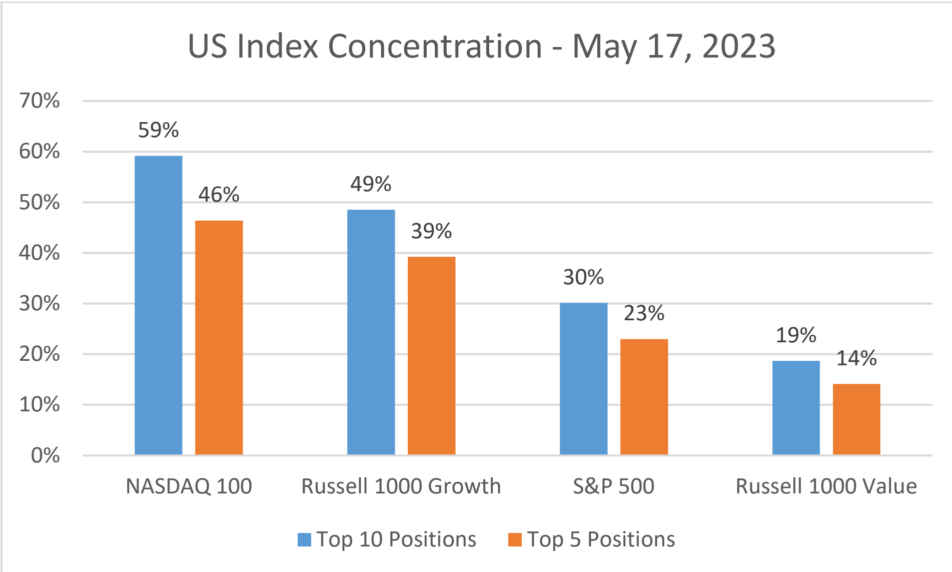


Source: Piper Sandler

Many Headline Indices Are More Active Than You Think

The recent period of poor market breadth has led to extreme levels of concentration in some headline indexes, particularly those that are more growth oriented. The top five stocks in the NASDAQ 100 index presently represent over 45% of the index. If the SEC did not provide waivers in 2019 to passive strategies following these indices, they would not be considered traditional "diversified" funds. We believe that is far too much concentration in a small group of stocks, and that an investment in this index is anything but passive.

While the level of concentration in the Russell 1000 Value index is far more reasonable, we note that allocating to passive management in the large cap value space has historically been a losing bet. We have written about this topic in ***past papers*** that are available on our website.



Source: FactSet

The Active Opportunity

We think that the market has delivered active management an attractive opportunity for future outperformance. History suggests that the current weak breadth in the market is unlikely to persist for long, and a stronger period of market breadth, during which a higher percentage of stocks in the index outperform the index as a whole, is an attractive environment for active managers who are positioned differently from the broad market indexes.

As noted earlier we have seen three markets this narrow in the past 20 years. In the subsequent two-year periods following those narrow markets, even without picking a particularly skillful manager the median large cap value active manager outperformed the Russell 1000 Value in all three periods, and the S&P 500 in two of the three periods.

We think that the market has delivered active value managers a fat pitch, and we’re excited to swing.