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In the Markets Now

The Big Five throws its weight around

The volatility of the last few months has been nearly unprecedented. Here, we aim to recap the action and hopefully provide some perspective to investors.

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RAPID FIRE ON HISTORIC MARKET CONCENTRATION

In the last 40 years, the five largest US stocks have never been as big a weight in the S&P 500 as they are now. This "Big Five" of consumer-tech firms (Amazon, Apple, Microsoft, Facebook, and Alphabet) now represent ~20% of the index, approximately the same as the smallest ~350 companies. **All five report earnings this week. What a time to be alive.**

This level of concentration tends to get people riled up, as it invokes comparisons to the dot-com and housing bubbles. It will assuredly generate a lot of media coverage over the coming weeks. And while I certainly don't have all the answers, I do have a few opinions on this phenomenon. To keep from boring you, we're going rapid fire:

- **Are there risks?** Yes. The increasing power of these firms has drawn significant anti-trust sentiment from Washington. Larger weights also mean greater influence on returns; S&P performance will suffer if one of these major players underperforms. Narrower markets are wobblier, and can also indicate poor participation from the wider universe of public companies.
- **Does it make sense?** In my opinion, yes. The Big Five are uniquely suited to this crisis, with products and services tailormade for a pandemic lockdown. Online shopping, social media, smartphone addiction, music/video streaming, cloud computing (to facilitate work from home). These firms were already massive, but the pandemic accelerated trends already in place, resulting in relative outperformance and heavier weightings (for now).

Source: Compustat, Goldman Sachs Global Investment Research

- **Is this like the dot-com bubble?** In my opinion, no. Not only do these "tech" firms generally produce tangible earnings and strong cash flow (unlike the dot-com bubble), but current valuation is well below the 1999 peak. By all accounts, retail participation and investor sentiment are far more muted today, as well. This crisis was never about an asset bubble.
- **Does this explain the chasm between the stock market and the economy?** Yes, to an extent. The S&P 500 is tilted toward techy, consumer companies and healthcare firms. These stocks, because of the unique circumstances of the crisis (again, it's a pandemic lockdown), have largely held up the best. Manufacturing, physical retail, and restaurants (to name a few) are some of America's biggest employers, but are far less represented in market cap-weighted indexes.
- **What is the big takeaway?** Know what you own. As we noted above, the S&P 500 (like most passive indexes) is market cap-weighted. This system is dynamic, rewarding recent winners and punishing recent losers as price movement leads to a larger or smaller weighting. The current level of concentration is high by recent standards, but it will ebb and flow as companies grow and flourish or fade and die.

As always, we end by encouraging our readers to reach out to a Baird Financial Advisor. They are experts designed to help build resilient portfolios and wholistic financial plans, essentials needed now as much as ever.

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