

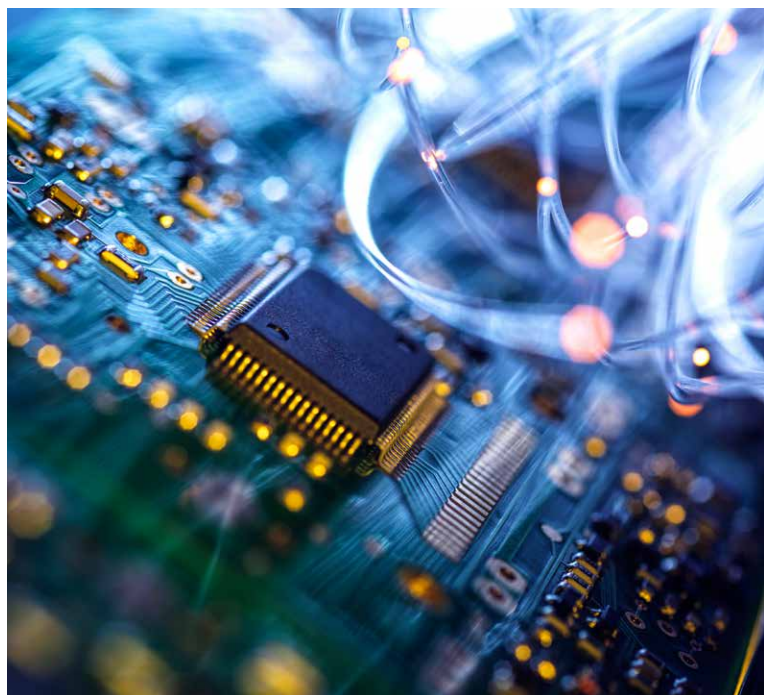
# The concentration conundrum



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## Time to tech stock

2020 so far has been a rollercoaster ride for global markets, financial advisers and investors. The spread of COVID-19 caused extraordinary levels of volatility and led to the fastest bear market in history. Uncertainty persists as economies around the world adapt to the ‘new normal’.

While these unprecedented events significantly impacted sectors and businesses around the world, technology stocks were far less affected. Throughout the ups and downs over the past six months and even after recent pullbacks, tech stocks have continued to dominate market returns.

After years of outperformance, the rise of tech may be unsurprising. However, the recent news that Apple\* became more valuable than the entire FTSE 100<sup>1</sup> shows now is a good time to take stock of the situation, in our view.

While tech’s impressive growth may create a compelling case to invest, we believe it has also exacerbated a significant concentration risk that financial advisers should be conscious of especially if they use index strategies.

## The concentration conundrum

The Retail Distribution Review in 2012 led to a surge in appetite for index strategies as a cost-effective well-diversified solution, with the FTSE All World or MSCI ACWI offering access to over 2000 constituents.

However, markets never stand still or rise in parallel. Since then US equities raced ahead of all other regions. The unintended consequence for global indices was staggering. The US started the previous decade with a weight of just under 40% in the global equity index MSCI ACWI, but today it sits at a whopping 58% and is five times larger than all 25 emerging markets combined.<sup>2</sup>

Just as the US dominates the global index, tech stocks in turn have become dominant within US equities. At the peak of the dot-com bubble, the ‘big five’ US stocks in the global index made up nearly 19% of the S&P 500.<sup>3</sup>

Today’s top five – Microsoft\*, Apple\*, Amazon\*, Alphabet\* (Google’s parent company), and Facebook\* – add up to nearly a quarter of that same index.<sup>4</sup> Indeed, market concentration has not been this high for the last 30 years. Furthermore, Microsoft\*, Amazon\* and Alphabet\* combined are now bigger than any one single country in the MSCI ACWI apart from the US.<sup>5</sup>

This means many advisers who chose index funds for their diversification qualities may have inadvertently exposed their clients’ investments to a high level of increasing stock concentration risk. As a result, their portfolios may be very sensitive to any tech news. With the ‘spill over’ from tech to other sectors now greater than ever, negative news flow may have far-reaching consequences.

1. FTSE, August 2020  
2. MSCI, July 2020  
3. S&P 500, July 2020  
4. S&P 500, July 2020  
5. MSCI, August 2020

\*For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.

### Recession and regulation risks

As we have shown, market cap exposure is increasingly carrying single-name risk and we are concerned that such a small group of companies is driving overall market performance.

We have liked tech for several years and believe the sector is well-positioned for a post-pandemic environment, especially as people are relying on technology for nearly every aspect of their lives. Tech companies also tend to have strong cashflows and balance sheets and will be able to take advantage of any potential distressed sellers.

However, we can see two potential developments that could negatively affect the sector: a 'normal' cyclical recession and an escalation of regulation. In our view, these issues highlight the risks attached with blindly following a global equity index and having too much exposure in a handful of stocks.

Tech stocks may have performed well during the COVID-19 recession this year thanks to superior earnings growth, but this was anything but a 'normal' recession. In a future normal cyclical recession we would expect tech earnings to behave more in line with historical patterns, i.e. exhibit some sensitivity to the economic cycle. Even over the past few years and despite its secular growth trend, tech has shown some sensitivity to changes in global PMIs. We would also expect bullish positioning to weigh on the sector in a more normal bear market, as strong tech returns become a potentially attractive source of funds for rotation into more non-cyclical stocks. This rotation could be exacerbated if private investors become a larger part of the tech investor base by the time of the next downturn.

The tech sector has also seen tightening regulation over recent years and this trend is expected to continue. We would be concerned if we saw a sudden escalation of regulation in the sector and believe the US elections could be the next potential catalyst. However, tech is also an important battleground in the China/US battle for domination so that may temper the US from being too aggressive and hurting its own tech sector, in our view.

### How we're diversifying our tech exposure

We continue to see great potential in tech, but we also believe it is important to diversify exposure to mitigate the concentration conundrum. One key way in which we are doing this is through investing in artificial intelligence (AI) which is at the heart of many if not most tech trends and growth, in our view.

We believe AI enjoys the same benefits as the larger US tech stocks including longer duration, low debt and strong balance sheets and it will do better in a lower for longer environment. But it tends to be smaller cap on average and is also less exposed to an escalation in regulation unlike the big tech names, and therefore is a good diversifier in portfolios.

### Adviser actions

A big question for advisers is whether it is possible to use cost-effective index trackers without taking a significant concentration risk. While this may be challenging, we believe they can. Instead of blindly investing in a global equity index, advisers can use or look for strategies that use regional equity indices to spread the risk across different geographies. This will help to avoid excessive concentration or stock-specific risk and create a more balanced allocation. Advisers may want to consider the exposure to US equities and its mega tech names in actively managed funds. An important difference to note here is that a high tech concentration in actively managed funds is typically a deliberate decision (unlike with global equity index trackers where it is inadvertent). Therefore, the focus here should be on the skill of the fund manager to choose the appropriate level of exposure in different market environments.

We also believe hindsight is the mental curse of diversification and advisers should be mindful of this. Just as there will always be an individual equity that outperforms all the others, there will always be an asset class that outperforms within a diversified portfolio. In 2019 that asset class was US equities for many multi-asset investors.

The temptation is to believe, with hindsight, that this outperformance was inevitable, and the winning strategy was obvious; that in this instance putting all the eggs in one basket was a good strategy. However, we know that past performance is not an indication of future returns. Therefore, we believe diversifying tech exposure can help to create a better risk/return profile over the long term.

Views expressed are of Legal & General Investment Management Limited as at 24 September 2020.

## Contact us

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### Key Risks

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