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ALLOCATOR'S ANGLE

A Quarterly Newsletter from **IORisk Aware**

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IOR Investment Office Resources | The New Option

SUMMARY IN BRIEF

- The U.S. equity markets have experienced a shift toward greater concentration, as a narrow subset of stocks have outperformed. While this presents challenges, it also provides a unique opportunity for asset allocators to revisit strategies to mitigate these risks. In this edition of ***Allocator's Angle***, we explore the hypothesis posited by active managers—that market dispersion and increased market breadth foster environments conducive to stock-picking success.

- Our findings indicate that neither higher dispersion nor broader market breadth consistently enhances active management performance, highlighting the need for a critical evaluation of manager capabilities in such conditions.

- Conversely, equal weighted indices outperform during periods of broad market participation but underperform when leadership is narrow, necessitating vigilant monitoring for signs of trend reversals and tactical adjustments in allocation.

CIO OUTLOOK

SUMMARY

In this edition of Allocator's Angle, we examine the performance of active managers in relation to market dispersion and breadth. Our analysis reveals that the performance of active managers is not closely tied to market regimes. Conversely, equal weighted indices consistently outperform in conditions of high market breadth, potentially providing allocators with a refuge should current concentration trends reverse.

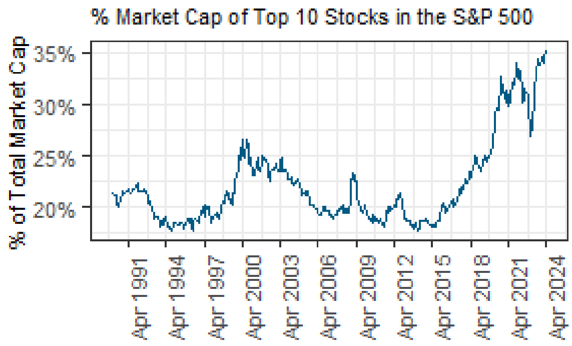
In recent years, equity markets have exhibited narrow leadership, with relatively few stocks driving capitalization-weighted indices to new heights. This trend has given rise to the term 'Magnificent Seven,' referring to a group of mega-cap stocks that have notably outperformed the broader market. This trend has not only intensified the spotlight on concentration risks but has also ignited consideration of effective strategies to mitigate these risks, particularly for allocators who are exposed to passive, cap weighted equity indices. In this edition of ***Allocator's Angle***, we delve into hypotheses posited by active managers—that market dispersion and increased market breadth create conducive environments for stock-picking success—and explore their implications for mitigating concentration risks. In this analysis, we find that while skilled managers can successfully navigate reversals in market concentration, active managers as a group generally do not experience significant benefits from such shifts. Conversely, our findings suggest that equal-weighted indices offer a more dependable approach to managing a reversal in market concentration.

If you're an allocator facing a problem that may benefit from a data-driven approach, we'd love to hear from you. Please drop us a line at iorisk@iorllc.com and we may discuss it in a future edition of ***Allocator's Angle***.

CONCENTRATION RISKS

In recent years, the composition of U.S. equity market indices, including the S&P 500, has dramatically shifted towards greater concentration, with the top 10 stocks representing a historically outsized portion of the index. This heightened concentration risk, as depicted in **Exhibit 1**, remains near historical highs despite some recent choppiness.

Exhibit 1: Elevated Concentration Risk



Source: IOR

The implications of such concentration are critical for asset allocators managing diversified portfolios. In response, we explore strategies to mitigate these risks and capitalize on potential shifts in market concentration. Our analysis focuses on two key areas: dispersion and market breadth. Dispersion measures the spread of returns across securities within an index. In highly concentrated markets, where few stocks dominate, dispersion tends to be low, posing challenges for active managers due to limited opportunities to exploit mispriced securities. However, a decrease in concentration may increase dispersion, improving conditions for active management.

Market breadth assesses the number of stocks contributing to market movements. A decline in concentration, leading to broader market participation, can create fertile grounds for active managers by providing opportunities to invest in outperforming securities. Our analysis of both dispersion and market breadth offers insights into managing concentration risk.

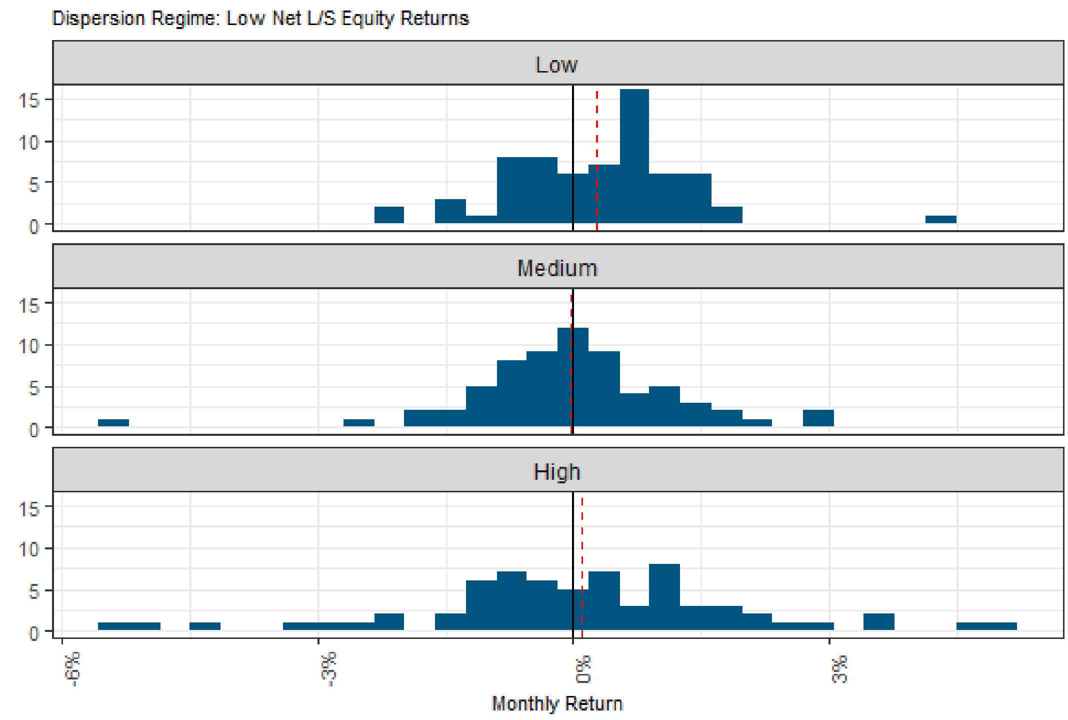
DISSECTING MARKET DISPERSION'S IMPACT ON STOCK PICKING

Market dispersion refers to the variance in returns across stocks within a market. It's theorized that higher dispersion provides a more fertile ground for active managers, presumably offering greater opportunity to differentiate between winners and losers. This argument suggests that in periods of heightened dispersion, the skillset of active managers should translate to superior performance relative to the broader market.

To test this claim, we categorized the dispersion of current S&P 500 constituents [1] into terciles representing low, medium, and high dispersion regimes. We then analyzed the returns of low-net long/short equity managers, serving as a crude proxy for active management, in the context of these dispersion regimes. **Exhibit 2** illustrates the monthly return distribution of these managers across the regimes, highlighted by a vertical red line indicating the average returns for each.

While the average return of active managers does not necessarily improve with increased dispersion, the range of potential outcomes widens significantly. This suggests that although active managers as a group might not capitalize on potential benefits from a shift in market concentration, those with exceptional skills are likely better prepared to navigate such environments. This observation underscores the increased responsibility for investors to evaluate whether their active managers could gain from heightened dispersion if market cap trends were to reverse.

Exhibit 2: Active Management Across Dispersion Regimes



Source: IOR

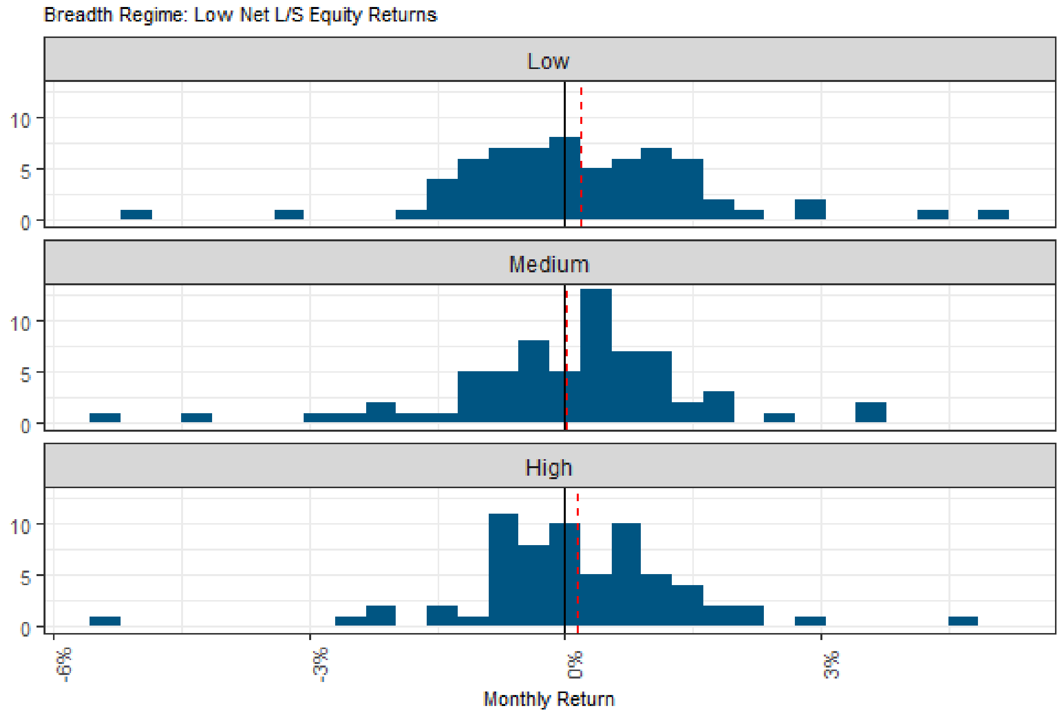
1 While we acknowledge the use of current S&P 500 constituents introduces a degree of survivorship bias, we believe its effect on dispersion calculations is likely to be immaterial.

BROAD MARKET PARTICIPATION: A CATALYST FOR ACTIVE STRATEGIES?

Given that increased dispersion is not necessarily a tailwind for active managers, we analyze whether increased market breadth may provide a tailwind for active managers as a whole. As noted above, it's commonly theorized that a broad market—characterized by a significant portion of stocks outperforming the index—is advantageous for active management. The rationale is that with more stocks outperforming a cap weighted benchmark, active managers have a larger pool of potential outperformers to select from, theoretically enhancing their ability to outpace benchmarks.

We tested this hypothesis by once again categorizing market regimes into terciles, this time representing low, medium, and high breadth. The findings, detailed in **Exhibit 3**, indicate that increased market breadth does not, on average, offer a significant advantage for active managers. This observation suggests that while broader participation across stocks might imply more opportunities for stock picking, the overall benefit to active managers in aggregate remains inconclusive. It raises important questions about the effectiveness of traditional stock-picking strategies in varying market conditions. Investors might consider this data when evaluating the potential for active management to add value to their portfolios, especially in environments characterized by fluctuating market breadth.

Exhibit 3: Active Management Across Breadth Regimes



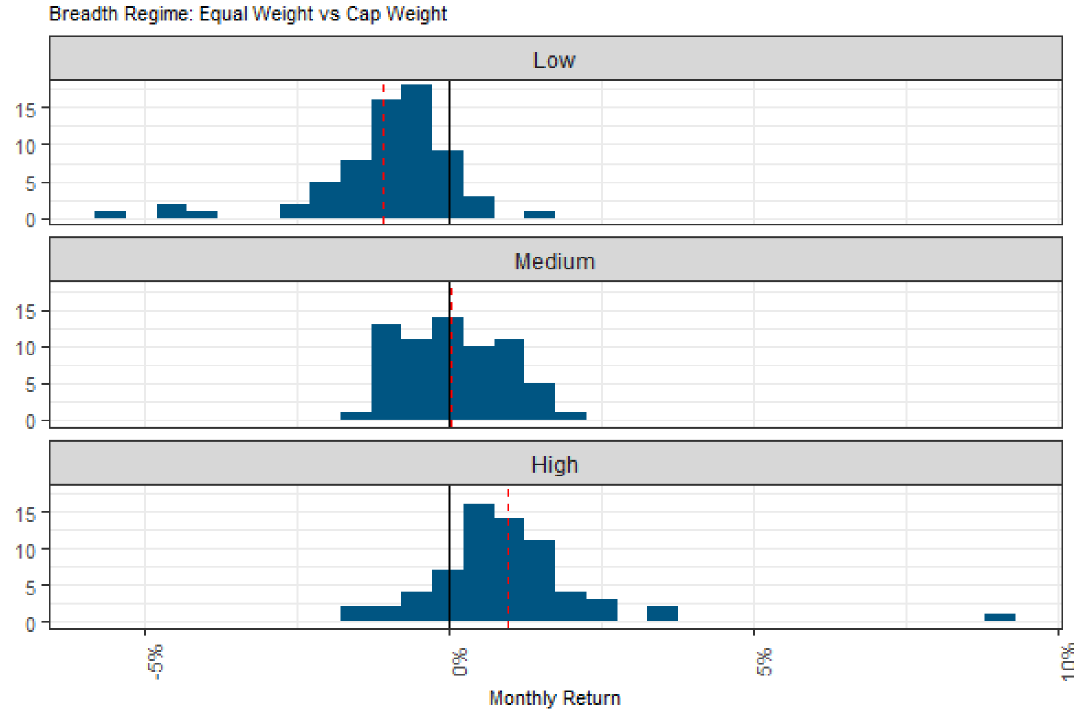
Source: IOR

EVALUATING THE CLAIMS: ACTIVE MANAGEMENT IN CONTEXT

Contrary to the conventional wisdom championed by active managers, our findings reveal no significant correlation between market dispersion or breadth and the relative success of active management strategies. This outcome suggests that the benefits of active management may not be as closely tied to these market conditions as previously thought. In light of this, we explore whether equal weighted indices may afford allocators refuge if trends in market capitalization reverse.

Exhibit 4 illustrates the distribution of excess returns for the S&P 500 Equal Weighted Index compared to the S&P 500 Cap Weighted Index across different breadth regimes. The plot reveals a distinct trend: as market breadth increases, the equal weighted index tends to outperform the cap weighted index. Unlike the inconsistent performance of active management under different market conditions, the excess returns of equal weighted indices are clearly linked to breadth regimes. This finding underscores the potential utility of equal weighted indices as a tool for managing concentration risks.

Exhibit 4: High Breadth a Tailwind for Equal Weight

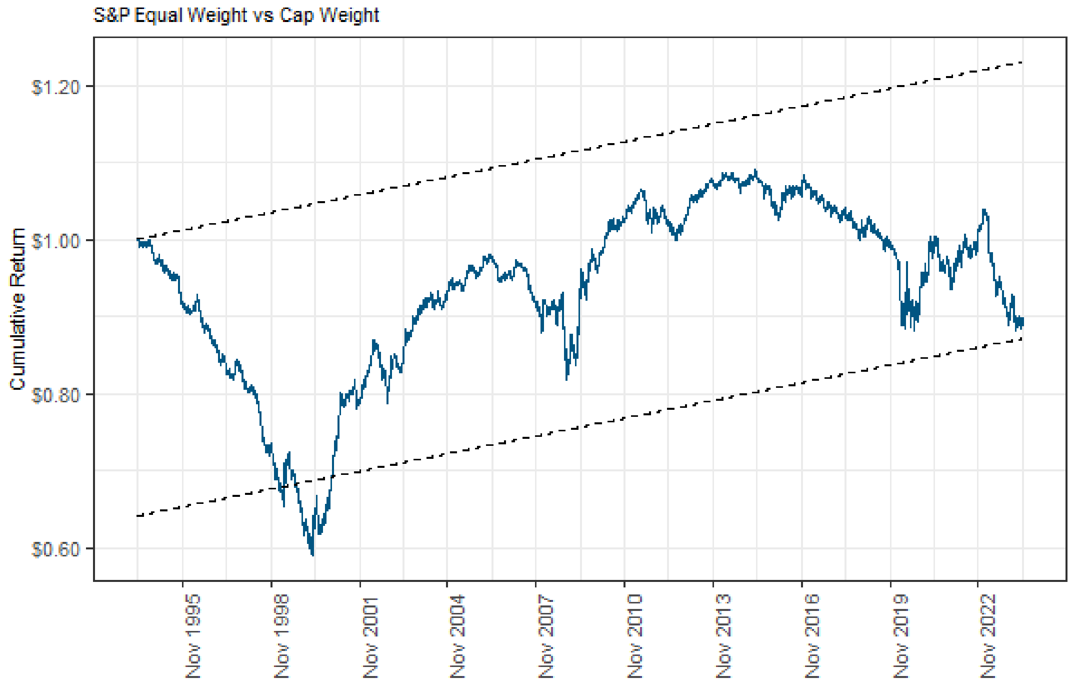


Source: IOR

STRATEGIC CONSIDERATIONS FOR ALLOCATORS

Importantly, it should be noted that equal weighted indices tend to underperform during periods of narrow market leadership. Therefore, if current concentration trends continue, we can expect equal weighted indices to lag behind. Given this, we are monitoring signs that the prevailing trend may reverse. **Exhibit 5** applies a linear regression to excess returns of the S&P 500 Equal Weighted vs. Cap Weighted indices. The dashed lines represent the upper and lower two standard deviation bands—a breach of these bands would indicate that the prevailing trend is overextended, signaling a higher probability of a reversal. Currently, the trend is near the lower two standard deviation band. While precise timing of a potential reversal is uncertain, the chart suggests that the risk-reward ratio may now be favorably skewed toward allocating in favor of the equal weighted index.

Exhibit 5: Tracking Potential Reversals in Equal vs. Cap Weighted Indices



Source: IOR

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