OSBORNE PARTNERS
Capital Management, LLC

The S&P 500 Concentration

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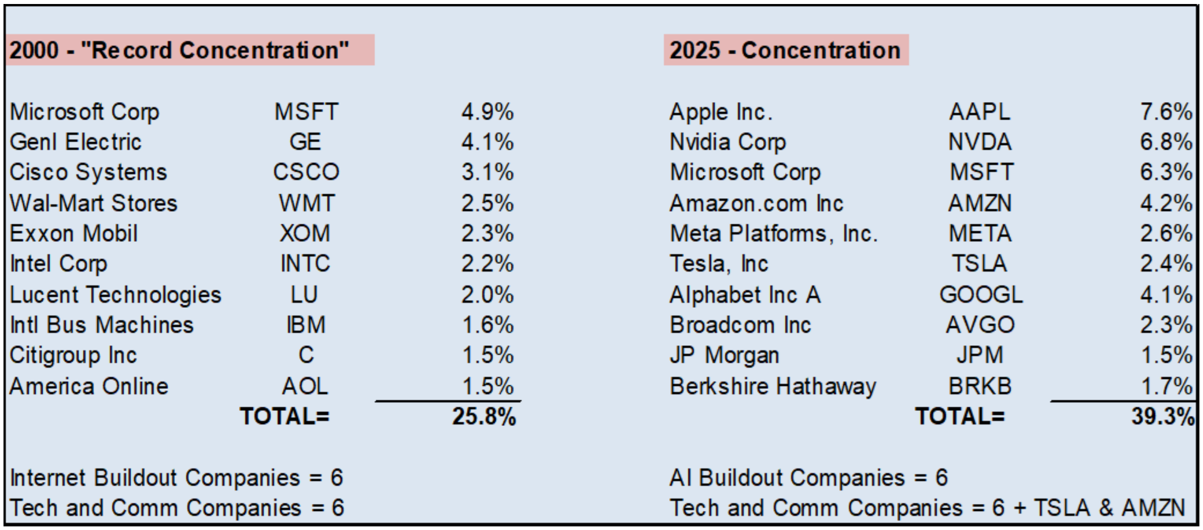
The S&P 500 is more concentrated today than at any other time in history. What does this mean for future returns of Growth stocks?

The past twenty-five years have been marked by asset bubbles, a global financial crisis, multiple bear markets, and rock-bottom interest rates for nearly half of the time. As we enter 2025, we face a new extreme of record concentration in domestic equities. Previously, the two most concentrated periods in history were 1980 and in early-2000 at the peak of the technology bubble, when the ten largest companies represented 26% of the market. In both periods, the companies that constituted the top ten underperformed the broader market in the subsequent years.

How concentrated are U.S. equities today? Today, the ten largest companies in the S&P 500 comprise nearly 40% of the index. Here is a side-by-side comparison of the "record concentration" in 2000 versus today.



2000 - "Record Concentration"			2025 - Concentration		
Microsoft Corp	MSFT	4.9%	Apple Inc.	AAPL	7.6%
Genl Electric	GE	4.1%	Nvidia Corp	NVDA	6.8%
Cisco Systems	CSCO	3.1%	Microsoft Corp	MSFT	6.3%
Wal-Mart Stores	WMT	2.5%	Amazon.com Inc	AMZN	4.2%
Exxon Mobil	XOM	2.3%	Meta Platforms, Inc.	META	2.6%
Intel Corp	INTC	2.2%	Tesla, Inc	TSLA	2.4%
Lucent Technologies	LU	2.0%	Alphabet Inc A	GOOGL	4.1%
Intl Bus Machines	IBM	1.6%	Broadcom Inc	AVGO	2.3%
Citigroup Inc	C	1.5%	JP Morgan	JPM	1.5%
America Online	AOL	1.5%	Berkshire Hathaway	BRKB	1.7%
	TOTAL=	25.8%		TOTAL=	39.3%
Internet Buildout Companies = 6			AI Buildout Companies = 6		
Tech and Comm Companies = 6			Tech and Comm Companies = 6 + TSLA & AMZN		

Source: Osborne Partners. 12/31/2024

It is hard to fathom that today, the largest stock index in the world's biggest stock market has ten companies equal to 40% of the entire index. Even more striking is that only one company from the top ten in 2000 remains among the ten largest today.

Here are a couple of other facts about the ten largest companies from 2000:

- Only eight of the companies exist today.
- Three have posted a negative return for the past 24 years.
- Exactly one of the ten have outperformed the S&P 500 since 2000: MSFT.
- The one outperformer, MSFT, underperformed the S&P 500 for nearly 19 years from 2000 to mid-2019.

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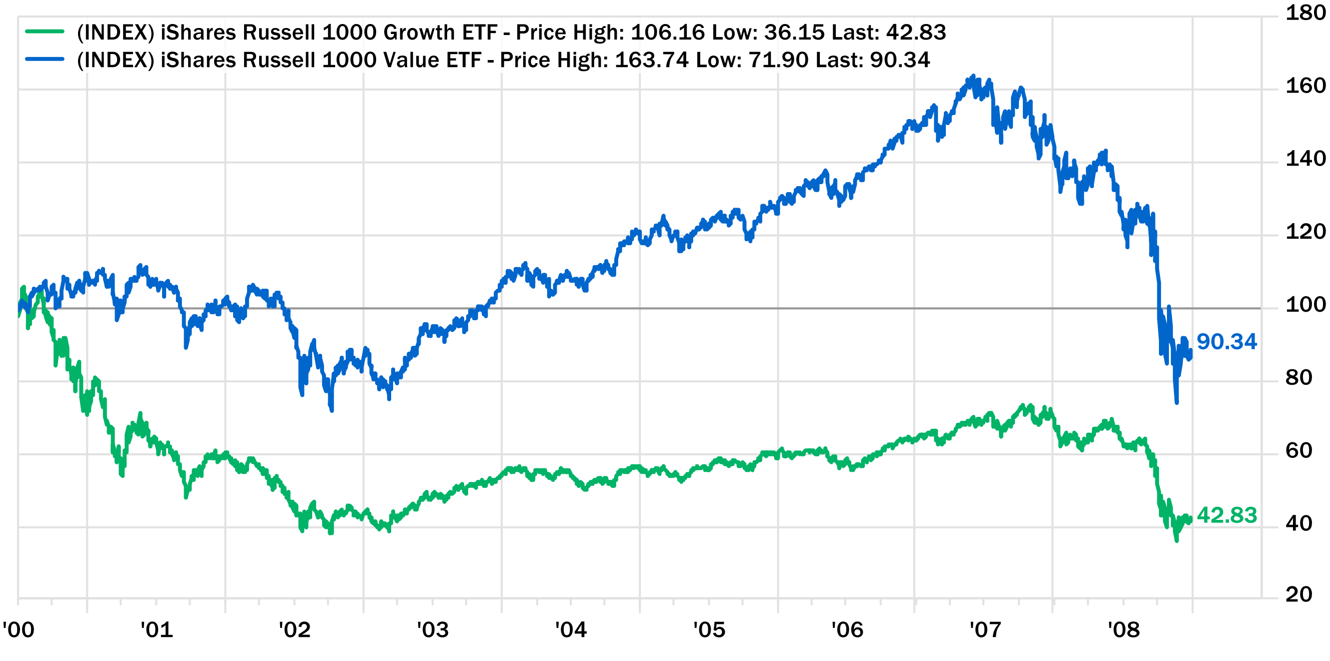
What does this say about the probability of the ten largest companies in 2025 outperforming in the future?

Just as mega-cap concentrations built up over the 1990s and culminated with a concentration peak and long-term future underperformance, a similar but more extreme build up has been seen since 2009.

But how did we get here? It's been a long journey that all started with the previous record concentration in 2000.

2000 TECH BUBBLE POPS: GROWTH OVERVALUED + S&P CONCENTRATED = BUY VALUE

The following chart shows what happened after the index concentration and technology peaks in 2000. From the 2000 peak through 2008, the Russell 1000® Growth Index (1000 largest Growth stocks) fell over 57%; annualizing at a nearly 10% loss per year for over eight years. Meanwhile, through two of the most major bear markets in a century, the Russell 1000® Value Index (1000 largest Value stocks) fell 9% total, and at one point in mid-2007 had outperformed Growth stocks by nearly 100% over seven years.



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Of course, by the end of 2008, investors had abandoned Growth stocks, since they "only go down." At the start of 2009, there was one technology stock in the ten largest, MSFT at a whopping 2% of the S&P 500.

However, this abandonment of Growth and subsequent once-a-century emergency monetary policy, was a perfect set up for Growth stocks to outperform.

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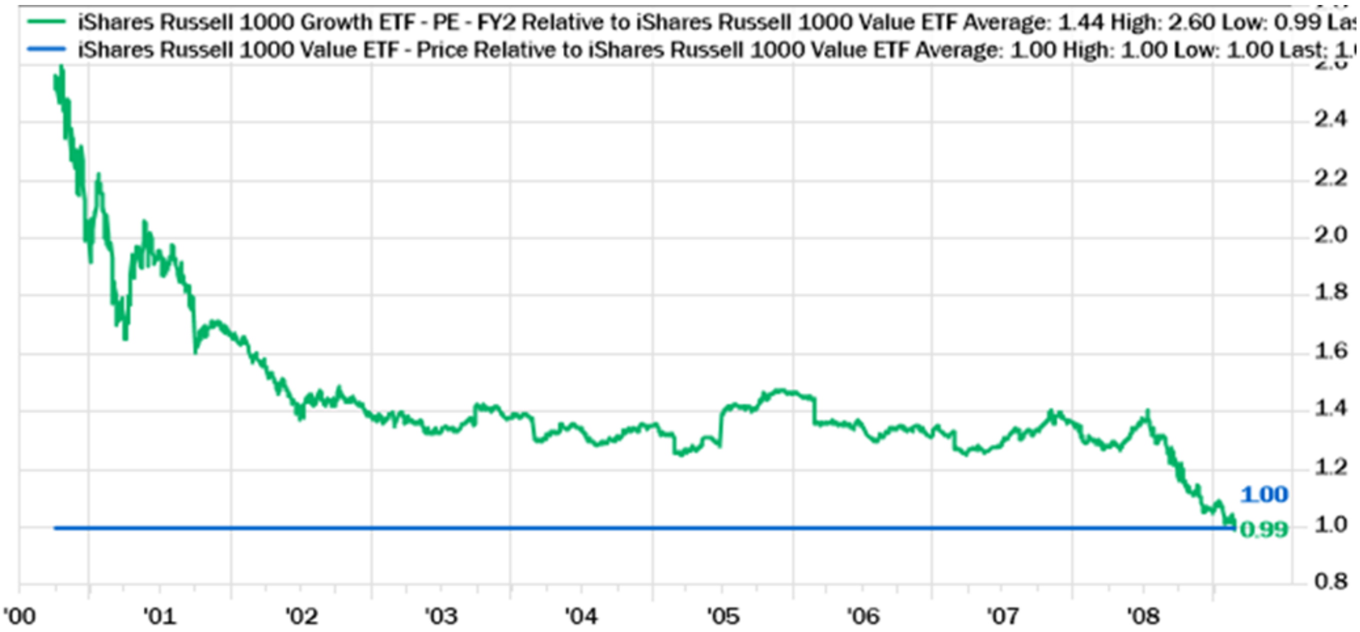
2009 GLOBAL FINANCIAL CRISIS: GROWTH ON SALE + ZIRP* = BUY GROWTH

Post-2000, the Growth stock valuation reset combined with major underperformance had caused investors to shun this cohort. However, by the end of 2008, for the first time in many decades, an astute investor could purchase Growth stocks at a discount to Value stocks. As seen in this next chart, within a few weeks of the ultimate stock market low in March 2009, Growth stocks that previously traded at over a 100% valuation premium to Value could now be purchased at a discount.



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At the same time, the Federal Reserve lowered the Fed Funds short-term interest rate from 5.50% to essentially 0% to combat the Global Financial Crisis and jump start the economy. Since Growth stocks are routinely valued on the present value of future earnings using an interest rate to discount the earnings to today, a 0% Fed Funds (zero interest rate policy, "ZIRP") makes those earnings higher and investors more comfortable owning and bidding up growth stocks.

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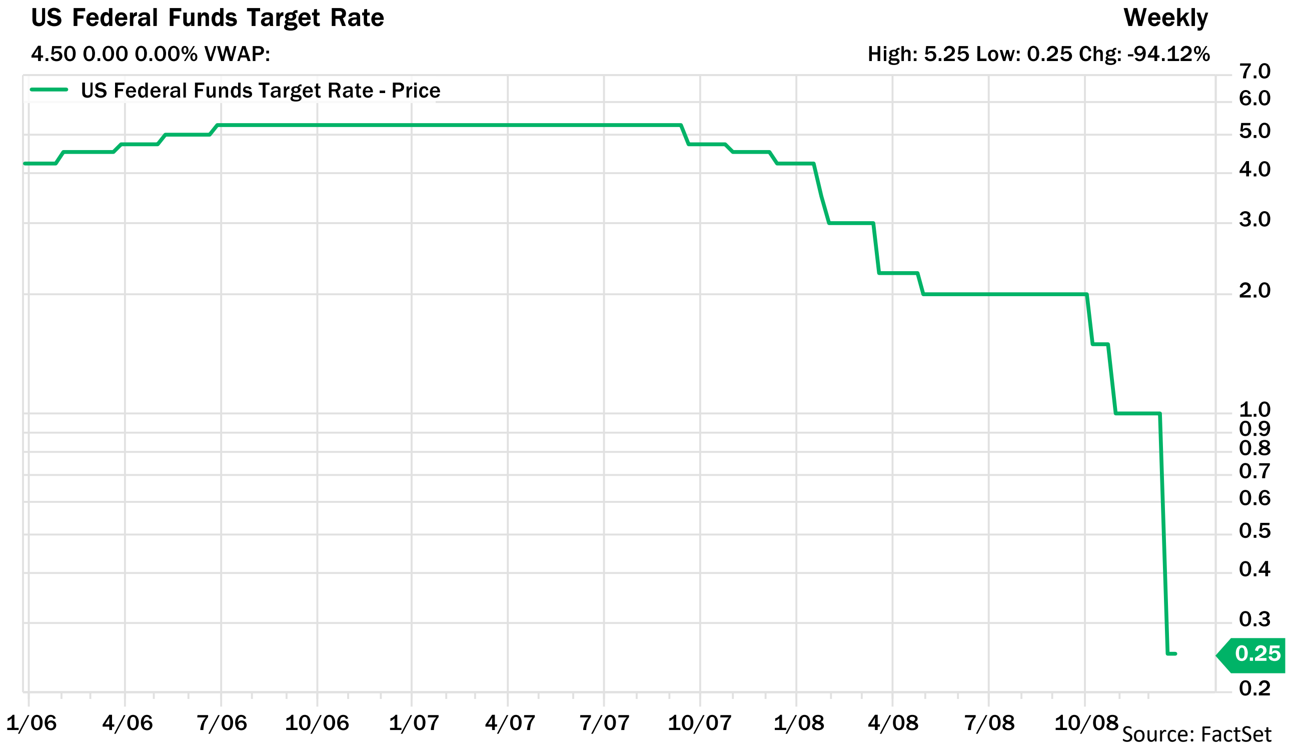

Source: FactSet

2013: CARRY TRADE + GROWTH AT A RELATIVE DISCOUNT = GROWTH OUTPERFORMANCE

By the start of 2013, Growth stocks had outperformed off of the 2009 low. In early 2013, Growth now traded at a 15% valuation premium to Value, which continued to be below the long-term average of about a 25% premium. But now an underrated tailwind for Growth was starting to ramp: the Carry Trade.

As the U.S. exited the Global Financial Crisis faster than most countries, and U.S. longer-term interest rates and currency rose, sophisticated institutions entered into numerous “carry trades”. A simple explanation of this strategy is when an investor borrows funds in a currency with a low-interest rate and with those borrowed funds invests in an asset offering a higher return. The preference is that the target investment be liquid in case the low interest rate rises, increasing borrowing costs, and the investment needs to be sold quickly for repayment. The investments used for the borrowed funds are more likely to be bonds and stocks versus illiquid investments like diamonds or art.

Starting around 2013, many institutions started to eye the Japanese carry trade. This first chart shows the interest rate yield difference between a U.S. ten-year Treasury and the Japanese equivalent. At the start of 2013, the U.S. yield was 100 basis points (1%) higher than Japan. But as time passed, the spread widened to over 200 basis points and by 2018 had reached 300 basis points.

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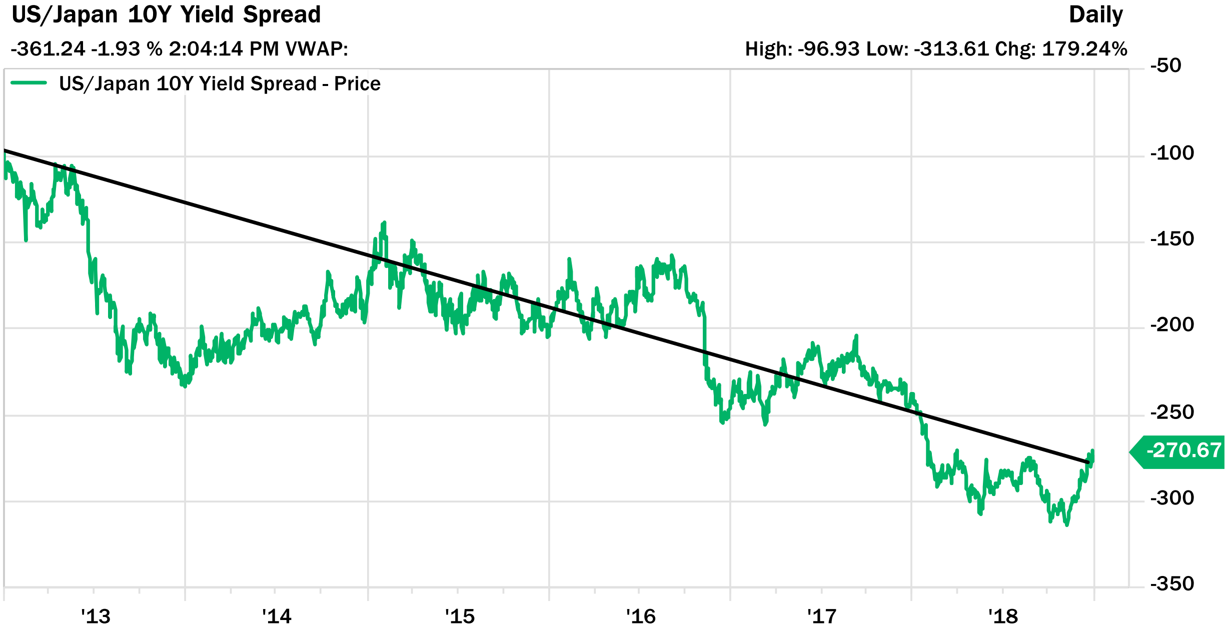
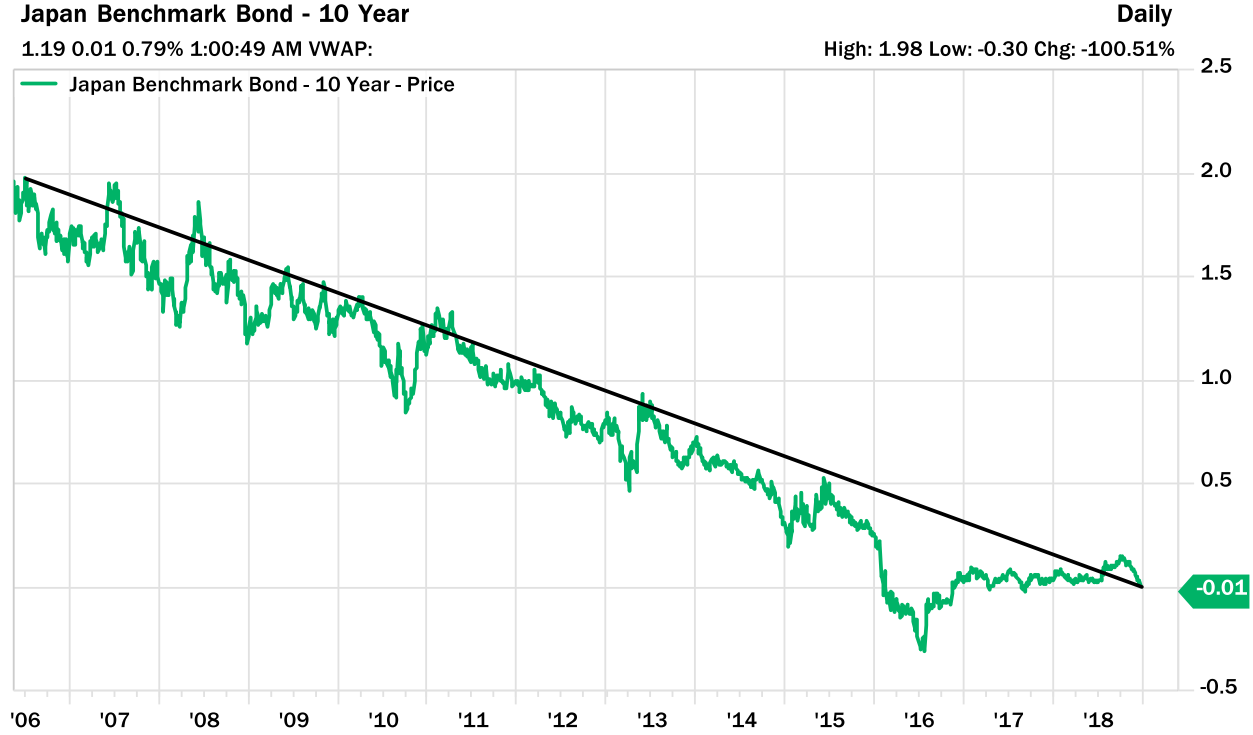


Source: FactSet

This second chart shows an investor's borrowing costs from Japan had fallen to below 1% to invest in a 4% U.S. Treasury, picking up a low-risk 3% return (the spread).



Source: FactSet

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But what if an institution was comfortable taking more risk by investing in stocks with the borrowed funds? The largest, most liquid stocks tend to be the largest U.S. stocks. Additionally, from 2013 through 2017 the Growth premium over Value vacillated between a 10% and 30% premium – at or below average.

Along with improved earnings and average relative valuations to Value stocks, various carry trades that targeted the largest Growth stocks helped Growth stocks to outperform Value stocks from 2013 to 2019 by nearly 38%.

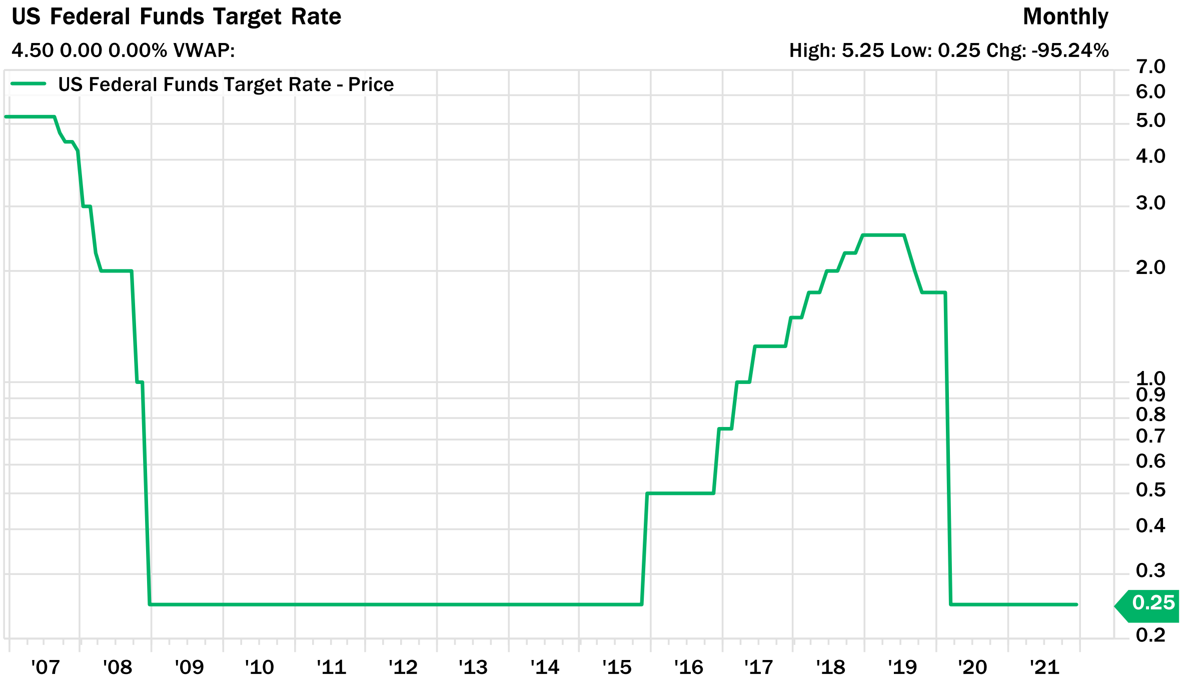
However, by the middle of 2019, the Growth valuation premium had expanded to nearly 50%, and Growth stocks started to underperform. Then COVID hit…

2020 COVID RESETS MARKETS TO THE GLOBAL FINANCIAL CRISIS: ZIRP = BUY GROWTH

By 2019, the Federal Reserve had started to normalize the once-a-century 0% interest rates. The Fed Funds rate had been increased to 2.50% and at that rate, along with relative valuations starting to favor Value stocks, the Growth trade had started to crack.

However, once COVID hit, the Federal Reserve, fearing an economic depression, reduced the Fed Funds rate back to 0%, the second time this "once-a-century" action was needed in barely a decade.

With zero interest rate policy (ZIRP) back in place, the green light was back on for Growth stocks. After the initial implosion of all stocks in the early months of COVID, investors (like Osborne Partners) dove into Growth stocks when they briefly traded under 16x earnings. Growth outperformed Value in 2020 by over 35%.



Source: FactSet

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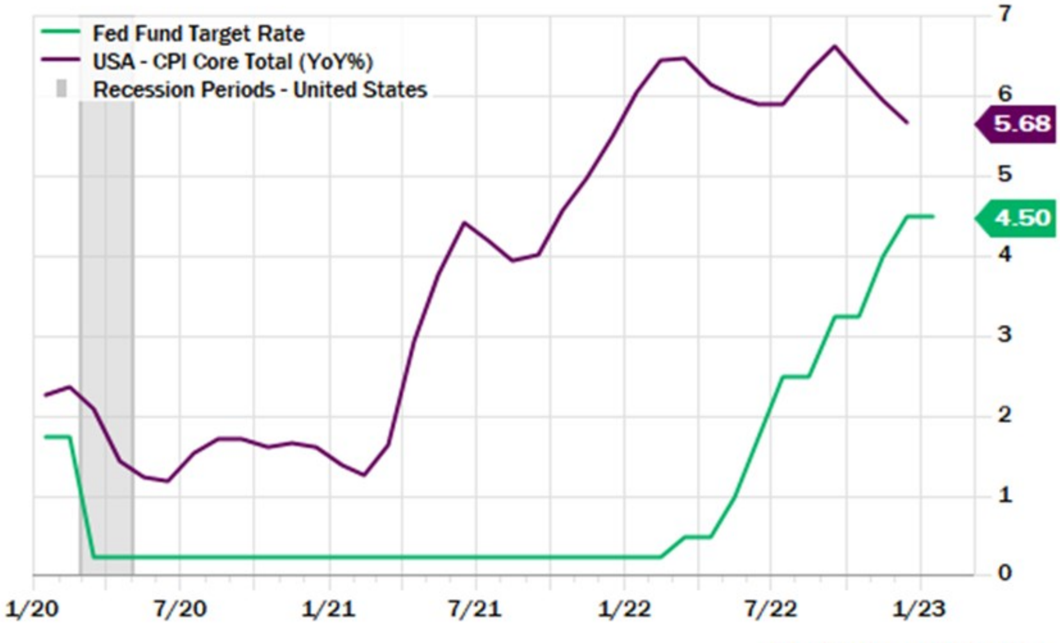
2021 COVID POLICIES CAUSE INFLATION SPIKE: FED TIGHTENS = GROWTH DESTROYED

Unlike the first “once-a-century” Fed Funds reduction to 0% that resulted in very little inflation, the COVID-derived Fed Funds reduction to 0% caused a massive spike in inflation from slightly above 1% to well over 6% by early 2022. Core CPI is shown in purple in the following chart.

Once the economy started to recover from COVID, the Fed needed to pivot from helping the economy to fighting multi-decade high inflation. By the end of 2022, the Fed Funds rate had increased to 4.50%, on its way to a 5.50% peak in 2023.



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The combination of rising interest rates and high valuations was a recipe for disaster for Growth stocks in 2022. While Value stocks lost about 7%, Growth stocks fell nearly 30%, with many of the more speculative Growth stocks falling 50% or more. More importantly, the “Magnificent-7” mega-cap Growth stocks that were favorites of individual investors, high risk hedge funds, and the carry trade, lost nearly half of their value in one year, falling 46%.

2024: INFLATION NORMALIZING BUT FED DELAYS EASING = EARNINGS GROWTH CONCENTRATED IN DATACENTER BUILDOUT FOR AI AND INFLATION PUSHERS

Entering 2024, with inflation falling from 6.5% to less than 4%, potentially on the way to normalizing below 3%, the Fed was likely to start normalizing interest rates back down to 3% or less. But after a few inflation anomalies caused the first couple of months of 2024 to show stubborn inflation, the Fed delayed the start of the easing cycle until September. This unwarranted delay caused numerous short-term equities problems in the U.S.. First, it caused the fundamental improvement in cyclical/value stocks to be delayed as high interest rates were hurting demand. Second, it caused earnings growth to be found in only a few narrow sub-segments of the market, most notably companies involved in the hardware buildout of datacenters for AI, software, and defensive companies that could somehow pass on inflation.

By the end of 2024, although the median U.S. stock rose only 3.9% and nearly 50% of all U.S. stocks posted a negative return, a small cohort of companies, most notably the 7 to 10 largest companies were up 65% (Mag-7) and 52% (10 largest), representing most of the gain for the entire S&P 500.

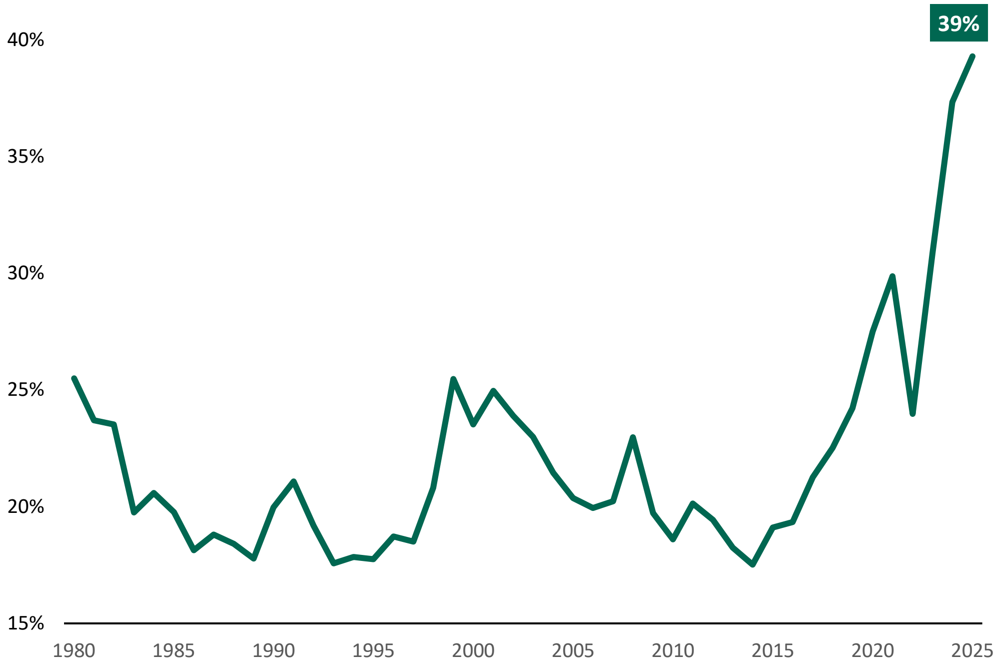
This phenomenon now places the major U.S. stock index, the S&P 500, in potentially the most dangerous position seen since the technology bubble in 2000.

END OF 2024: RECORD HIGH S&P 500 CONCENTRATION AND 2000-ESQUE ABSOLUTE AND RELATIVE VALUTIONS IN GROWTH

Since 2000, we've seen numerous bear markets and two lengthy (and rare) stints of interest rates tethered at 0% which caused dangerous speculation and Growth stock outperformance. So, where do U.S. stocks stand as we start 2025?

First, as mentioned earlier, after peaking at 26% two different times over the past 50 years, the ten largest holdings in the S&P 500 are now nearly 40% of the index. History has shown this is not the time to own these mega-cap growth stocks, regardless of valuation.

Market cap of 10 largest S&P 500 firms, % of index total



Source: S&P

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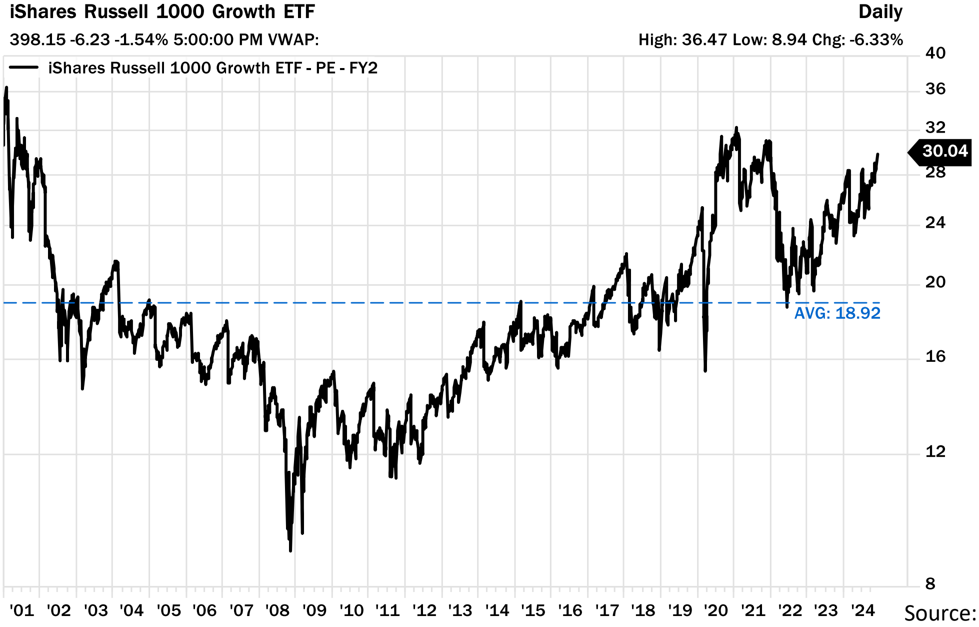
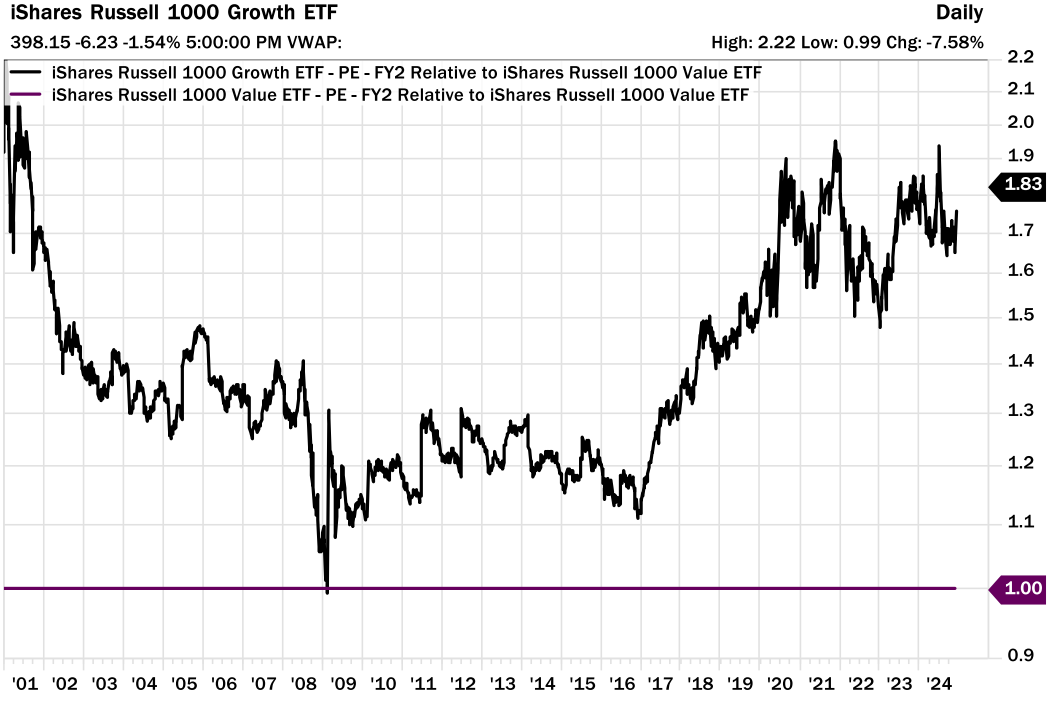
Speaking of valuation, after bottoming at a forward earnings P/E of 10x in 2009, the Russell 1000® Growth index trades at a forward P/E of over 30x – three times higher than the bottom and over 50% above the long-term average of 19x.



Source: FactSet

On a relative basis, after trading at a discount to Value stocks in early 2009, Growth stocks now trade at an 83% premium, nearly matching the 2021 high.



Source: FactSet

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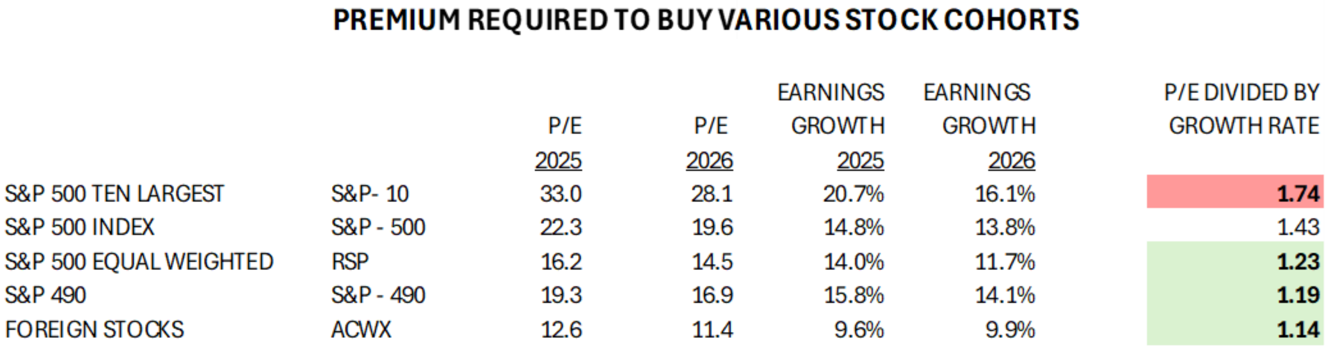
2025: THE DANGER IN GROWTH EVEN ASSUMING STRONG FORWARD EARNINGS GROWTH

The typical argument for owning Growth stocks when they are overvalued is either a qualitative argument – “they’re the best…everyone loves them…it’s the technology of the future…the CEO has an amazing black alligator skin jacket”, or a more quantitative argument pertaining to earnings growth – “they grow faster, so you should pay more for them.” Let’s examine that argument using estimated earnings growth rates.

As seen in these next tables, the ten-largest companies are expected to have higher earnings growth in 2025 and 2026 versus the other four cohorts listed – the entire S&P 500, the equal-weighted S&P 500, the S&P 490 excluding the ten-largest, and the rest of the world (ACWX). However, along with the higher earnings growth is a far higher valuation.

Looking at each group and simply calculating the P/E divided by the earnings growth rate (PEG), the premium price required to own the equal-weighted S&P 500, the S&P 490, and foreign stocks is a very reasonable 1.14-1.23 (14% to 23%). However, if an investor wants to own the ten largest, that investor must pay a 74% premium for the earnings growth they may receive.

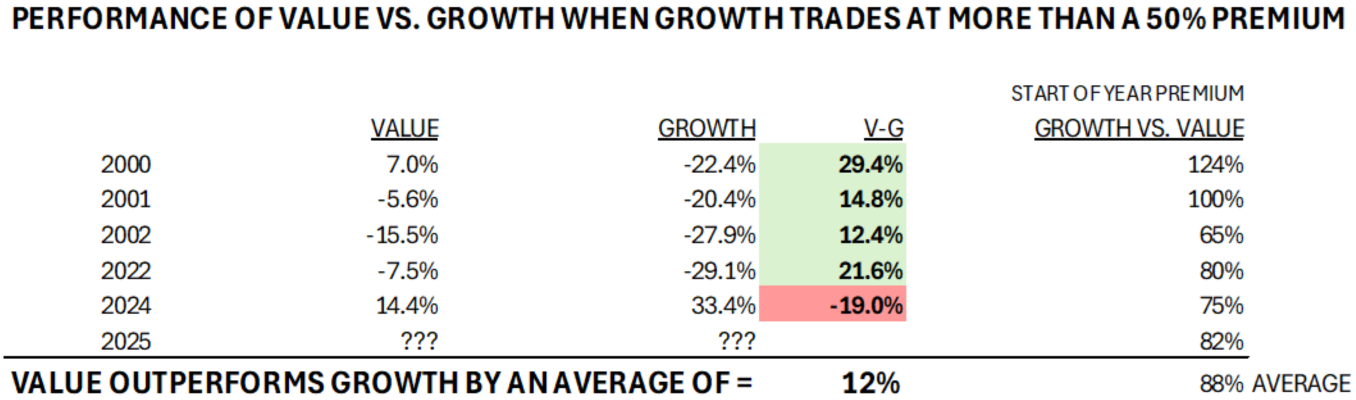


PREMIUM REQUIRED TO BUY VARIOUS STOCK COHORTS

		P/E 2025	P/E 2026	EARNINGS GROWTH 2025	EARNINGS GROWTH 2026	P/E DIVIDED BY GROWTH RATE
S&P 500 TEN LARGEST	S&P- 10	33.0	28.1	20.7%	16.1%	**1.74**
S&P 500 INDEX	S&P - 500	22.3	19.6	14.8%	13.8%	1.43
S&P 500 EQUAL WEIGHTED	RSP	16.2	14.5	14.0%	11.7%	**1.23**
S&P 490	S&P - 490	19.3	16.9	15.8%	14.1%	**1.19**
FOREIGN STOCKS	ACWX	12.6	11.4	9.6%	9.9%	**1.14**

Source: OPCM

As a side note, a general word of caution lies in the historic relationship between Growth and Value when the Growth valuation premium is above 50% to start the year. Although 2024 was an exception due to the reasons previously discussed, the historic results have not been great for Growth when premiums pierce 50% - and are over 80% today.



PERFORMANCE OF VALUE VS. GROWTH WHEN GROWTH TRADES AT MORE THAN A 50% PREMIUM

	VALUE	GROWTH	V-G	START OF YEAR PREMIUM GROWTH VS. VALUE
2000	7.0%	-22.4%	**29.4%**	124%
2001	-5.6%	-20.4%	**14.8%**	100%
2002	-15.5%	-27.9%	**12.4%**	65%
2022	-7.5%	-29.1%	**21.6%**	80%
2024	14.4%	33.4%	**-19.0%**	75%
2025	???	???		82%
VALUE OUTPERFORMS GROWTH BY AN AVERAGE OF =			**12%**	88% AVERAGE

Source: OPCM

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2025: RECIPE FOR RECORD CONCENTRATION AND OVERVALUATION TO CONTINUE

The recipe for a continuation of 2024's anomaly would require most of the following to occur.

- The Fed delays further interest rate cuts through 2025.
- Delay in broadening of earnings growth for another full year.
- Strong U.S. dollar continues through 2025.
- AI hardware buildout grows at the same pace as 2024.
- The ten-largest companies grow earnings far above already elevated expectations.

DISCIPLINED, STYLE-AGNOSTIC INVESTING POINTS TO THE MAJORITY OF OPPORTUNITIES ARE OUTSIDE OF THE S&P 10 (40% OF THE INDEX).

One of the reasons our investment discipline has worked well for the past three decades is because we are style-agnostic. We invest in individual companies that provide the highest reward-to-risk ratio (RR), regardless of size or style. Some periods we find the best RRs in large-cap growth, like 2009. At other times we find superior RRs in more cyclical/value companies, like today. The key is when we write about one style having potentially exceptional future returns versus another, we are not expressing the opinion due to having a particular management style.

Today, when we say the RRs are generally poor in the largest growth companies and strong in large-to-midsized cyclical/value companies, this is not because we are a value manager who is praying for our style to lead after many years of underperforming. We say this because it is our unbiased opinion and our research indicates this is where many of the future outperformers reside.

At the time of this writing, the Osborne Partners U.S. equities asset class trades at a forward P/E of 17x with estimated earnings growth of over 15% or a PEG of 1.08 (only an 8% premium). The portfolio sports a free cash flow yield of over 5.3%, and importantly the average balance sheet leverage (debt minus cash divided by profit) is close to zero versus the S&P 500 at 1.7x.

We have a lengthy watch list of potential new portfolio investments. From a style-agnostic standpoint, the majority of these candidates are either outside the largest U.S. stocks or outside the U.S. itself. Being disciplined and style agnostic helps the investment team avoid being married to a particular style and avoid being heavily invested in the most vulnerable companies at the wrong times. ■

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