# Concentrated Disruption

June 2021

DelMarche

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## Points of Discussion

**01** Concentration within the IT Sector Surrounding Substantial Bear Markets

**02** Concentration within the IT Sector Leaders over Time


## Abstract

Our paper is focused on researching the growing concentration within the information technology sector of the S&P 500 during two highlighted market drawdowns. The paper specifically looks into the Dot-com Bubble and the COVID-19 Crisis to uncover similarities and differences during the markets surrounding two of the historic bear markets. Finally, we dig into the attributes of "New Economy" stocks and how the concentration at the top of the S&P 500 is affecting the index's returns. Ultimately, we want to identify how, or if, diversification and performance are adversely impacted during these time periods.


## Introduction:

Horse drawn carriages and the Internet, two good ideas separated by hundreds of years and relevant to this paper when considering that all things have a place in time and contribute to the innovation and growth of their eras. The clear difference is that before the turn of the last century, technological advancements permeated society and global markets at the plodding pace of a horse, while technological innovations today are integrated at the speed of a gigabit connection—impacting society and economic growth over months rather than decades. What is similar about both periods in time is that innovative ideas and the strong leadership of a small group of forward thinkers proved to be very successful.

Today's version of technology-based market leadership emerged with the broad adoption of the internet in the early 1990s. The internet opened new pathways for market penetration and the distribution of ideas. While exuberance for the growing reach of the internet helped fuel the Dot-com Bubble, the accelerated flow of information remains important today for the distribution of products and services. Companies that have managed to effectively utilize these new distribution models have seen exponential growth in both revenues and market capitalization. However, this robust success has created both strong returns and growing concentration risks in many broad market indices.

This paper will focus on assessing the impact of concentration within the S&P 500 and identify what drove market performance and sector leadership over the last few market cycles. We will also seek to highlight the importance of diversification over the long term.

We will:

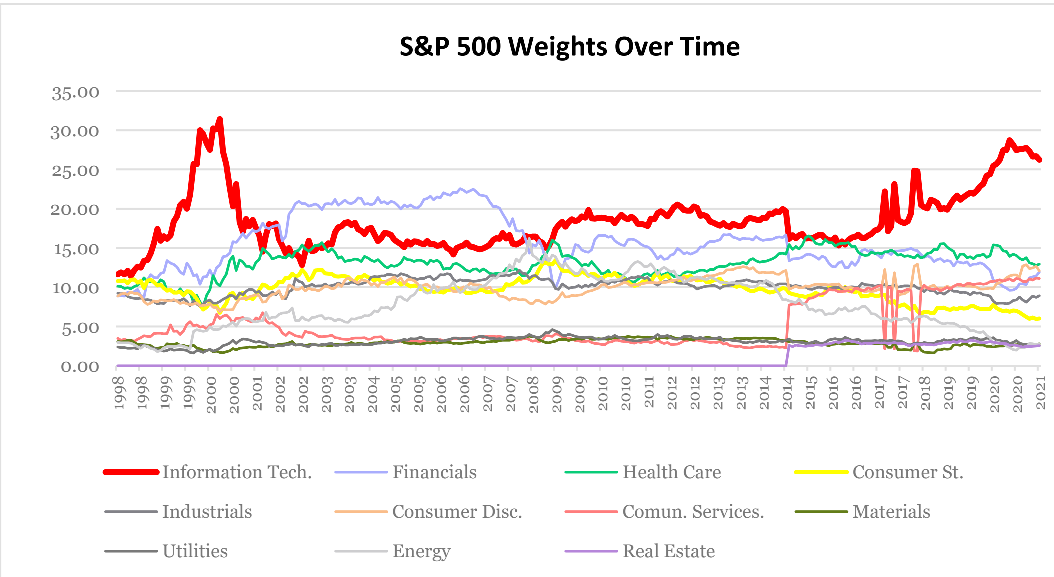
- Look into trends present within the information technology sector over the past 25 years and highlight the similarities and differences we found when comparing the Dot-com Bubble and the COVID-19 Crisis.
- Uncover which stocks drove returns before and after market downturns.
- Look under the hood of "New Economy Stocks" to see how those names have impacted S&P 500 returns.

**NEW ECONOMY STOCKS** – *A BROAD BASE OF INNOVATIVE COMPANIES THAT ARE LEADING THE TRANSITION TO THE INTERNET AND CLOUD. THINK: THE INTERNET OF THINGS, SOCIAL MEDIA, CRYPTOCURRENCY, CLOUD STORAGE, E-COMMERCE, STREAMING, FINTECH, ARTIFICIAL INTELLIGENCE AND MAY EXHIBIT LESS STABLE FUNDAMENTALS OVER MULTIPLE MARKET CYCLES.*

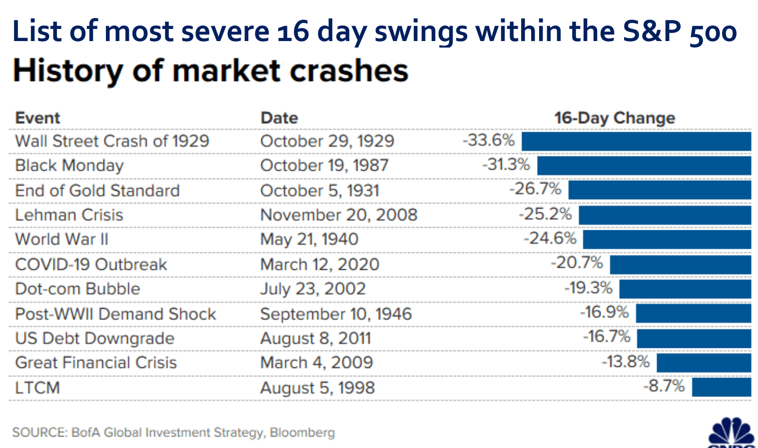
**OLD ECONOMY STOCKS** – *WERE BUILT ON INNOVATION, AND MAY STILL OFFER NEW IDEAS, BUT GENERALLY ARE LARGER, MATURE, WELL-ESTABLISHED BUSINESSES WITH RELATIVELY STEADY FUNDAMENTALS OVER MULTIPLE MARKET CYCLES.*[1]

This paper's analysis is focused on the two bear markets in which we observed that information technology had grown to account for more than 25% of the S&P 500 Index, followed by the subsequent decline in their leadership.

Since 1990, there have been two instances where an equity market sector's weight composed more than 25% of the S&P 500. The most recent bear market and subsequent recovery, from February 2020 to April 2021, marks the second instance, with information technology accounting for more than a 25% weight in the S&P 500 Index. The previous occurrence was in the late 1990s to early 2000s, more commonly referred to as the Dot-com era. Market and economic factors varied going into each significant drawdown; however, information technology-related stocks and seemingly frenzied growth were clear contributors to return just before the market's abrupt change of direction in 2000 and 2020.




The magnitude of these market corrections was not only significant to wealth creation, but also to investors' behavioral responses. Trailing only the Wall Street Crash of 1929 and the Great Financial Crisis (2007-2009), the Dot-com Bubble (1999-2000) was the third largest drawdown in the S&P 500's history (-49.0%). The global pandemic, which brought on the shortest bear market in recent history, began in mid-February 2020. It accounted for a (-34%) market drawdown, which lasted until late March 2020. Note in the table how the COVID-19 crash stacked up historically to the largest 16-day swings in the market's history since 1929.


List of most severe 16 day swings within the S&P 500

History of market crashes

| Event | Date | 16-Day Change |
|---|---|---|
| Wall Street Crash of 1929 | October 29, 1929 | -33.6% |
| Black Monday | October 19, 1987 | -31.3% |
| End of Gold Standard | October 5, 1931 | -26.7% |
| Lehman Crisis | November 20, 2008 | -25.2% |
| World War II | May 21, 1940 | -24.6% |
| COVID-19 Outbreak | March 12, 2020 | -20.7% |
| Dot-com Bubble | July 23, 2002 | -19.3% |
| Post-WWII Demand Shock | September 10, 1946 | -16.9% |
| US Debt Downgrade | August 8, 2011 | -16.7% |
| Great Financial Crisis | March 4, 2009 | -13.8% |
| LTCM | August 5, 1998 | -8.7% |

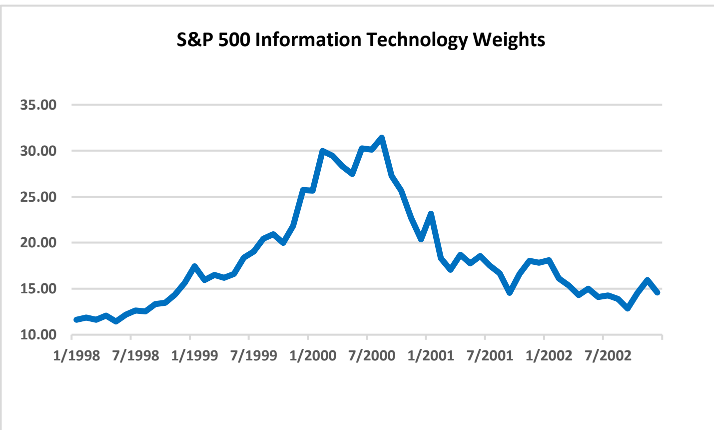
SOURCE: BofA Global Investment Strategy, Bloomberg

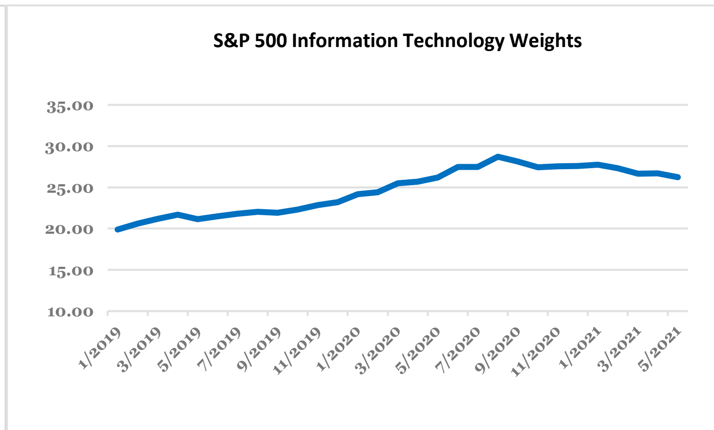
[1] *What's the difference between old- and new-economy stocks?* FNTalk.com. (2018, March 3). https://fntalk.com/economy/whats-difference-old-new-economy-stocks/.

**INTANGIBLE ASSETS –** *ITEMS UNABLE TO BE SEPARATED FROM A CORPORATION INCLUDING INTELLECTUAL PROPERTY, R&D, TRADEMARKS, PATENTS, AND SOFTWARE.*

## *The Information Technology Sector over Time:*

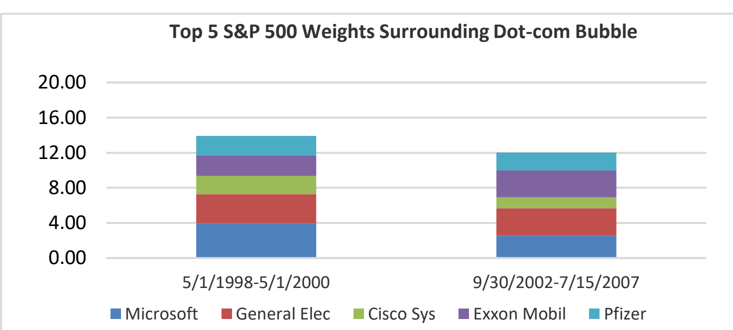
There were two trends occurring in the information technology sector leading up to both the Dot-com Bubble and COVID-19 Crisis; overall sector weight increases and the concentration in a select group of technology-related stocks. The information technology sector averaged an 18.7% weight within the index during the Dot-com Bubble, reaching a high of 31.6% during August of 2000. Since the COVID-19 pandemic, information technology has been flirting with the Dot-com record, reaching a high of 28.7% at the end of August 2020. While the IT sector's peak weights are nearly two decades apart, they were at similar levels just before a drop. Interestingly, both IT sector peaks occurred in the month of August.

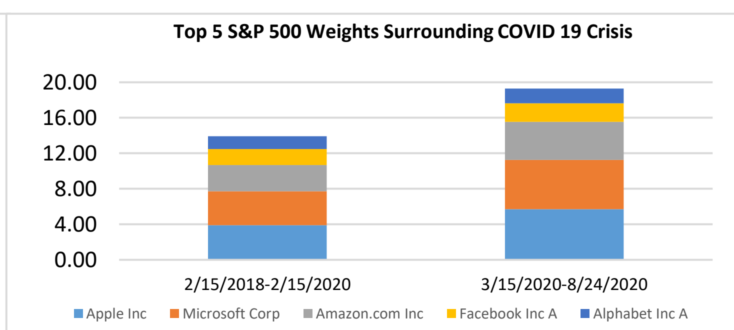



## *New Leaders, Same Wolf Pack:*

A recognized difference between technology leadership in the late 1990s and early 2000s compared to today is that the current leaders have more sustainable business models than the startups that emerged during the Dot-com era. Today's successful new economy companies are investing in intangible assets as a path to grow revenues. First quartile companies in terms of growth in gross value-added that are located in the telecommunications, media, and technology sectors were found to have invested 5.2 times more in intangibles than companies falling in the bottom two quartiles.[2] These increases in intangible assets include investments in R&D, software, and the filing of new patents. Companies falling in the top quintile of the largest 750 U.S. Stocks, when ranked by R&D to sales, have outperformed names falling in the bottom quintile by 5.6% annually from 2011-2020.[3] This activity, along with strong investor support, has resulted in an increase in security concentration within the IT sector (and in



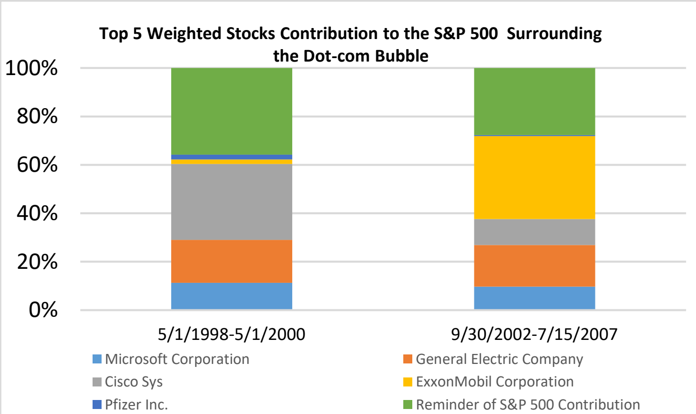

[2] Hazan, E., Smit, S., Woetzel, J., Cvetanovski, B., Krishnan, M., Gregg, B., Perrey, J., & Hjartar, K. (2021, June 17). *Getting tangible about intangibles: The future of growth and productivity?* McKinsey & Company. https://www.mckinsey.com/business-functions/marketing-and-sales/our-insights/getting-tangible-about-intangibles-the-future-of-growth-and-productivity.

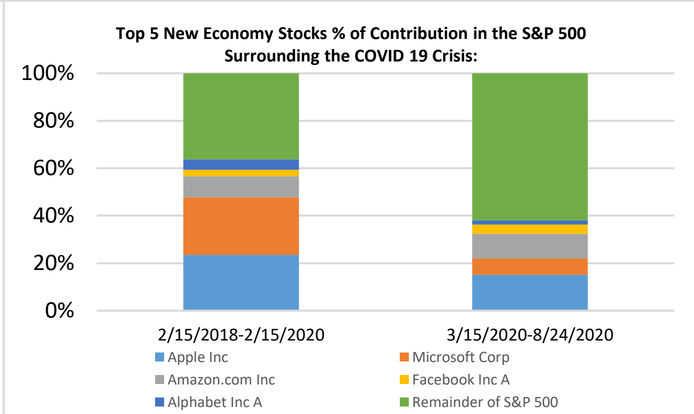
[3] Nicolaescu , M. G., Neuman, B. (2021, June). *Innovation: Driving Returns and Wealth Creation*. Alger. *DeMarche Webinar - Facing the Fear: Asset Allocation in a Post-COVID World*.

some cases, IT-related stocks that have been reclassified to other sectors). Concentration today is arguably more present than it has ever been, with New Economy stocks such as Apple, Microsoft, Amazon, Facebook, and Google (Alphabet Inc.) accounting for a combined average weight of 18% in the S&P 500 Index over the trailing 15 months. The last time the S&P 500 experienced concentration nearing these levels was in 2000 where Exxon Mobil, General Electric, Cisco Systems, Microsoft, and Pfizer occupied similar territory, accounting for an average weight of 14% during the bull market leading up to the burst of the Dot-com Bubble. Concentration present at the top of the IT sector drove returns before the market decline, but also rebounded strongly after.

## *How Could Concentration Impact your Portfolio?*

The S&P 500 is a market-capitalization weighted index; thus, concentration in a handful of stocks may drive the index's returns. Those same securities may be overweight in your portfolio as more than one of your investment managers may hold them. Since the internet's entrance as a market phenomenon in the 1990s, New Economy stocks have meaningfully impacted S&P 500 returns. The top five largest market-weighted stocks in the S&P 500 contributed around 65% of the return during the bull market preceding the Dot-com Bubble. Similarly the top five New Economy stocks contributed 62% of the index's returns during the bull market preceding the COVID-19 outbreak. Interestingly, the return trend following the market downturns differed. The graph below shows the recovery of the Dot-com Bubble was predominately driven by the same top five stocks as the initial bull market preceding the drawdown, whereas the recovery following the COVID-19 Crisis shows the returns are driven by the remainder of the S&P 500 stocks not the top five New Economy stocks.




The current result could be attributed to the unique aspects of the global market shutdown and potentially the impact of Tesla not being added to the S&P 500 until mid-December. Regardless, we believe a diversified portfolio is the key to long-term market success and that portfolio concentrations should be reviewed regularly in accordance with investment policy statements.

## *Conclusion:*

Investment decision making in the last 18 months has been challenging. We witnessed uncommon market behavior as growth-oriented stocks led going into the market decline AND coming out of it through October 2020. Going forward, investors have a plethora of issues to consider in building efficient, successful portfolios to meet their respective long-term objectives. New Economy stock concentrations remain an ongoing phenomenon, and their potential impact on performance should be considered in both up and down market periods. At DeMarche, we focus our clients' attention on understanding relationships within risk and return to build investment policies that leave room for opportunities, while also ensuring guardrails are in place to ease behavioral tendencies in times of stress.

In closing we ask, how have New Economy stocks impacted your portfolio, and what steps have you taken to prepare for the future? We stand ready to have that conversation with you and help you plan to meet your long-term investment policy objectives.

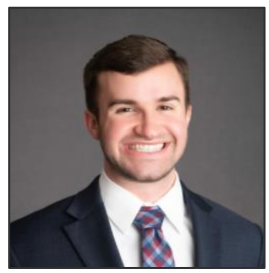
*Sources Utilized:*

- *Morningstar*
- *CNBC*
- *McKinsey & Company*
- *Fred Alger & Company, LLC*

## Put Research to Work

with the DeMarche Team

**Peg VanWagoner**
Senior Consultant
(913) 981-1364
pvanwagoner@demarche.com



**Jack O'Brien**
Associate,
Investment Research
(913) 981-1306
jobrien@demarche.com