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Tips for Managing the Concentration of U.S. Stocks in Global Equity Strategies

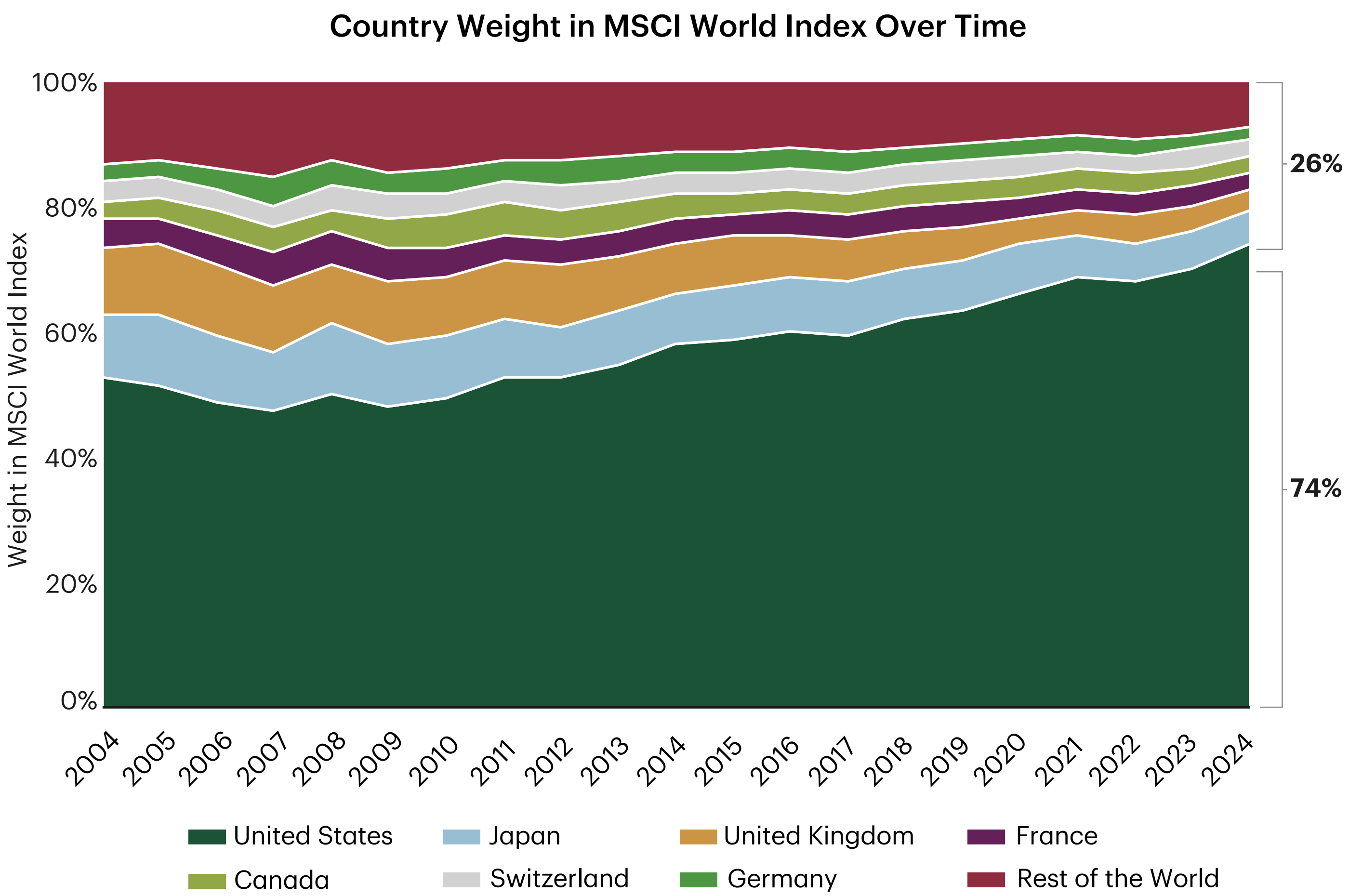
Nifty Fifty, FAANG, Magnificent 7 - the media is obsessed with acronyms and names for the groups of equity securities that dominate market performance. The S&P 500 Index, and by extension the MSCI World Index, which now has over a 70% weight in the U.S.,[1] have indeed grown more concentrated over time and this has become a cause of concern for many investors. Various global equity markets have had similar experiences in the past. For example, Nokia made up 72% of the Helsinki All Share Index in March 2000.[2] Nortel was a heavy weight in the Toronto Stock Exchange at 33% at its peak in August 2000.[3] China Mobile carried 18% of weight in the MSCI China Index in 2007.[4] Nokia, Nortel and China Mobile are no longer dominant constituents in their respective markets, exemplifying performance reversal over time. While we do not expect imminent underperformance of the Magnificent 7 stocks (which include Alphabet Inc., Microsoft Corporation, Apple Inc., Amazon.com, Inc., NVIDIA Corporation, Tesla, Inc. and Meta Platforms, Inc.), the current level of concentration presents challenges for active managers and risks to investors. Being underweight these stocks may be a likely source of underperformance, while being overweight may make the portfolio more volatile and less diverse.

[1] https://www.msci.com/documents/10199/178e6643-6ae6-47b9-82be-e1fc565ededb (Accessed February 25, 2025)
[2] Source: https://www.lseg.com/en/insights/ftse-russell/when-is-an-index-too-concentrated#:~:text=In%202000%2C%20during%20the%20technology,again%20reached%20the%20same%20heights (Accessed February 25, 2025)
[3] Source: https://www.cbc.ca/news/business/nortel-and-the-tse-299-1.230333 (Accessed February 25, 2025)
[4] Source: TDAM, FactSet Research System

Evolution of U.S. Dominance in Global Equities

For many investors, Global Equity is a popular strategy; it's simple to implement and provides diversified exposure to developed equity markets. While the U.S. has always dominated the MSCI World Index, its current weight of approximately 74% has drastically reduced the significance of other markets. The U.S. has consistently outperformed other regions since recovering from the global financial crisis in 2009, so its weight in the MSCI World Index has grown since.

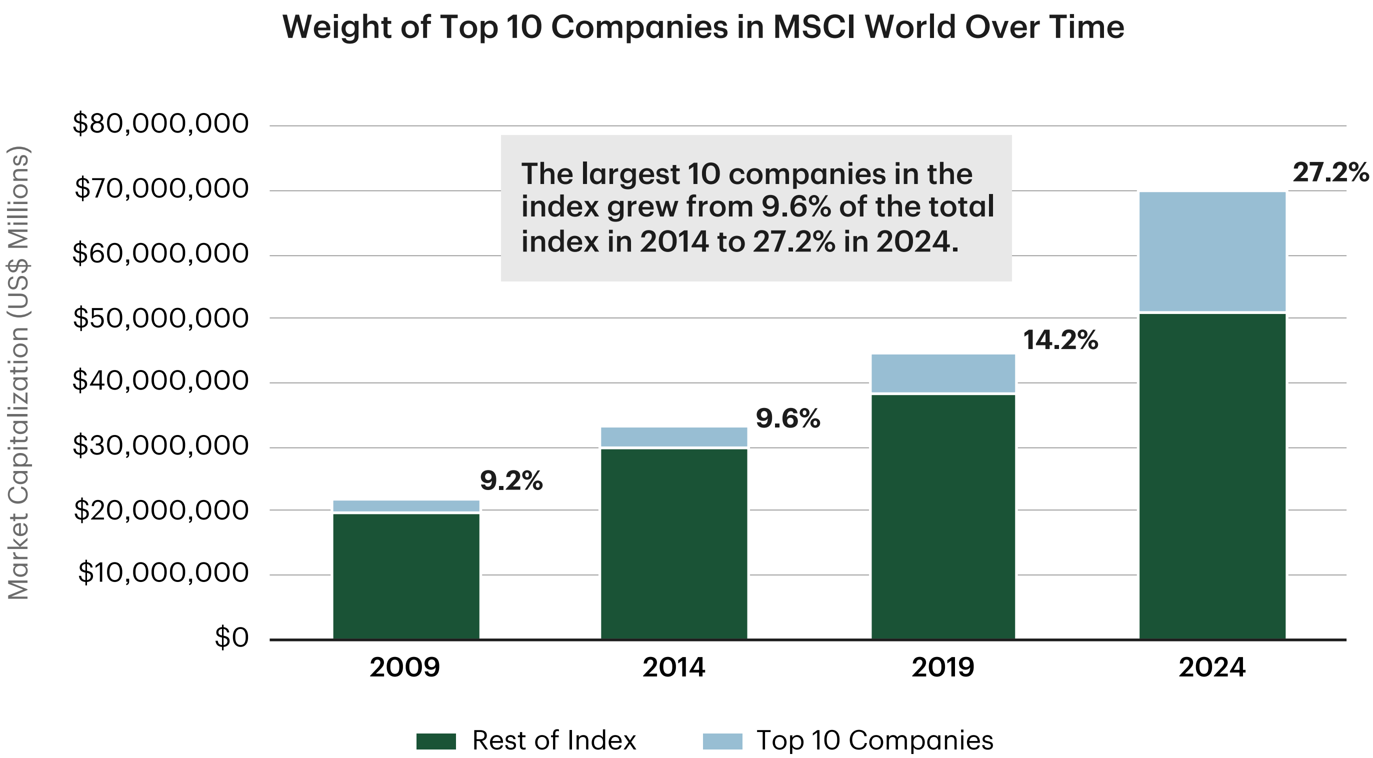
Figure 1: MSCI World Index Country Weight Trend from 2004 to 2024



Source: FactSet Research Systems Inc. All data is in CAD as of Dec 31, 2024.

Diversify

Figure 2: Top 10 Company Weight Trend within MSCI World from 2009 to 2024



Source: FactSet Research Systems Inc. As of December 31, 2024.

The top 10 companies in the MSCI World Index have changed meaningfully over the last 10 years. In 2014, the top 10 companies resided in the IT, Financials, Energy, Healthcare, Industrial and Consumer Staple sectors. In 2024, IT, Communications and Consumer Discretionary companies occupied eight of the top 10 spots. In addition, only three stocks - Microsoft, Apple and JP Morgan Chase - were amongst the top 10 in 2014 and 2024. Consistent outperformance over a long period of time is an outstanding achievement that few have attained. It won't come as a surprise if the composition of the top 10 looks different in the next decade.

Figure 3: MSCI World Index Top 10 Constituents

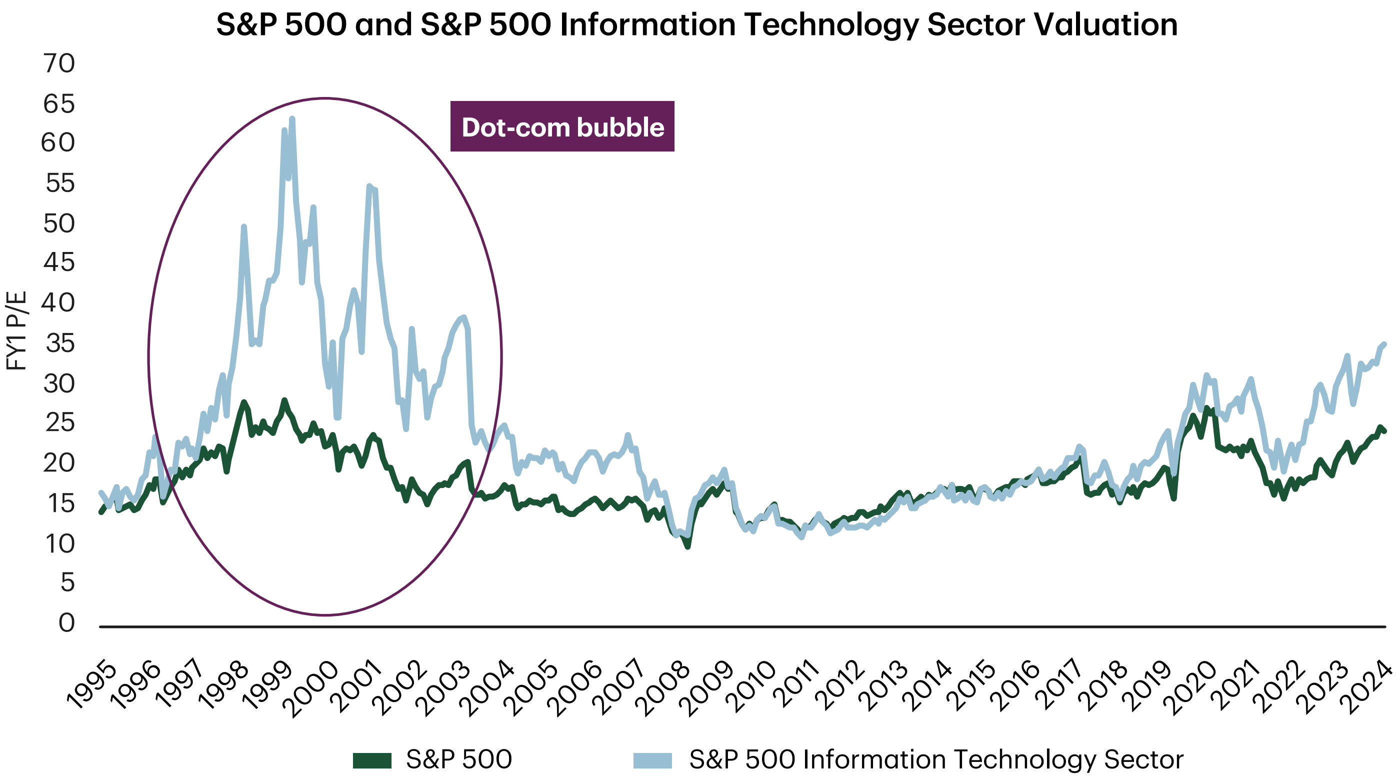
2009	%	2014	%	2019	%	2024	%
Exxon Mobil	1.51	Apple Inc.	2.00	Apple Inc.	2.97	Apple Inc.	5.45
Microsoft Corporation	1.13	Exxon Mobil	1.19	Microsoft Corporation	2.56	NVIDIA Corporation	4.72
HSBC	0.91	Microsoft Corporation	1.10	Alphabet Inc.	1.83	Microsoft Corporation	4.26
Apple Inc.	0.87	Johnson & Johnson	0.89	Amazon.com, Inc.	1.74	Amazon.com, Inc.	2.97
BP p.l.c.	0.84	Wells Fargo & Company	0.82	Meta Platforms Inc	1.11	Alphabet Inc.	2.96
Johnson & Johnson	0.82	GE Aerospace	0.77	JPMorgan Chase & Co.	1.00	Meta Platforms Inc	1.83
Procter & Gamble Company	0.81	Procter & Gamble Company	0.75	Johnson & Johnson	0.86	Tesla, Inc.	1.66
IBM Corp.	0.79	Nestle S.A.	0.72	Visa Inc. Class A	0.73	Broadcom Inc.	1.47
Nestle S.A.	0.78	JPMorgan Chase & Co.	0.71	Nestle S.A.	0.72	JPMorgan Chase & Co.	0.98
AT&T Inc.	0.76	Novartis AG	0.65	Procter & Gamble Company	0.70	Eli Lilly and Company	0.89

Source: FactSet Research Systems Inc. As of December 31, 2024.

What Are the Risks?

Higher market concentration also means higher concentration in contribution to returns. With such a high level of concentration in particular sectors and stocks, performance of a few companies may have an outsized impact on the overall market returns. While the IT stocks today look quite different from the tech stocks during the early 2000s, and while we are not predicting an imminent period of underperformance, it's important to be mindful of current valuation levels, which resemble those of the dot-com bubble era.

Figure 4: S&P 500 and S&P 500 IT Sector Valuation Trend from 1995 to 2024

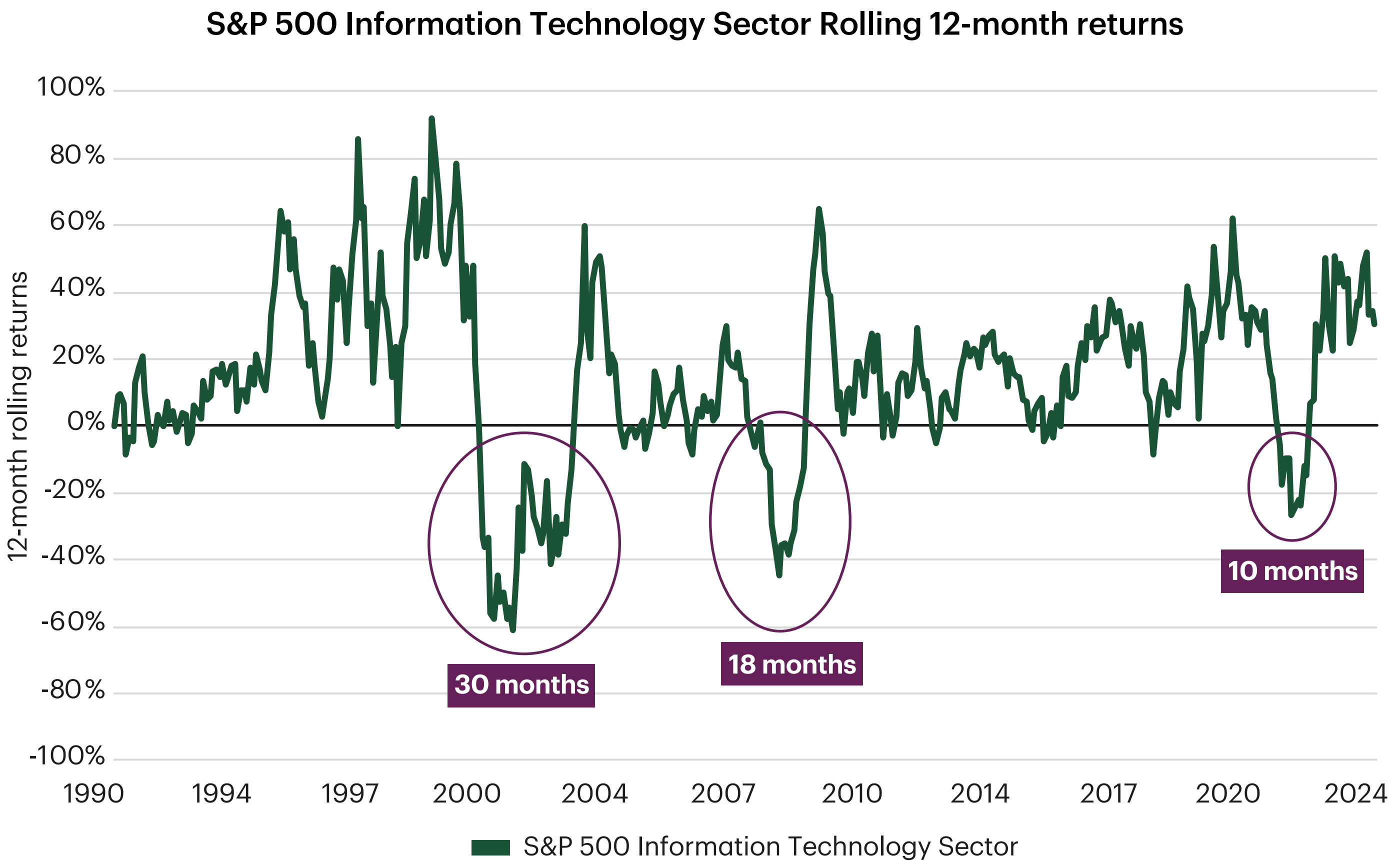


Source: FactSet Research Systems Inc. As of December 31, 2024.

It's also important to consider that the IT sector is not immune to drawdowns. In fact, the IT sector has experienced episodic drawdowns of over 20% on a rolling 12-month basis about 10% of the time since 1990. The longest duration was in the early 2000s during the dot-com bubble that spanned 30 months. Most recently, the weakness the IT sector exhibited in 2022 spanned 10 months and contributed to the underperformance of many growth managers that year.

Trends

Figure 5: Rolling 12-month Return of the S&P 500 IT Sector from 1990 to 2024



Source: FactSet Research Systems Inc. As of December 31, 2024.

Solutions for Mitigating U.S. Concentration in Global Equity Strategies

Investors concerned about high U.S. concentration in their global equity allocations have various solutions, both active and passive, to choose from. In this paper, we consider three passively managed and two actively managed solutions.

Passive Solutions

Passively managed investment strategies aim to replicate the characteristics and returns of an index of stocks using rules-based methods to determine which stocks to invest in and by how much. The most popular approach is to weight stocks by market capitalization. However, as investors' needs have evolved, so too have indexing methodologies.

Given the rising levels of concentration in indexes weighted by market-capitalization, like the S&P 500, investors can look to indexes using different rules to gain exposure to U.S. equities and manage concentration risk at a low cost.

Below, we examine three potential alternatives to investing in the S&P 500 Index, ranging from most to least similar when compared with the capitalization-weighted index.

1 S&P 500 3% Capped Index

Imposes capped weights on the S&P 500 companies. The weight of each stock is based on its float-adjusted market cap, but it is modified such that no stock has a weight over 3% as of each rebalancing.[5,6] Any excess weight is then re-distributed amongst all uncapped companies in proportion to their weight.

As of December 31, 2024, four stocks would effectively be capped to 3% based on this methodology - Apple, NVIDIA, Microsoft and Amazon. This methodology results in different sector weights relative to the S&P 500, mainly an underweight to the IT sector; three of the four capped stocks reside in the IT sector. As well, the capped index is overweight Healthcare, Financials and Consumer Staples.

Despite these differences in sector allocation, the S&P 500 3% Capped Index has closely tracked the returns of the S&P 500 Index, according to back-tests.[7] This potentially makes it a good alternative for investors seeking a benchmark less concentrated than the S&P 500 Index, with a low tracking error and relatively simple rules. On the other hand, investors should consider that a 3% cap is arbitrary. If the weight of the largest companies continues to rise, the 3% capped index may be overly limiting and unable to deliver returns sufficiently similar to the capitalization-weighted benchmark.

2 MSCI USA Size Tilt Index

A second and more dynamic approach, the Size Tilt, aims to reduce concentration by weighting stocks using the square root of their market capitalization weight.[8] The MSCI Size Tilt indexes currently employ this methodology. Concentration is lowered as larger stocks are increasingly penalized. This implies bigger differences in terms of risk and returns between the Size Tilt and capitalization-weighted indexes, especially when market concentration is at historical highs. The IT and Communication Services sectors are the largest underweights; Industrials and Real Estate are the largest overweights.

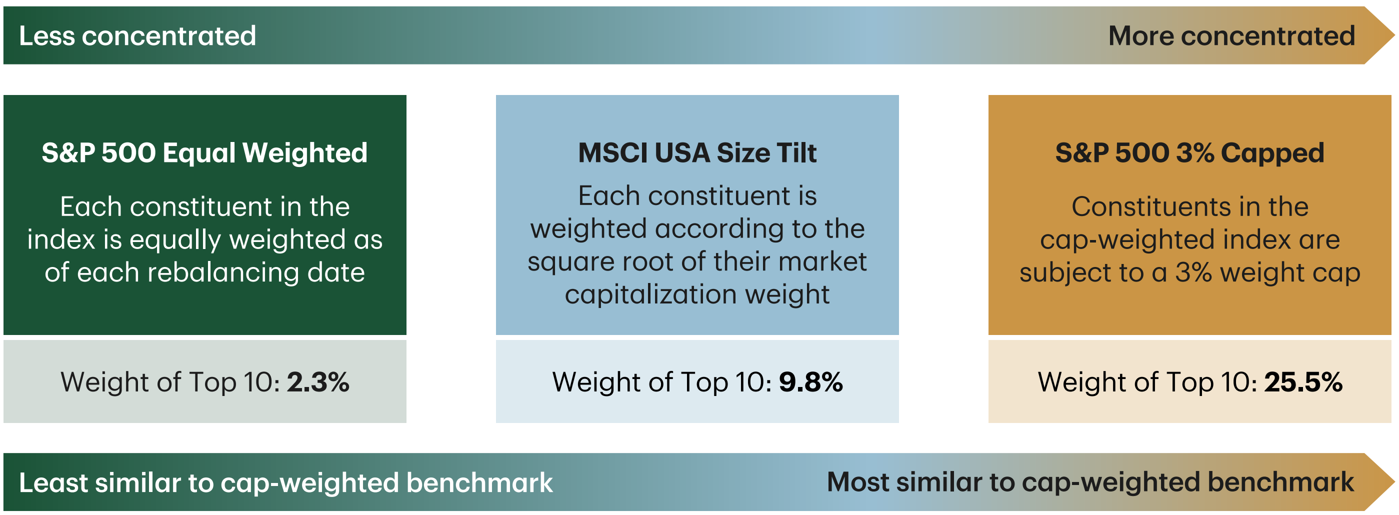
[5] Source: https://www.spglobal.com/spdji/en/indices/equity/sp-500-3-capped-index/#overview (Accessed February 18, 2025)
[6] Source: https://www.spglobal.com/spdji/en/documents/education/education-introducing-the-sp-500-3-capped-index.pdf (Accessed February 18, 2025)
[7] Source: https://www.spglobal.com/spdji/en/documents/education/education-introducing-the-sp-500-3-capped-index.pdf (Accessed February 18, 2025)
[8] Source: https://www.msci.com/eqb/methodology/meth_docs/MSCI_Size_Tilt_Index_Methodology_Feb2023.pdf (Accessed February 18, 2025)

3 S&P 500 Equal-Weighted Index

Finally, the third and most forthright approach to reducing concentration is by attempting to eliminate it altogether using an Equal-Weighted Index. As the name suggests, this would entail assigning an equal weight to each stock. For example, in the S&P 500 Index, each stock would be assigned a weight of approximately 0.20%. While this approach is the least concentrated of the three presented, it also diverges most from the capitalization-weighted benchmark.

In summary, investors can use passively managed strategies to customize their exposure to equity markets at a lower cost than active approaches. However, a comprehensive understanding of indexing methodologies is essential to effective implementation.

Figure 6: Three Alternatives to Cap-Weighted Benchmarks

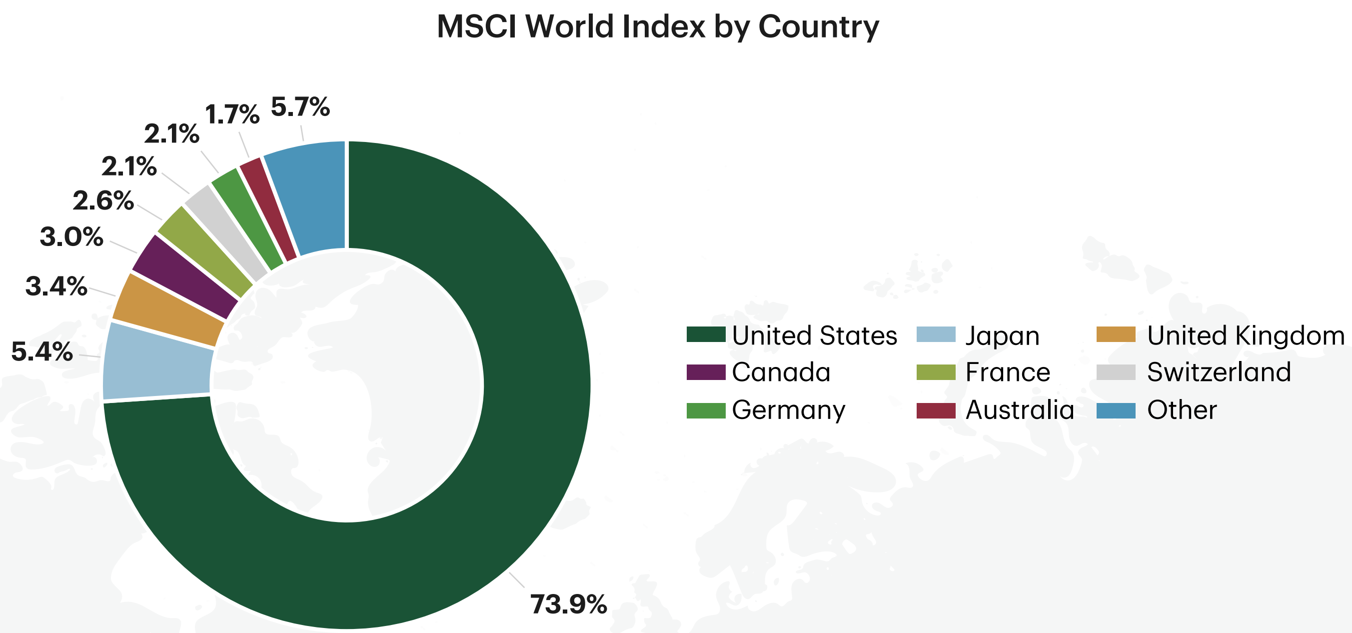


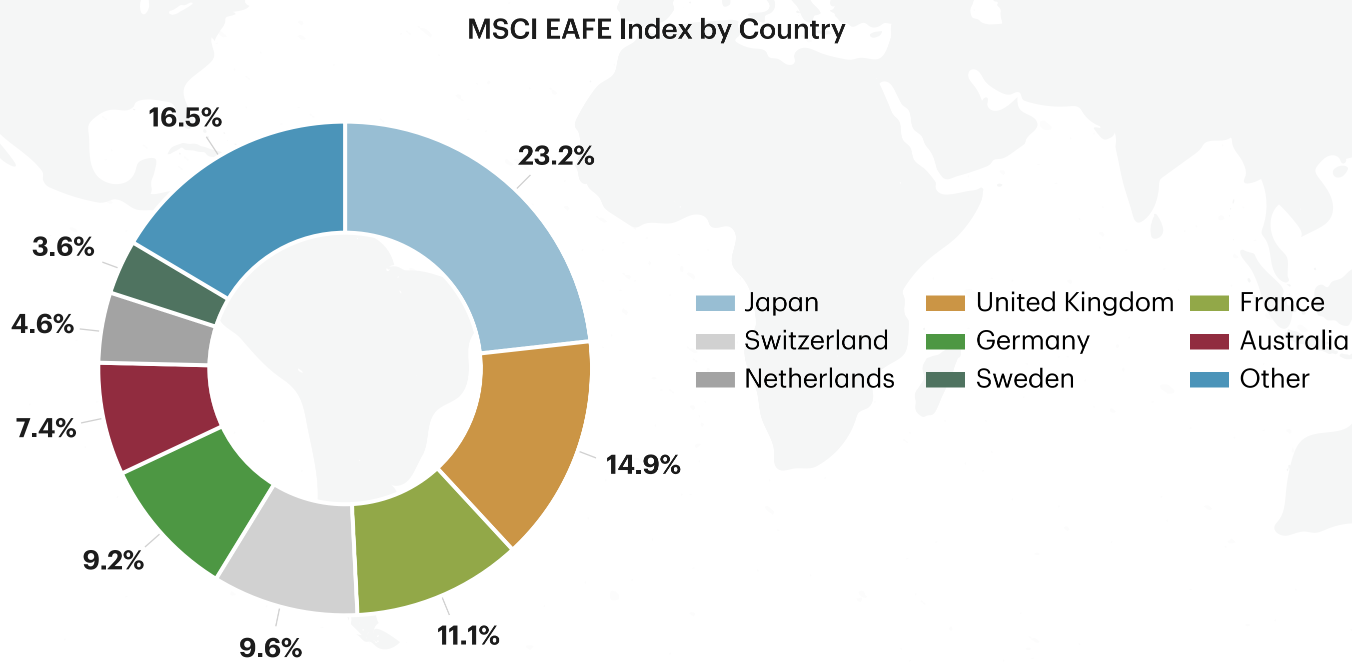
Source: FactSet Research Systems Inc., Standard & Poor's, MSCI Inc. As of December 31, 2024.

Active Solutions

For active investors in strategies tracking the MSCI World Index, adding a Europe, Australasia and Far East (EAFE) allocation or combining two different styles of Global Equity strategies could produce diversification benefits. The MSCI EAFE benchmark has a very different distribution in countries and sectors compared to the MSCI World benchmark.

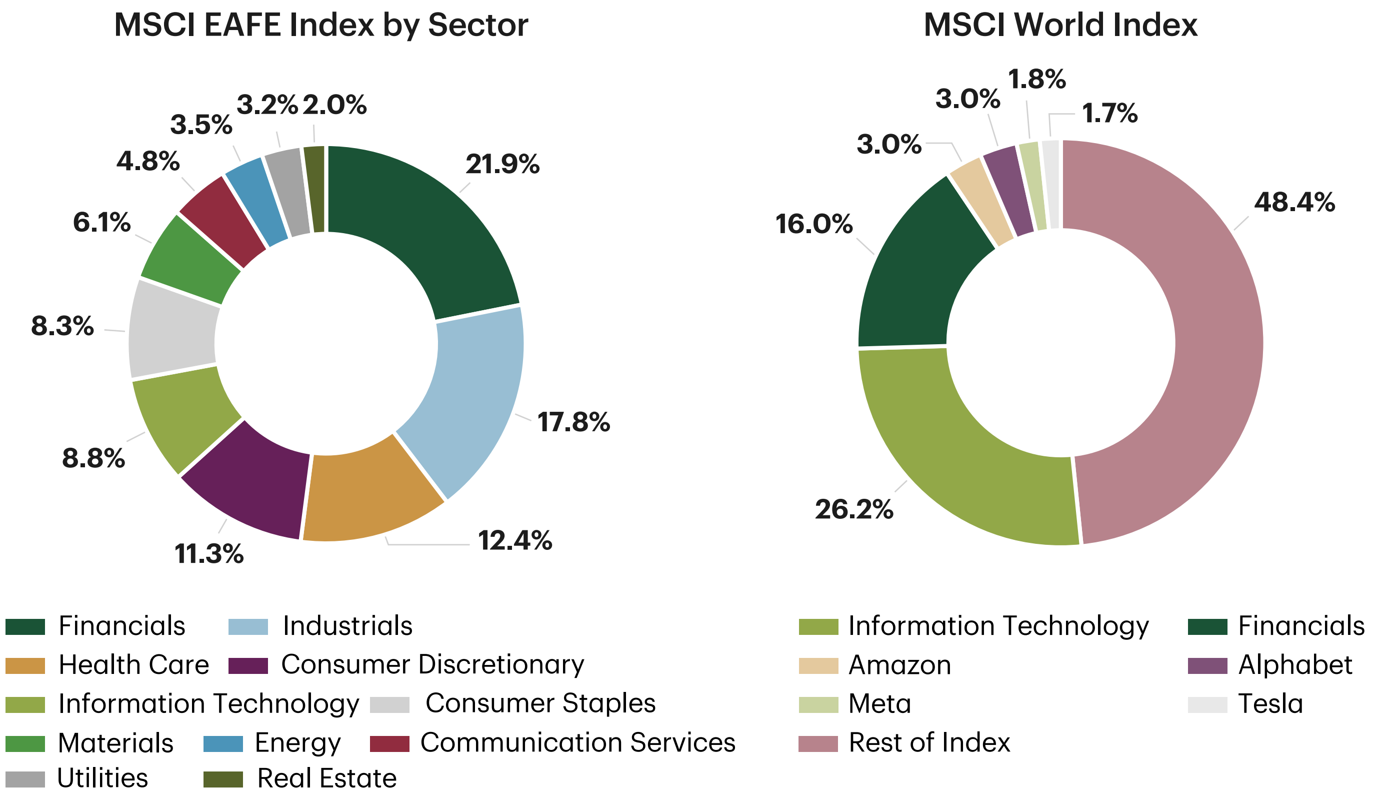
Figure 7: Country Weight of MSCI EAFE vs MSCI World Index





Source: TDAM, FactSet Research Systems Inc. As of December 31, 2024.

Figure 8: Sector Weight of MSCI EAFE vs MSCI World Index



Source: FactSet Research Systems Inc. As of December 31, 2024

Substituting just 10% of a current Global Equity strategy (we are basing our analysis on the MSCI World Index to be approach-neutral) with the TD Greystone International Equity Fund[9] can provide material protection to value erosion in a meaningful IT sector drawdown.

Figure 9: Scenario Analysis

Assumptions	NVIDIA -20%	S&P 500 IT Sector -20%	Magnificent 7 -20%
MSCI World Index	-3.01%	-8.96%	-7.90%
Sample Portfolio*	-2.78%	-8.30%	-7.41%
Alpha Protection	23 bps	63 bps	49 bps

Methodology: The scenario analysis was carried out using the Northfield Global Equity Risk Model's Monte Carlo simulation. The drop in securities value is instantaneous. The stress test was performed as of December 31, 2024, which was the last trading day in 2024.
* The sample portfolio consists of 10% of the TD International Equity Fund and 90% of the MSCI World Index.
Source: TDAM, FactSet Research Systems Inc., eVestment Alliance LLC. As of December 31, 2024.

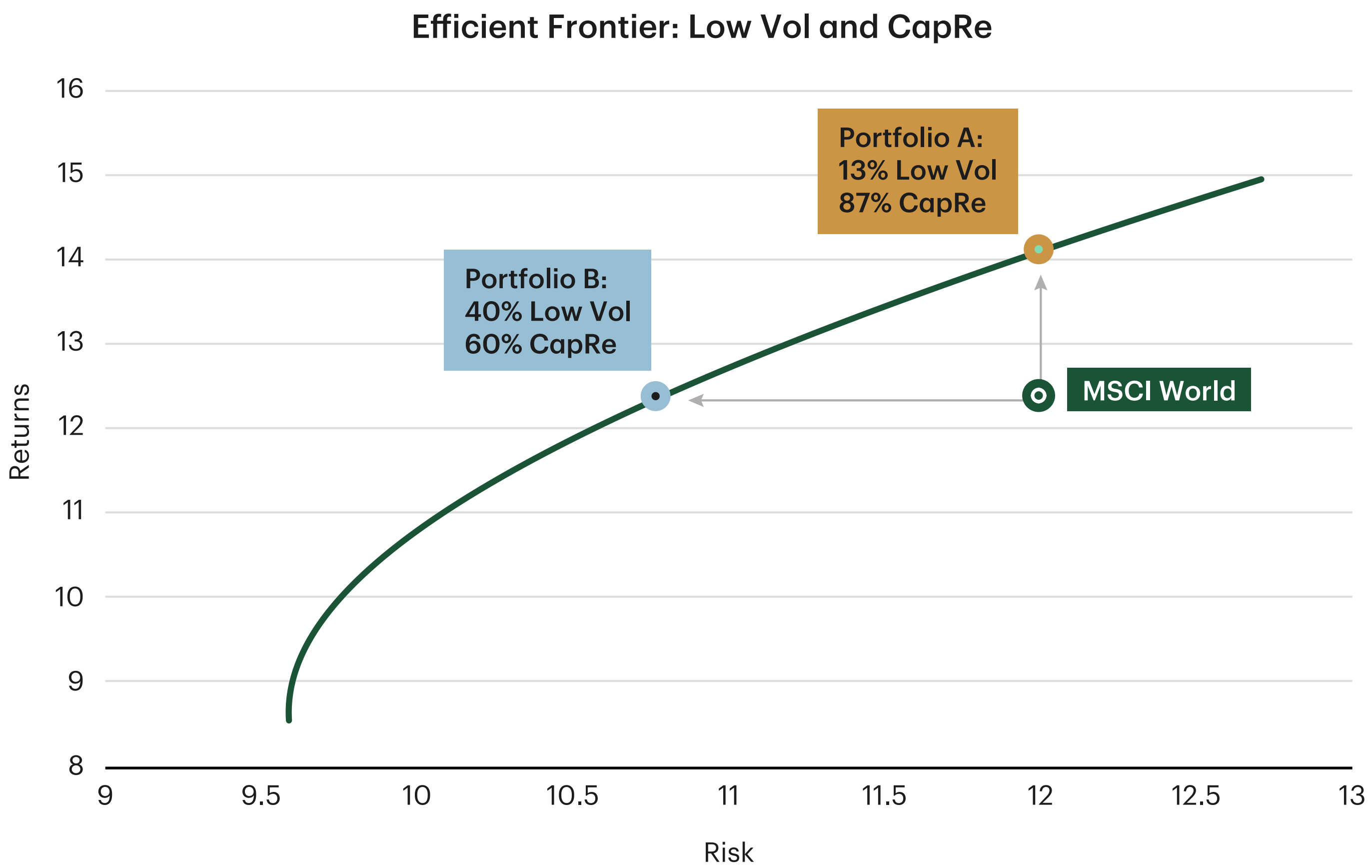
[9] As of December 31, 2024, the TD Greystone International Equity Fund produced a one-year return of 7.76%, a three-year return of 0.74%, a five-year return of 6.24% and a 10-year return of 8.59%.

Given a low 10% weight to an EAFE strategy, the portfolio characteristics of the sample combined portfolio remains similar to the MSCI World Index with a 0.68 tracking error. (The analysis was run on data from December 31, 2019 to December 31, 2024.) This allows the portfolio to be managed as a single allocation against the MSCI World Index for ease of implementation.

For investors interested in a bespoke solution, combining two strategies with different styles can potentially result in diversification as well as enhanced portfolio characteristics. We investigated combining the TD Global Low Volatility (Low Vol) Fund[10] with the TD Epoch Global Quality Capital Reinvestment (Cap Re) Fund.[11]

Portfolios with an allocation to both funds have historically exhibited the potential to provide higher returns at the same level of risk as the benchmark, or alternatively a five-year return similar to that of the benchmark but with a lower level of risk, as measured by standard deviation. The sample portfolios also generated improved characteristics with attractive alpha and higher Sharpe Ratios.

Figure 10: Efficient Frontier of TD Epoch Cap Re and TD Global Low Vol Funds



Source: eVestment Alliance, LLC. Five-year return and risk figures as of December 31, 2024.

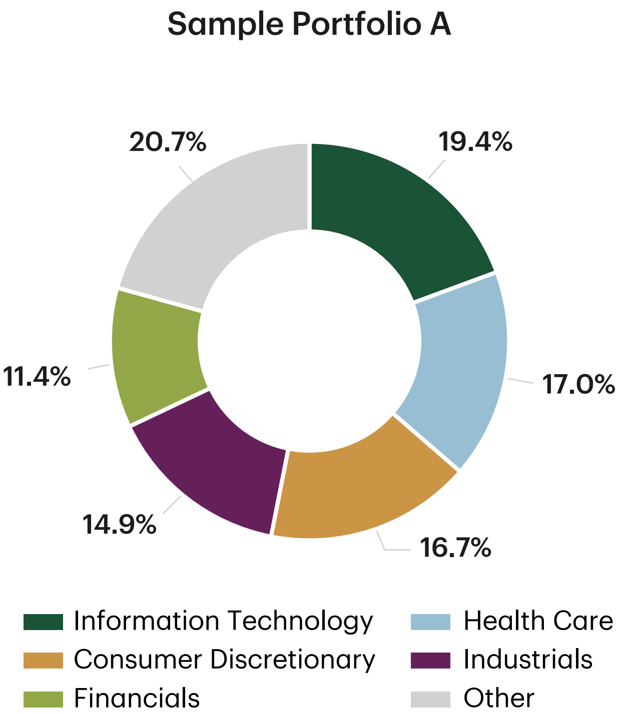
The TD Epoch Cap Re fund is tilted towards quality growth, while the TD Low Vol fund is focused on risk mitigation. These two funds have different styles and factor exposures, and their five-year excess return correlation is -0.16[12], making them complementary. The resulting portfolio has more balanced diversification across sectors. Below, we show the sector weights of the MSCI World Index and the sector weights of Sample Portfolio A, which is comprised of an approximately 13% allocation to the TD Low Vol fund and 87% allocation to the TD Epoch Cap Re fund.

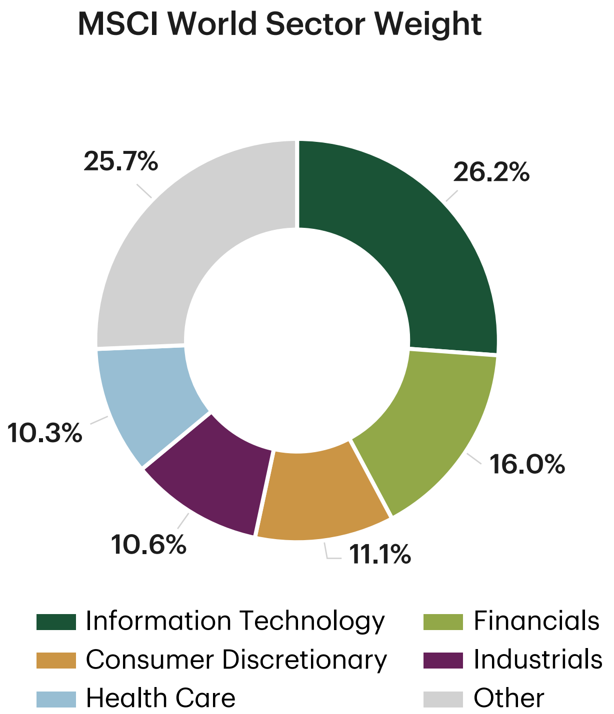
[10] As of December 31, 2024, the TD Global Low Volatility Fund produced a one-year return of 16.92%, a three-year return of 6.71%, a five-year return of 5.41% and a 10-year return of 8.56%.

[11] As of December 31, 2024, the TD Epoch Global Quality Capital Reinvestment Fund produced a gross composite one-year return of 22.52%, a gross composite three-year return of 10.82%, a gross composite five-year return of 16.91% and a gross composite 10-year return of 14.93%. (Composite returns are presented gross and net of management fees and include the reinvestment of all income.)

[12] Excess return correlation is calculated per month for a five-year period. Excess return is calculated in Canadian dollars using the MSCI World Index. The index returns are net of dividends. Source: TD Asset Management Inc., FactSet Research Systems Inc. As of December 31, 2024.

Figure 11: Sector Weights of the Sample Portfolio vs MSCI World Index





Source: TDAM, FactSet Research Systems Inc., eVestment Alliance, LLC. As of December 31, 2024.

Conclusion

Market concentration is not something new and is not unique to the current U.S. and Global Equity markets. When markets become increasingly concentrated, as we have witnessed before in Finland, Canada and China, a reversal eventually occurs. Regardless of the trajectory of the current U.S. concentration, being cognizant of the risks and managing the concentration according to your investment objectives seems like a prudent plan. ■

Solutions

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