BostonPartners

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The missing ingredient in today's large cap allocations: value stocks

An extraordinary performance run in a handful of tech-oriented stocks has left many investors with a concerning amount of concentration risk in their equity portfolios.

Today, seven stocks — Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla, often referred to as the "Magnificent Seven" — have taken center stage as new technologies transform certain segments of our economy. The utter market dominance of this handful of companies, however, should give investors pause. As of the close of 2023, these seven stocks represented just under 30% of the S&P 500's total market capitalization. This is uncharted territory. Over the past 40 years, the seven largest stocks in the bellwether index rarely accounted for more than 20% of its market cap. The performance record behind these seven names is even more disproportionate. Last year, the Magnificent Seven gained more than 100%, while an equal-weighted allocation to the S&P 500 returned just 14%.

More than just a source of ballast, value stocks can offer meaningful alpha to a diversified portfolio.

There might be a silver lining to this tale if these seven stocks represented a broad cross section of the economy. They do not. All seven are growth stocks, all are technology-focused companies, and all have valuations (as measured by forward P/E ratios) higher than the S&P 500 Index itself—in some cases, two or three times higher.[1]

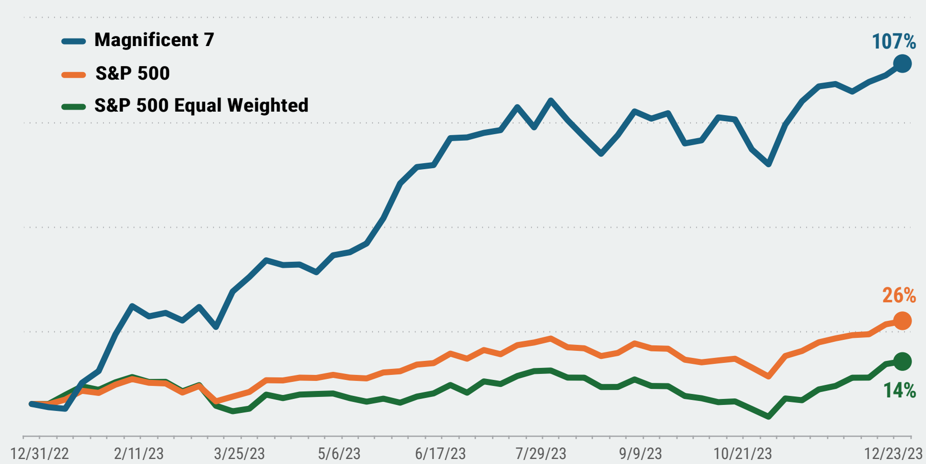
Extreme concentration, high valuations, sector bias—the risks are significant and, in many ways, mounting. But that doesn't mean investors are without recourse. We believe investors can counteract some of the most pronounced challenges in today's equity market by refocusing on first principles.

The seven largest stocks represent a massive part of today's market

Percentage of S&P 500 Index represented by the seven largest stocks over time

Source: Standard & Poor's, Data through February 2024.

And their relative performance has been even more disproportionate



Source: Standard & Poor's, 2024.

1 FactSet, Boston Partners, as of December 31, 2023.

Cast a wide net: Seek to proactively mitigate the concentration risk in today's market

To spell out the problem behind concentration risk even more explicitly, a bet on any narrow segment of the stock market is unlikely to pay off with any consistency. We can clearly see this in action by looking at the S&P's underlying sector performance over the past 15 years. It's frequently been the case that a top performer one year will be at the bottom of the pack the next, or vice versa. Case in point: Information technology was the top performer last year but one of the market's worst-performing sectors in 2022.

Sector performance within the S&P 500 Index has been unpredictable

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	TOTAL
INFT 61.7%	REAL 32.3%	UTIL 19.9%	FINL 28.8%	COND 43.1%	REAL 30.2%	COND 10.1%	ENRS 27.4%	INFT 38.8%	HLTH 6.5%	INFT 50.3%	INFT 43.9%	ENRS 54.6%	ENRS 65.7%	INFT 57.8%	INFT 1,679.5%
MATR 48.6%	COND 27.7%	CONS 14.0%	COND 23.9%	HLTH 41.5%	UTIL 29.0%	HLTH 6.9%	TELS 23.5%	MATR 23.8%	UTIL 4.1%	TELS 32.7%	COND 33.3%	REAL 46.2%	UTIL 1.6%	TELS 55.8%	COND 925.6%
COND 41.3%	INDU 26.7%	HLTH 12.7%	REAL 19.7%	INDU 40.7%	HLTH 25.3%	CONS 6.6%	FINL 22.8%	COND 23.0%	COND 0.8%	FINL 32.1%	TELS 23.6%	FINL 35.0%	CONS -0.6%	COND 42.4%	S&P 610.9%
REAL 27.1%	MATR 22.2%	REAL 11.4%	TELS 18.3%	FINL 35.6%	INFT 20.1%	INFT 5.9%	INDU 18.9%	FINL 22.2%	INFT -0.3%	S&P 31.5%	MATR 20.7%	INFT 34.5%	HLTH -2.0%	S&P 26.3%	HLTH 578.8%
S&P 26.5%	ENRS 20.5%	TELS 6.3%	HLTH 17.9%	S&P 32.4%	CONS 16.0%	REAL 4.7%	MATR 16.7%	HLTH 22.1%	REAL -2.2%	INDU 29.4%	S&P 18.4%	S&P 28.7%	INDU -5.5%	INDU 18.1%	INDU 541.4%
INDU 20.9%	TELS 19.0%	COND 6.1%	S&P 26.5%	INFT 28.4%	FINL 15.2%	TELS 3.4%	UTIL 16.3%	S&P 21.8%	S&P -4.4%	REAL 29.0%	HLTH 13.5%	MATR 27.3%	FINL -10.5%	MATR 12.6%	MATR 440.1%
HLTH 19.7%	S&P 15.1%	ENRS 4.7%	INDU 15.4%	CONS 26.1%	S&P 13.7%	S&P 1.4%	INFT 13.9%	INDU 21.0%	CONS -8.4%	COND 27.9%	INDU 11.1%	HLTH 26.1%	MATR -12.3%	REAL 12.4%	REAL 433.0%
FINL 17.2%	CONS 14.1%	INFT 2.4%	MATR 15.0%	MATR 25.6%	INDU 9.8%	FINL -1.5%	S&P 12.0%	CONS 13.5%	TELS -12.5%	CONS 27.6%	CONS 10.8%	COND 24.4%	S&P -18.1%	FINL 12.2%	FINL 396.2%
CONS 14.9%	FINL 12.1%	S&P 2.1%	INFT 14.8%	ENRS 25.1%	COND 9.7%	INDU -2.5%	COND 6.0%	UTIL 12.1%	FINL -13.0%	UTIL 26.4%	UTIL 0.5%	TELS 21.6%	REAL -26.1%	HLTH 2.1%	CONS 373.7%
ENRS 13.8%	INFT 10.2%	INDU -0.6%	CONS 10.8%	UTIL 13.2%	MATR 6.9%	UTIL -4.8%	CONS 5.4%	REAL 10.9%	INDU -13.3%	MATR 24.6%	FINL -1.7%	INDU 21.1%	INFT -28.2%	CONS 0.5%	TELS 285.2%
UTIL 11.9%	UTIL 5.5%	MATR -9.6%	ENRS 4.6%	TELS 11.5%	TELS 3.0%	MATR -8.4%	REAL 3.4%	ENRS -1.0%	MATR -14.7%	HLTH 20.8%	REAL -2.2%	CONS 18.6%	COND -37.0%	ENRS -1.3%	UTIL 281.1%
TELS 8.9%	HLTH 2.9%	FINL -17.1%	UTIL 1.3%	REAL 1.6%	ENRS -7.8%	ENRS -21.1%	HLTH -2.7%	TELS -1.3%	ENRS -18.1%	ENRS 11.8%	ENRS -33.7%	UTIL 17.7%	TELS -39.9%	UTIL -7.1%	ENRS 164.6%

COND Consumer Discretionary
CONS Consumer Staples
ENSR Energy
FINL Financials
HLTH Health Care
INDU Industrials
INFT Information technology
MATR Materials
REAL Real Estate
TELS Communications Services
UTIL Utilities
S&P S&P 500

Source: Standard & Poor's, 2024.

None of this is to suggest a bias against tech stocks or any other segment of the market. Our concern has more to do with the idea of intent. Investors with allocations to large-cap growth strategies would expect to see these seven stocks represented in their portfolios in meaningful ways. The problem, we believe, lies with investors in passive large-cap strategies and even in many actively managed large-cap core strategies. For these investors—who would rightly expect their investments to offer broadly diversified exposure to the most dynamic economy in the world—something approaching one-third of their allocation is targeting a single, homogeneous, relatively expensive segment of the stock market. Fortunately, this is a problem with a simple, time-tested solution.

Passive and core-based approaches in today's market are heavily weighted in favor of growth stocks in general and the Magnificent Seven specifically.

Diversify with purpose: Dedicated allocations to growth and value strategies can help investors avoid chasing yesterday's winners

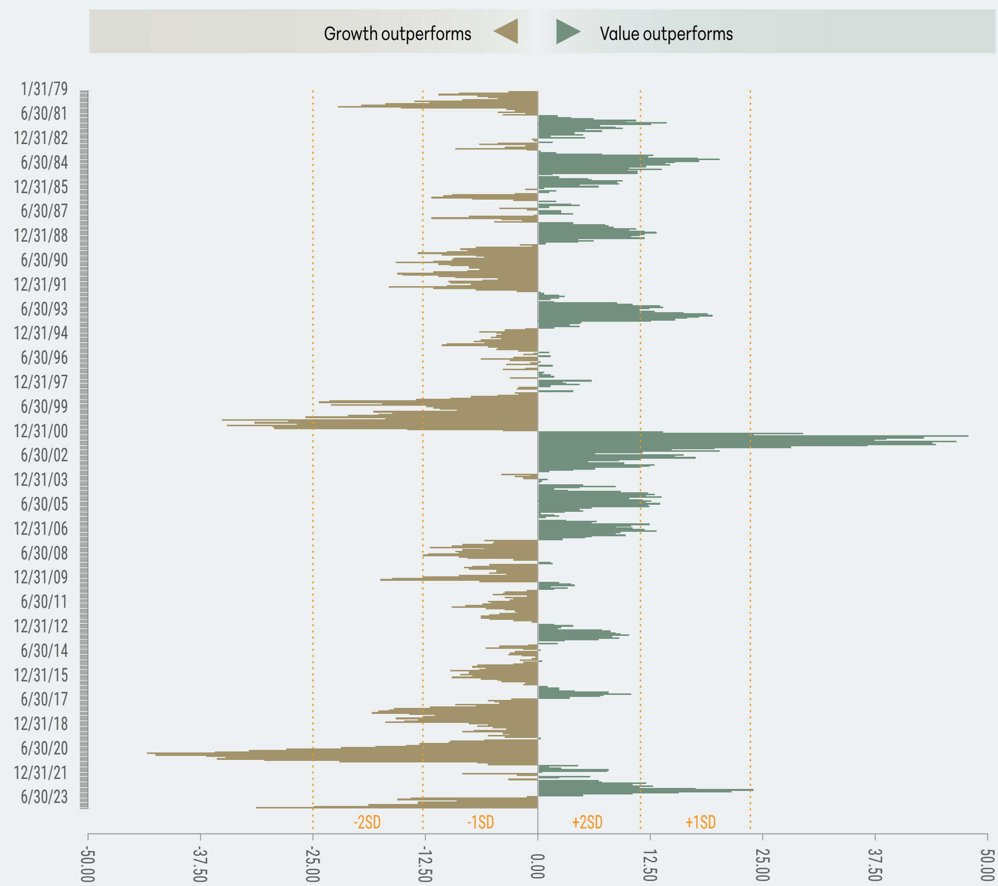
We believe there's a fairly easy way to counteract today's extreme levels of concentration risk: a dedicated allocation to large-cap value stocks. How to implement such an approach is open to debate, but the pitfalls deserve review. Passive and core-based approaches in today's market are heavily weighted in favor of growth stocks in general and the Magnificent Seven specifically. In fact, essentially any approach oriented toward the S&P 500 or Russell 1000 Index would tend to overexpose investors to these seven securities due to their disproportionate representation in those indexes, and continued strong performance in the tech sector will only compound the problem.

For that reason, we believe it may be more prudent to target those types of tech-oriented holdings intentionally via a large-cap growth allocation—and then, with equal intention, to diversify away from those securities via a large-cap value position. This two-pronged approach is about as straightforward a way of dealing with concentration risk as there is: Exposure to, and reliance on, the Magnificent Seven would immediately be reduced significantly.

Such an approach also eliminates some of the temptation to chase yesterday's winners. Consider that over the past 45 years, growth and value have traded market leadership positions 27 times.

Growth and value stocks have changed leadership positions 27 times in 45 years

Russell 1000 Value Index – Russell 1000 Growth Index returns (trailing 12-months)



It's worth pointing out that this 45-year snapshot reflects a period of relative parity between growth and value investment styles: The Russell 1000 Growth Index returned 11.96% per year during this time frame while the Russell 1000 Value Index returned 11.57%. This hasn't always been the case, and there are two realities that deserve addressing head on, first by looking at more recent history and then by taking an even broader view of the landscape. To begin, it's true that since 2007, growth stocks have tended to outperform value stocks—why is ultimately a matter for another paper. The second point is to highlight what an anomaly the past decade-plus has been. Looking back to 1927—and including those recent years of value's relative underperformance—value has still outperformed growth by an average of more than 4% per year. And in those calendar years where value does outperform, the difference has been huge: nearly 15% on average.[2] More than just a source of ballast, value stocks can offer meaningful alpha to a diversified portfolio.

2 Dimensional, "When It's Value vs. Growth, History Is on Value's Side," September 26, 2023.

Buy low, sell high: Dollar-cost averaging and regular rebalancing can help investors stay diversified and reduce volatility

One of the under-appreciated risks associated with any concentrated exposure is behavioral: Investors tend to have a fairly low tolerance for volatility. Every year, Morningstar calculates the average return for various asset classes and compares those figures with the dollar-weighted returns. The result, invariably, is a "gap"—the difference between the returns investors actually achieved and the more hypothetical performance any given category produced.

Morningstar found that volatility consistently undermines investor returns, both across categories and within. For example, allocation funds, which generally exhibit less volatility than equity strategies, posted a significantly smaller return gap over the past 10 years than several equity categories. The gaps within categories track volatility as well. U.S. equity funds with higher standard deviations experienced larger gaps than those that were relatively more stable. Per Morningstar, "the general trend makes intuitive sense, as funds that expose investors to less volatility should be easier to own and less prone to erratic cash flows, thus leading to better investor results."[3] Ultimately, volatility isn't a problem in itself—it becomes one when it motivates investors to lock in losses or, on the upside, to buy into market peaks. A lower volatility profile within a U.S. equity allocation isn't simply a means to help investors feel better: it can actually enhance long-term returns.

Defined contribution plans are an ideal setting for helping investors to put such a program into action. The nature of dollar-cost averaging acts as a check on over-allocating to the priciest parts of the market, while many plans' automatic rebalancing features can help keep investors' portfolios appropriately diversified. By way of reminder, dollar-cost averaging is one of those rare investing concepts that acts like more of a law of physics: When buying any variable quantity of something—whether it's shares of a mutual fund or gallons of gas—if the dollar investment is fixed, you'll end up buying more of it when it's cheap and less when it's expensive. The result over time is to drive down the cost basis, which is the key to any successful long-term investment strategy.

Price matters: The investor with the lowest cost basis ultimately wins

We hope by now it's clear that the reports of value investing's demise have been greatly exaggerated. There's no shortage of evidence to demonstrate that lower relative prices lead to higher prospective returns. We believe value stocks remain a meaningful source of alpha and that investors would be remiss to pass over the opportunity, especially given the inherent concentration risks involved in any strategy that doesn't expressly incorporate value stocks into a portfolio.

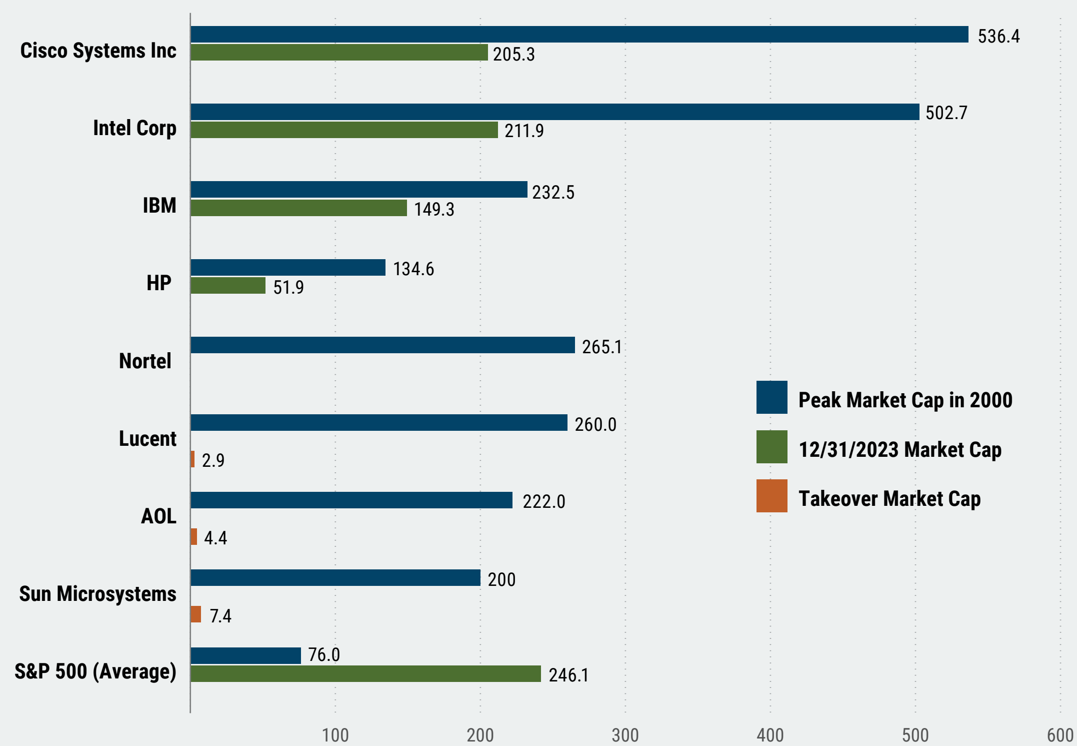
3 Morningstar, "Mind the Gap 2023: A report on investor returns in the U.S.," July 31, 2023.

For those investors who may have grown skeptical of value investing's potential or have inadvertently seen their portfolios tilt toward growth, now may be the perfect time for a reexamination: Our own research suggests that we may be in the early innings of a market leadership pivot away from large-cap growth toward large-cap value. But again, rather than shoulder the impossible task of trying to time such a transition, we believe investors are better served by owning both growth and value stocks throughout various market regimes—and to hold them in roughly equal proportions by rebalancing regularly.

There is some urgency to act: When the tech-led selloff began in late 2000, it took just 12 months for the Russell 1000 Growth Index to lose more than half its value.[4] While we certainly can't predict the future, it's worth considering that with seven stocks making up such an outsized portion of the market—and, consequently, of many investor portfolios—a reversal of fortune or spike in volatility in just three or four of those companies could have dramatic consequences for investor returns. We believe that's the kind of risk most long-term investors would gladly avoid.

More than 20 years later, the titans of the dot-com era are priced at fractions of their former valuations

Market cap ($Billions)



Source: Boston Partners, 2024.

4 Bloomberg, FTSE Russell, 2024.

About Boston Partners

Boston Partners is a value equity manager with a distinctive approach to investing—one that combines attractive valuation characteristics with strong business fundamentals and positive business momentum in every portfolio. The consistent application of this approach over nearly 30 years by an experienced and long-tenured team has created a proven record of performance across economic cycles, market capitalizations, and geographies.

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