VERGENCE
INSTITUTIONAL PARTNERS

Index funds are boring?

"Nothing is boring if you look at it carefully" – Freeman Dyson, mathematician

The objective of an index fund is to provide a return that falls within a reasonable tolerance of the index it mirrors. Most index funds, at least those used by institutions, consistently achieve that objective. That can make index funds boring topics of discussion in investment reviews. That is until they surprise you. And it's rarely good news when investments that some consider "boring" (like index, stable value, or money market funds) surprise you. To avoid getting caught off guard, plan sponsors should ensure they pay appropriate attention to each investment.

As an example of how interesting index funds can be, we look at how the concentration of holdings in a selection of frequently-tracked, capitalization-weighted indices has changed over time – sometimes in surprising fashion.

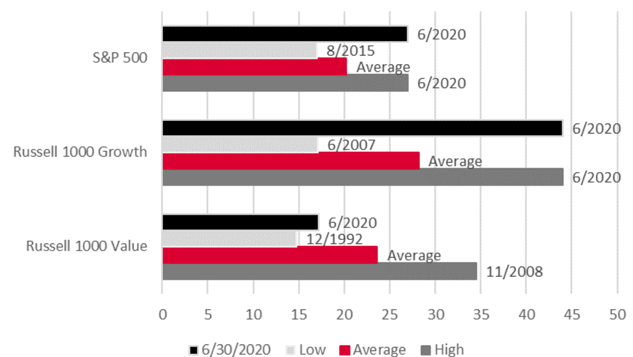
SUMMARY

- In a cap-weighted index, component stocks are weighted according to their market capitalization (stock price x outstanding shares); the highest cap stocks have the heaviest weightings within the index
- Cap-weighted index funds which track the largest capitalization stocks have the greatest potential for significant holdings concentration, as well as volatility of concentration
- Cap-weighted index funds that track smaller capitalization segments have a lower potential for concentration, as growing stocks eventually graduate out of the index (e.g., move from a small-cap index to a mid-cap index)
- Rule changes or composition decisions by index providers (e.g., MSCI expanding inclusion of Chinese equities) can also impact holdings concentration
- Several of the most tracked indices currently appear to be highly concentrated when compared to historical levels, including the S&P 500, Russell 1000 Growth, and MSCI ACWI ex USA
- We aren't suggesting that any index-based strategies are necessarily imprudent, but that plan sponsors should pay the same careful attention to index funds as they do to actively managed funds

US LARGE CAP INDICES

% of Value in Top Ten Holdings
September 1989 to June 2020

Current, Low, Average, and High % in Top Ten Holdings
September 1989 to June 2020

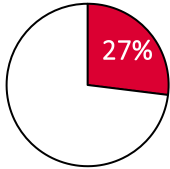


*Source: Morningstar Direct.***

US large-cap equity indices have experienced some of the most significant variations in concentration of holdings over time. Because these indices sit at the top of the market cap food chain, successful stocks don't graduate out of the index – they just make up more and more of the index as their relative values grow. Hence, large-cap index funds have some of the greatest potential for high levels of holdings concentration.

S&P 500 Index

Above Historical Average Concentration



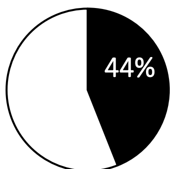
Given that an S&P 500 index fund is often one of the two largest core fund allocations in a DC retirement plan (with the other being stable value), concentration in the S&P 500 Index should be of particular interest to plan sponsors.

Since 1989, the average allocation to the top ten holdings of the S&P 500 has been just over 20%. Only five years ago, in August of 2015, the top ten holdings made up just over 17% of the index's total value – the lowest point since 1989. At the end of June 2020, the top ten holdings made up 27% of the index's value. This is the highest concentration in the top names in 30 years, rivaled only by the Dot Com Bubble period of 1999-2000.

Much of the recent increase in top ten concentration has been driven by the momentum of a select number of technology, consumer discretionary, and communication services stocks known as the FANMAGs: Facebook, Apple, Netflix, Microsoft, Amazon, and Alphabet (Google). ***The three biggest names - Microsoft, Apple, and Amazon - now make up over 16% of the index.***

Russell 1000 Growth

Above Historical Average Concentration

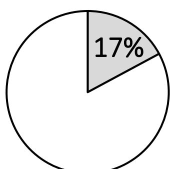


The stocks driving holdings concentration in the S&P 500 have done the same to the Russell 1000 Growth Index. ***44% of the index's value rested in its top ten holdings at the end of June.*** That's the highest concentration in the history of the index and a remarkable increase from the low of just over 17% in June of 2007.

To amplify that point: since September of 1989, the top ten concentration of the Russell 1000 Growth has averaged just over 28%. At the end of the 2nd quarter of this year, roughly 28% of the index was allocated to just the three biggest names, Microsoft, Apple, and Amazon. Those three stocks contributed over half of the Russell 1000 Growth's 1-year return ending June 30: 12.01% of 23.28%.

Russell 1000 Value Indices

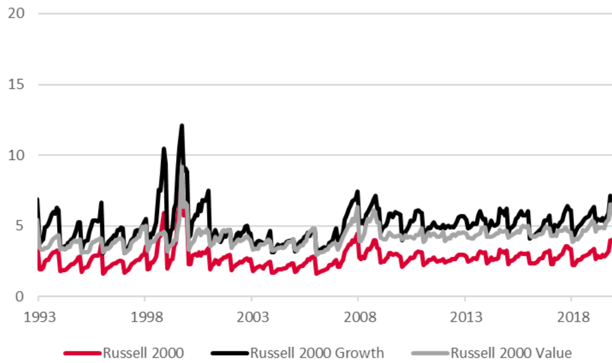
Below Historical Average Concentration



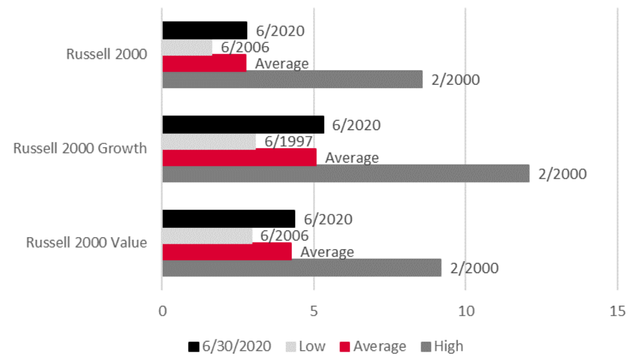
The Russell 1000 Value's decreasing concentration stands in sharp contrast to the increase in its Growth counterpart. The top ten allocation on the value side stood at 17% at the end of June 2020, vs. a 2008 Financial Crisis high of over 34%. ***The 1000 Value's top ten share hasn't been so low since the early 1990s when it bottomed below 15% in 1992.*** Concentration in the 1000 Value's top ten has averaged 23.6% since 1989.

US SMALL CAP INDICES

% of Value in Top Ten Holdings
June 1993 to June 2020



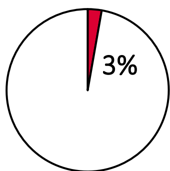
Current, Low, Average, and High % in Top Ten Holdings
June 1993 to June 2020



*Source: Morningstar Direct.***

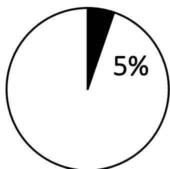
The Russell 2000 family of US small-cap equity indices haven't seen, and are unlikely to see, the levels of top-name concentration of their large-cap counterparts. This is due in part to a high number of constituents, but more so to a relative ceiling on market cap, created by the process whereby growing companies graduate from small- to mid-cap indices. You can see a regular, jagged pattern of decreasing concentration each year, following the June reconstitution of the market cap-weighted indices.

Russell 2000 Index
Near Historical Average Concentration



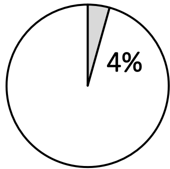
For most of the time since 1993, the top ten concentration of the Russell 2000 has hovered between 2 and 4% of the index's value. It bumped the top of that range early this year, before ending the 2nd quarter at 2.8%. The primary escape from this range occurred during the Dot Com Bubble years of 1999 and 2000 (though the effect of the reconstitution reset is still evident in each of those years).

Russell 2000 Growth Index
Near Historical Average Concentration



The Growth and Value flavors of the Russell 2000 generally sustain a higher level of top ten concentration than the parent index, given that they are smaller portfolios composed of subsets of the Russell 2000's constituents. The Russell 2000 Growth ended Q2 2020 with 5.3% of value in the top ten names. That's lower than the pre-reconstitution level of over 7%, and a far cry from the all-time high of 12% hit during the Dot Com Bubble. The three months when the top ten exceeded 10% of value all occurred during the Dot Com years.

Russell 2000 Value Index
Near Historical Average Concentration

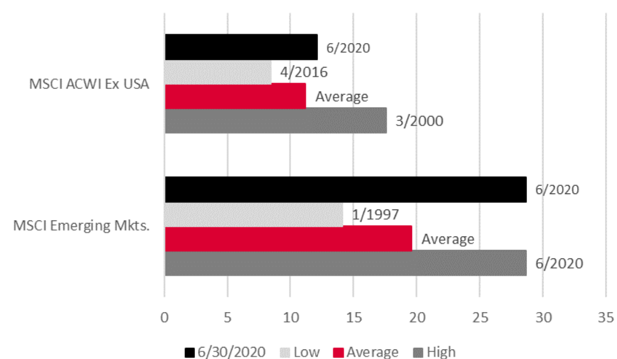


Top ten concentration in the Russell 2000 Value has, historically, run at a lower level compared to the Growth Index. The top ten index holdings have infrequently exceeded 5% of total value and, in only one month, exceeded 7%. At the end of the 2nd quarter of this year, the top ten made up 4.4% of the index. The high point of concentration occurred in February of 2000 (the same month as the 2000 Growth), with a low of 2.9% in June of 2006.

EX-US EQUITY INDICES

*% of Value in Top Ten Holdings December 1995 to June 2020**

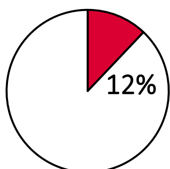
*Current, Low, Average, and High % in Top Ten Holdings December 1995 to June 2020**



*Source: Morningstar Direct.***
** Includes back-tested data for MSCI ACWI ex USA (12/1995 to 5/2007) and MSCI Emerging Markets (12/1995 to 12/2000)*

As with US equity indices, concentration in ex-US indices is driven by diversity (or lack thereof) and market cap segment. However, multinational indices also introduce the factor of geographic exposure.

MSCI ACWI ex USA
Near-average concentration

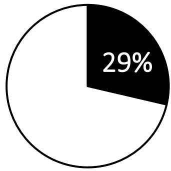


As both a hugely diverse and "ceiling-less" index, the MSCI ACWI ex USA has characteristics that both hinder and contribute to concentration. In the index's first decade, focus in the top ten grew from roughly 10% in 1995-96 to averaging over 15% in 2000-2003, only to fall back to the region of 10% in 2007. For most of the time since 2007, top ten concentration seldom exceeded 10%. Concentration has made a relatively mild spike since the end of 2019; the top ten names' share has grown steadily, to end Q2 at just over 12%.

Note that another meaningful change to the allocation of the index has been taking place since 2018: the staggered inclusion of China A-shares. China A-shares are equities traded in the Chinese Renminbi, as opposed to Chinese shares traded in foreign currencies which have been a part of the index for many years. The relative performance of Chinese equities combined with the addition of A-shares has boosted the total China exposure in the MSCI ACWI

ex USA Index from 7.7% in August of 2018 to 11.7% at the end of June (with 1.35% of that due to the A-share inclusion).

MSCI Emerging Markets
Above-average concentration



Following a pattern bearing more resemblance to the S&P 500 than the MSCI ACWI ex USA, the MSCI Emerging Markets Index held 28.6% of total value in its top ten names in June 2020 – an all-time high. That places concentration well above its December 1995 to June 2020 average of 19.6% and double its 1997 low of 14.1%. In a more contemporary comparison, top ten concentration has grown from 18.6% to the current 28.6% in just the last five years.

As with the MSCI ACWI ex USA, the allocation of the EM index to Chinese equities has grown in recent years. ***Exposure to China has risen even more quickly in the Emerging Markets Index, with China's share increasing from 32.2% in June of 2018 to 40.3% at the end of June 2020 (including 4.71% A-shares).***

OUR PERSPECTIVE

We aren't suggesting that index funds that follow any particular benchmark are imprudent investments or that capitalization-weighted indexing strategies don't belong in retirement plans. A fund that increases or decreases in concentration, even dramatically, may still constitute a prudent investment option and still fulfill the role it was intended to play in a plan or portfolio.

What we are suggesting is that fiduciaries should apply the same attention to monitoring index funds as they do to actively managed investments. While index funds largely avoid the relative security selection risk of active funds, passive management doesn't automatically confer any greater measure of prudence than an active approach. Index funds may legitimately be judged differently from active funds, but fiduciaries must have sufficient information to form that judgment.

We've used concentration for our demonstration, but the necessity to monitor index funds extends to other issues beyond performance and fees, including index suitability, replication strategy, securities lending activities, and trading practices.

In addition, sponsors should pay careful attention to how index options are communicated to participants (in writing, on the internet, or over the phone). Whether investing in index funds or active funds, participants still face the promise of gain and the threat of loss. No additional measure of safety or certainty should be implied.

Offering index funds, with low costs and, quite often, performance advantages, can be a boon for participants and sponsors alike. But no type of strategy can absolve fiduciaries of their responsibilities, and any strategy has the capacity to surprise. To avoid being surprised, plan sponsors should apply the same rigor to "boring" investments as they do to all the others.

Contact Jay Young (jay.young@vergencepartners.com) or me (tom.douglas@vergencepartners.com) with any comments or questions. Visit www.vergencepartners.com to see what else we're thinking about.

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