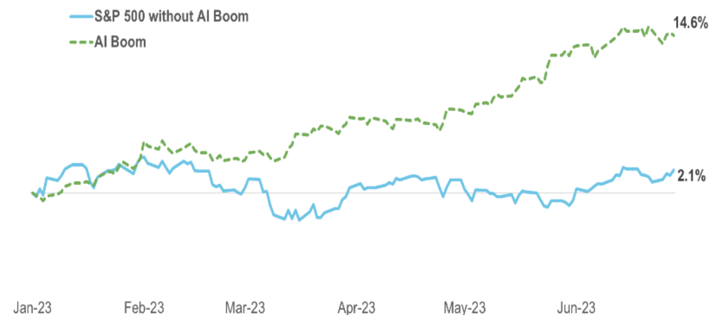
On The Mark

July 2023

The "Artificial" Magic in the Stock Market Rally

Key Takeaways

- The stock market rally has been driven by a narrow group of stocks in 2023.
- Narrow leadership can persist for a while and be painful for investors with diversified portfolios as trends in markets shift over time.
- Investors should be mindful of what they own and ensure they are well diversified for what lays ahead.



Source: Bloomberg. Year to date data as of 6/30/2023. AI related companies defined as: Alphabet, Apple, Amazon, AMD, Nvidia, Meta, Microsoft, Tesla

The stock market (S&P 500 index) is up nearly 17% for the first half and has proven surprisingly resilient despite numerous challenges. These include ongoing recession worries, instability in regional banks, and high inflation.

However, for many investors, the S&P 500's performance does not reflect the results of their diversified equity portfolios.

That's because a narrow group of big technology-related stocks, many powering artificial intelligence (AI), are dominating the returns in the overall index. These stocks are some of the largest in the S&P 500 index and include Alphabet (Google's parent company), Apple, Amazon, Advanced Micro Devices, Nvidia, Meta Platforms (formerly Facebook), Microsoft, and Tesla. For the year, these eight stocks contributed 14.6%, while the rest of the stocks in the S&P 500 only contributed 2.1%.

Why does this matter?

This has three implications. First, as an investor, if your portfolio did not include some of these names, you have likely underperformed the index. Notably, if your portfolio owned high-quality dividend stocks, then you may even see losses for the year, as these stocks were not in vogue in 2023 after showing resiliency in turbulent markets in 2022.

Second, owning the S&P 500 is not as diversifying as investors may think and does not equate to owning a basket of 500 stocks equally. The S&P 500 is a market cap index, which means that the larger stocks carry more weight in the index. The top 10 companies account for almost 32% of the index's weight, a record concentration dating back at least three decades[1]. This means that investor dollars in the S&P 500 index are reliant on the performance of just a few companies. If these companies don't pull their weight in terms of generating profits to meet the hype, this could prove challenging for future returns.

Lastly, many investors in the US are naturally biased to domestic stocks, given this is home turf. This has served many investors well, as the US stock market has outperformed many of its international peers for the last decade and a half. However, this home bias has magnified the risk of concentration in investors' portfolios. As the US has beaten its international peers, its size in the global equity market now accounts for approximately 60%[2] of the value of all the stocks in the world, a roughly 12% increase over the last decade[3]. In fact, Apple, the most highly valued public company in the US today, has a valuation greater than the entire UK stock market, the third biggest stock market in the world, and twice the size of Germany's entire stock market[4].

Key takeaway

The S&P 500's nearly 17% year-to-date total return masks the uneven and narrow market participation driven by AI. For investors, this concentration could leave their portfolio vulnerable to potential losses should the hype fizzle out. With a slowing economy and ongoing high inflation, equity markets could prove more challenging in the second half of the year. Investors should be mindful of what they own and ensure they are truly diversified for what lays ahead.

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[1] JPMorgan Guide to the Markets. Q3 2023

[2] https://www.msci.com/documents/10199/a71b65b5-d0ea-4b5c-a709-24b1213bc3c5

[3] https://www.msci.com/documents/1296102/27036039/MSCI+ACWI.pdf

[4] Dimensional Funds, 2023 Matrix Book

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