BLOG

Is Benchmark Concentration Merited?

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In the competitive business world, the divergence between the winners and losers of innovation is often dramatic, but the Covid-19 pandemic has enabled some leading companies to accelerate the pace at which they disrupt entire industries and increase their market share. For many of these companies, this powerful acceleration of digital trends has been accompanied by strong earnings growth and free cash flow, rather than the heavy costs and losses that are often the case in "brick and mortar," capital intensive companies. Some investors are concerned that digital trends have led to market indices becoming highly concentrated but if the growth, financial performance and free cash flow generated by these industry leaders are properly understood, in my opinion, these fears are unfounded.

The S&P 500 Index's concentration in just five companies is high, but not entirely new to the market. Today, Microsoft, Apple, Amazon, Alphabet and Facebook represent 21% of the index's market capitalization as of early May 2020. Concentration has been higher during periods like the Nifty 50 era of the 1970s, but the current concentration is the highest it has been in three decades. At Alger, we believe investors should keep the following points in mind:

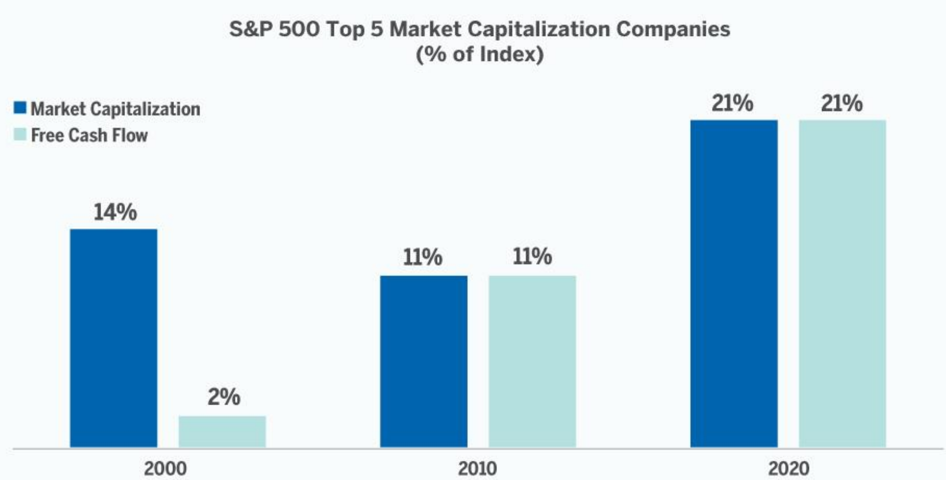
- The rising weight of the top stocks is a result of the growth of the internet and technology in our economy, which has increased the proportion of overall S&P 500 profits that are generated by companies that act as platforms for commerce, social interaction or work. This secular trend remains the strongest and largest growth trend in the U.S. and the world; it should not be underestimated in either importance or durability. The coronavirus crisis, like past crises, has accelerated, not inhibited, the adoption of innovative new services and technologies.
- Unlike in past times, free cash flow of the largest S&P 500 Index constituents is proportionate to the companies' market capitalization relative to the index. As of early May, the five largest S&P 500 constituents accounted for 21% of the benchmark's free cash flow, which is proportionate to the percentage of the index's market capitalization that the companies represent. In particular, this is in no way similar to the valuation levels achieved by leading stocks at the end of the Internet 1.0 period in 1999 and 2000 (See chart on next page).
- Innovation is providing leading companies with potential to continue growing their earnings and free cash flow. We are in an unusual period when the largest companies are innovators, not laggards, in important areas.

As a result, even as they have dominant businesses in one area, they also have rapidly developing new enterprises that can drive their future growth. Google's search is the core and foundation of Alphabet's success, but the company also has one of the leading self-driving car initiatives in Waymo and a leading cloud computing service, Google Cloud--significant growth opportunities. Other examples include streaming media and advertising at Amazon, which are adding to Amazon's turbocharged growth during Covid-19 as consumers accelerate their use of ecommerce across product categories. We believe the relatively small size of these enterprises combined with their ability to capture share in rapidly growing markets by disrupting existing business practices provides significant future growth opportunities, even for these already giant leaders.

Weightings of Internet Leaders

The disparity in the business results of traditional stores and online retailers provides insights into the power of disruption driven by internet-based companies, the rising weight of the largest companies within indices and why certain companies are generating a substantial portion of overall S&P 500 free cash flow and earnings. The multiyear struggle of brick and mortar retailers to remain relevant in the face of growing ecommerce took a turn for the worse when the government shut down shopping malls. This became the final nail in the coffin for storied, 110-year-old retailer JCPenney, which will jettison 154 of its 846 stores. In doing so, JCPenney joins a long list of retailers, including Sears and Macy's, that have closed physical stores and, in some cases, gone bankrupt. The overall growth of ecommerce, meanwhile, received a boost from consumers subjected to stay-at-home orders and social distancing who have been increasingly shopping online. This prompted Amazon.com to hire 175,000 employees earlier this year, and more recently, the company said it will make 70% of those employees permanent.

Market Capitalization Is Increasingly Concentrated But So Is Free Cash Flow



Source: FactSet and Alger. The last datapoint is May 2020.

Other disruptors are reporting increased demand from the pandemic—Facebook is experiencing strong growth in user activity as people reach out to friends and family. Facebook has also seen a large uptick in adoption of its Oculus virtual reality headset as people shift to online entertainment and gaming. The cloud-computing services of most leading providers, from Microsoft to Amazon to other data center companies, are benefiting from businesses moving more activities online, and the resulting demand for even more bandwidth, computing power and storage capacity.

Free Cash Flow Is Strong

From a broader perspective, the strong fundamentals of the largest benchmark constituents are illustrated by free cash flow, or the amount of cash a company produces from operations minus expenditures on assets. The 21% of the benchmark's free cash flow generated by the five largest benchmark constituents is particularly encouraging when considering that the five largest companies in 2000 represented 14% of the index's market capitalization but only 2% of its free cash flow.

Innovation Can Support Free Cash Flow

At Alger, we believe that innovation is continuing to provide potential for dominant internet companies to grow their earnings and free cash flow by further disrupting entire industries. This trend, we believe, illustrates that index concentration is a result of the success of leading businesses rather than a warning sign for investors. We believe the largest companies within the S&P 500 have potential to continue capturing market share with disruptive products as businesses and individuals increasingly embrace online services. This trend can potentially allow industry disruptors to continue to strengthen their free cash flow generation.

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S&P 500®: An index of large company stocks considered to be representative of the U.S. stock market. S&P 500 Index performance does not reflect deductions for fees or expenses.

The following positions represented the noted percentages of Alger assets under management as of March 31, 2020: Microsoft, 6.33%; Apple, 0.1%; Amazon, 5.67%; Alphabet, 3.16%; Facebook, 2.84% JCPenney, 0.00%; Macy's; 0.00%; and Sears, 0.00%.

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