# The Heightened Risk of Passive in U.S. Large-Cap Growth

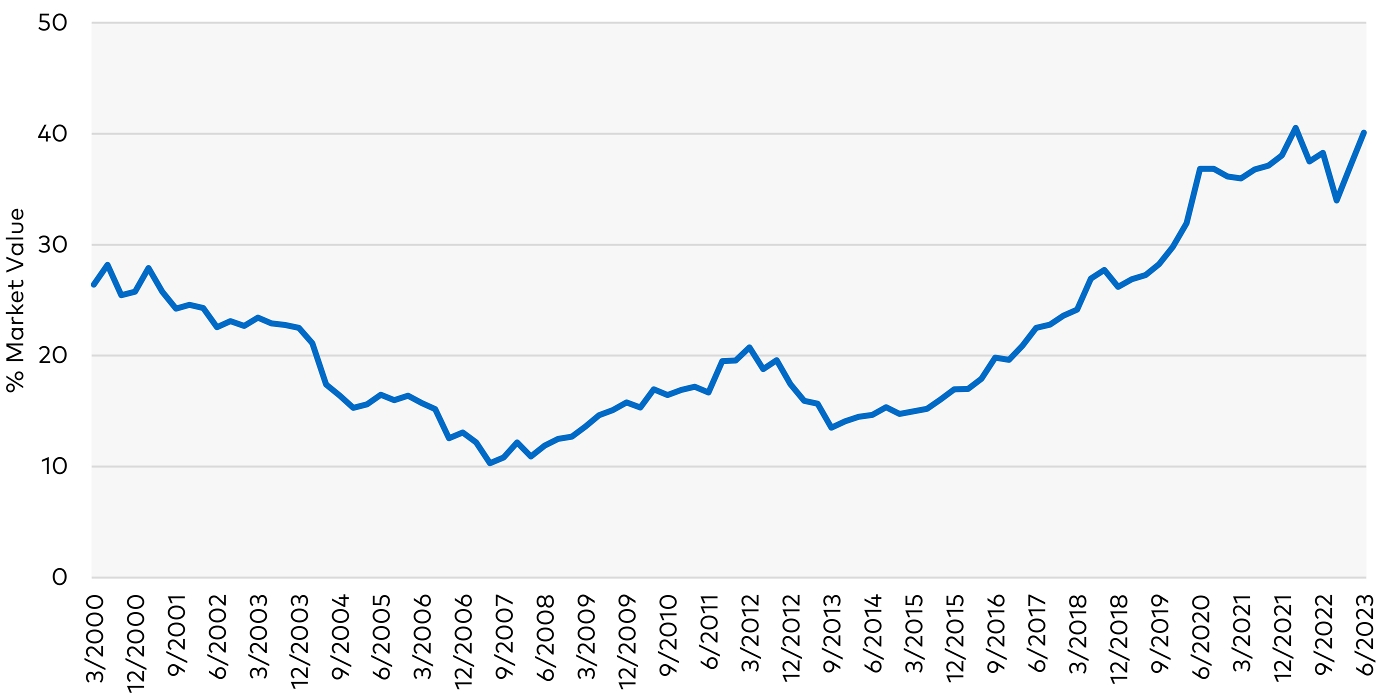
## Think twice about passively going along for the ride in a concentrated market

The Russell 1000 Growth Index has reached the highest concentration level in its 40-year history. Most people look to indices as a reasonable barometer of diversified exposure to a given asset class. But, in U.S. large-cap growth, this is arguably not the case.

### It's Getting Crowded in Here

As a proxy for the U.S. large-cap growth market, Figure 1 depicts the weight of the five largest Russell 1000 Growth Index constituents since the Tech Bubble in 2000, the last instance at which the top five holdings in the benchmark were as comparably high as they are today.

**Figure 1: % Market Value of Russell 1000 Growth Index Top Five Constituents**



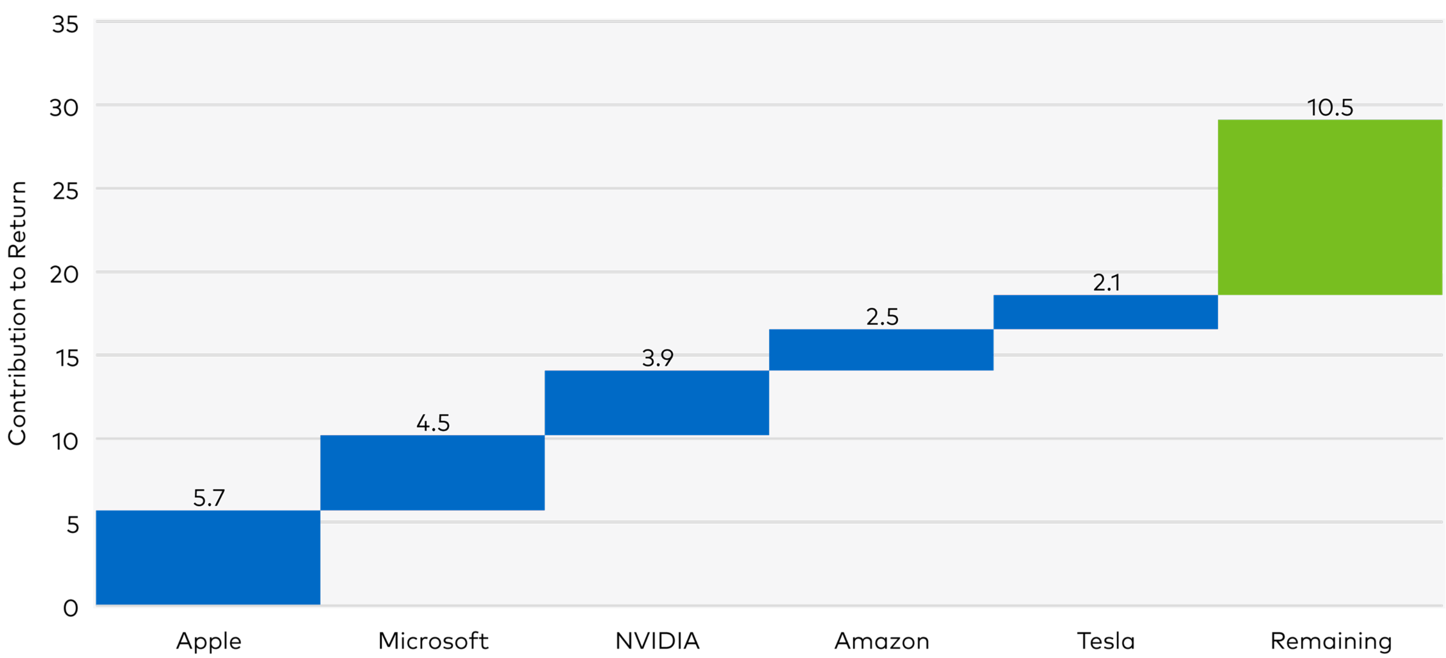

Source: Bloomberg. Data from 3-31-2000 to 6-30-2023. Includes observations of top 5 holdings in the Russell 1000 Growth, rebalanced quarterly.

Currently, ~40% of the Index's market value is accounted for by the top five holdings—Apple, Microsoft, Amazon, NVIDIA, and Tesla. The factors behind this unusual phenomenon are varied in our opinion. The generally low interest rate environment over the past decade, breakthrough innovations, the emergence of platform businesses, and winner-take-all (or most) market dynamics are all possible explanations beyond this piece's scope.

## 2023: A one-two punch of concentration and narrow markets

In the first half of 2023, the high level of concentration and strong performance from the Index's largest weights resulted in very narrow market performance. In 1H23, Apple, Microsoft, NVIDIA, Amazon, and Tesla accounted for 64% of the Russell 1000 Growth Index's return, as shown in Figure 2.

**Figure 2: 64% of the Index Return from Five Stocks**




Source: Bloomberg. Data from 3-31-2000 to 6-30-2023. Includes observations of top 5 holdings in the Russell 1000 Growth, rebalanced quarterly.

The average return of all stocks in the Russell Growth Index during that period was 15.3%[1],roughly half of its headline 29% YTD return. With just 23% of Index constituents outperforming the overall Index in the first half of the year, active managers likely found it challenging to keep pace with the benchmark without a substantial weighting in the top five holdings.

## Possible Pitfalls of Passive

Experience has shown us that consistent earnings growth year after year drives share prices. However, overpaying for growth that proves to be less durable adds another layer of risk. We think many would acknowledge that Apple, Microsoft, Amazon, NVIDIA, and Tesla are among the most competitively advantaged companies worldwide. At the same time, this does not mean that each of these companies individually offers an attractive risk/reward at this point in time. And therein lies the risk for investors, based on our research. The large collective weight of these five businesses in the Russell 1000 Growth Index means that passive investors will see their prospective returns heavily influenced by the performance of these holdings.

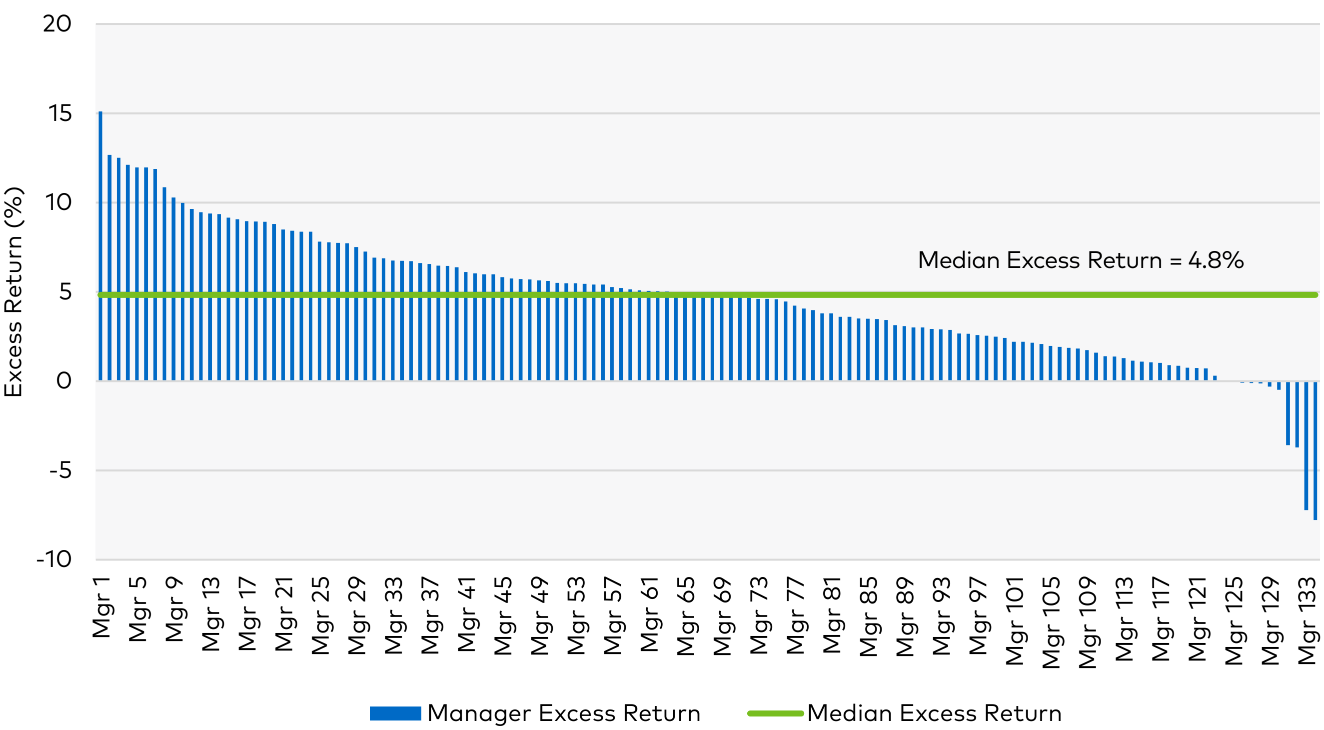
If history is a guide, then investors would be wise to take a more nuanced approach, in our opinion. As noted previously, the last instance in which the Index was this concentrated occurred in June 2000[2]. When the Tech Bubble burst in the early 2000s, the concentration in the Russell 1000 Growth Index (using the top five holdings as a proxy) declined for a prolonged period until it bottomed eight years later in March 2008.

[1] Source: Bloomberg. Data from 12-31-2023 to 6-30-2023.[2] Source: Blomberg. Data examined from 3-31-2000 to 6-30-2023.

Figure 3 shows the individual manager excess returns of the eVestment U.S. large-cap growth peer universe. Over this period of peak-to-trough concentration, the median U.S. large-cap growth active manager outperformed the Russell 1000 Growth by 4.8% annualized, gross of fees, and over 90% of active managers outperformed.

In other words, as the concentration of the Index's top five holdings slowly deflated between 2000-2008, this period proved to be a favorable environment for active growth managers. The most likely explanation for this, in our view, is that active managers weren't anchored to the top weights in the Index like their passive brethren, as those top weights collectively underperformed the benchmark.

**Figure 3: Annualized Excess Return of U.S. Large Cap Growth Active Managers, 6-30-2000 to 3-31-2008**




Source: eVestment U.S. large-cap growth universe of active managers. Data shown 6-30-2000 through 3-31-2008 to capture the unwinding of extreme market concentration. Blue bars are individual manager excess returns gross of fees, comprising 134 data points; the median manager excess return is denoted by the green line.

We are not suggesting that one should categorically avoid or underweight the top five Index companies. But history suggests that the high level of concentration among the top holdings in the Index may not persist. If this is true going forward, it implies that some of these large Index positions will underperform. In our opinion, this argues for a more active investment approach because passive benchmark investors may be unwittingly accepting an unfavorable risk/reward scenario.

## More Space for Active Management

Today, passive investors are effectively betting on the go-forward success of a small subset of companies that, in some cases, may offer a less attractive risk/reward trade-off than they realize. Previous market history illustrates the pitfalls of being anchored to a top-heavy index. By contrast, active management may be well positioned to navigate quick shifts in market dynamics should the next decade look different than the last.

# Authors

**Stephen Atkins, CFA**

Portfolio Strategist & Analyst

Stephen joined Polen Capital in 2012. Prior to joining Polen Capital, Stephen spent 12 years as a portfolio manager at Northern Trust Investments, including eight years as a mutual fund co-manager. Before joining Northern Trust, Stephen spent two years as a portfolio manager at Carl Domino Associates, LP. Stephen received his B.S. in Business Administration from Georgetown University and a General Course degree from the London School of Economics. Stephen is a CFA® charterholder and a member of the CFA Institute and the CFA Society of South Florida.

**Andrew DeVizio**

Investment Specialist

Andrew joined Polen Capital in 2022. Prior to joining Polen Capital, Andrew was an Investment Specialist at Wellington Management, where he spent over seven years serving in various roles. Prior to that, Andrew worked as an Equity Analyst at Prudential Investment Management. Andrew received a B.S. in Finance and International Business from Villanova University.



The Russell 1000® Growth Index is a market capitalization weighted index that measures the performance of the large-cap growth segment of the U.S. equity universe. It includes Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The index is maintained by the FTSE Russell, a subsidiary of the London Stock Exchange Group.

The volatility and other material characteristics of the indices referenced may be materially different from the performance achieved by an individual investor. In addition, an investor's holdings may be materially different from those within the index. Indices are unmanaged and one cannot invest directly in an index.

The Tech Bubble was a rapid rise in U.S. technology stock equity valuations fueled by investments in Internet-based companies in the late 1990s. During this period, the S&P peaked in Mar-2000 and bottomed in Oct-2002.