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# How Can Passive Indices Be So Aggressive?

## Heavy Index Concentrations Pose New Risks and Opportunities

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Recently, there has been controversy around whether certain popular benchmark indices, like the S&P 500 Index, can be considered passive.  As widely covered in the media, for the first time in history, an index manager was allegedly insider trading on index inclusion–a far cry from the more typical crime of insider trading on mergers and acquisition deals that are usually priced at a premium.  Given that recent events suggest it is possible to insider trade on index inclusion and lock in a profit, mainly from the massive inflows from institutions like pensions and 401k retirement plans into index-tracking products, there is a new twist to the debate about whether indices are passive.

Also in the news has been a battle over anti-trust laws that could impact some of the biggest names in the large-cap indices weighted by market capitalization. Facebook, Amazon, Apple and Google, which were roughly 17% of the S&P 500 Index as of September 30, 2020, may be significantly affected by possible legislation. Although regulation heavily influences some big sectors like health care and financials, the concern here is the outsized impact the regulation may have on so few companies.

Here's why index concentration matters.

This year's global pandemic has distinct winners and losers. For example, in the S&P 500 Index, the information technology sector gained 28.7% while the energy sector lost 48.1% year-to-date through September 30, 2020. However, technology's gain was far more significant to the S&P 500 Index performance than energy's loss since the index weight in technology is now more than 10 times bigger than energy's weight.

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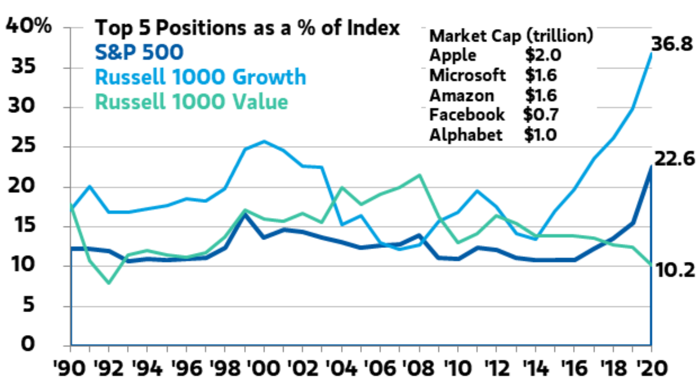
Throughout history, the S&P 500 Index, which is weighted by float-adjusted market capitalization, has rotated its leading sectors. By the end of 1990, energy comprised 13.4% of the S&P 500 Index, which was nearly twice as much as technology. However, by 1996, technology surpassed energy, and continued to grow until it reached 33.6% in August, 2000. Then the tech sector lost more than half its weight in the index by September 2001 as the tech bubble burst. While technology rebounded after 2002, it remained relatively steady for the next several years, while energy was experiencing incredible growth from global oil shortages brought on by geopolitical tensions and a series of natural disasters that disrupted supply. These events evened the two sectors up again by June 2008, each at about 16.5% weight. Post the global financial crisis, energy has diminished from oversupply caused by fracking and multiple instances of excess supply in the battle for market share, while technology doubled its index weight, recently reaching 28% in September 2020, from growing demand with increased use of smartphones, tablets, social media, messaging, streaming and more. Chances are the technology sector won't dominate forever, but in the meantime, a new, and potentially concerning index characteristic has emerged during this pandemic crisis. Further, the top five stocks in the S&P 500 Index are now more heavily weighted than ever, comprising over 20%.

**Exhibit 1: Top 5 Stock Weights of the S&P 500 and Russell 1000 Growth Reach a New High**




Source: Morgan Stanley Wealth Management, FactSet

Since active managers inevitably compare their performance to benchmarks, their portfolios are often shaped by the composition of these benchmarks. For example, active managers may use the set of stocks within the benchmark as their eligible universe to choose from, and may set guidelines outlining over/underweights per sector and per individual stock positions. According to Larry Siegel, Research Director of the Research Foundation of CFA Institute, "Benchmarks determine the performance of investment managers perhaps more than any other influence, including managers' determination to succeed and the resources and skills they bring to this task. We in the industry have largely overlooked this fact, perhaps at our peril."

Given the heavy influence of benchmarks in the construction of active manager portfolios, the record-high concentration of the top five stocks in the S&P 500 Index and Russell 1000 Growth Index, which are commonly used as benchmarks, is concerning from both a risk management perspective and the managers' ability to generate favorable performance. Therefore, in this paper, we will examine major benchmark index concentrations and their impact on active large cap core, large cap growth and large cap value managers.

## Index Concentrations

While there are nearly three million indices calculated, according to the Index Industry Association, very few are considered standard benchmarks. For example, the S&P 500 Index is widely used as a benchmark by active managers and as a gauge of US large cap equities. According to the S&P Dow Jones Indices Annual Survey of Assets in 2019, there were $6.6 trillion in actively managed funds where the performance of the active manager was measured against the S&P 500. Most other indices, even well-known and simple ones like the S&P 500 Equal Weight Index, are not commonly considered benchmarks. This is because many active managers and investors consider the choice to equal weight rather than market cap weight to be a deliberate decision to generate alpha, which can be defined as excess return relative to the benchmark and adjusted by the degree of market risk exposure.

The Russell 3000 Index is also commonly used as a large cap equity benchmark along with the S&P 500. For large cap style benchmarks, the Russell 1000 Growth Index, Russell 3000 Growth Index, Russell 1000 Value Index and Russell 3000 Value Index are generally used. Similar to the S&P 500, the Russell 1000 and Russell 3000 are market cap weighted, and the weight of the top 5 stocks in those indexes are summarized in Exhibit 2.

**Exhibit 2: Top 5 Holdings of Major Large Cap Benchmarks Show High Concentration, Except Value**

| | S&P 500 (%) | | Russell 3000 (%) | | Russell 1000 Growth (%) | | Russell 1000 Value (%) | |
|---|---|---|---|---|---|---|---|---|
| | AAPL | 6.7 | AAPL | 5.6 | AAPL | 11.3 | BRK.B | 2.7 |
| | MSFT | 5.7 | MSFT | 4.7 | MSFT | 9.5 | JNJ | 2.3 |
| | AMZN | 4.8 | AMZN | 4.0 | AMZN | 8.1 | JPM | 2.0 |
| | FB | 2.3 | FB | 1.9 | FB | 3.8 | VZ | 1.7 |
| | GOOGL | 1.6 | GOOGL | 1.3 | GOOGL | 2.1 | DIS | 1.5 |
| | GOOG | 1.5 | GOOG | 1.3 | GOOG | 2.0 | | 0.0 |
| **Total Top 5 Positions** | | **21.0** | | **17.6** | | **34.8** | | **10.2** |
| **Total Top 5 Positions + GOOG** | | **22.6** | | **18.9** | | **36.8** | | **10.2** |

Source: Morgan Stanley Wealth Management, FactSet as of Sept. 30, 2020.

Besides the significant concentration of the top five positions combined for the S&P 500, Russell 3000, and Russell 1000 Growth as shown in Exhibit 2, there are several instances of single positions greater than 5%, and even more than 10%. This creates a challenge for active managers if they have position limits in their guidelines that won't allow them to track the index as closely as they intend. Next, we will examine how some active large cap managers are positioned in light of these benchmark concentrations.

# Active Large Cap Position and Sector Limits Versus their Benchmarks

Since the goal for most active managers is to outperform their benchmarks over time, weighting differences by sectors and individual stocks becomes necessary to generate alpha; however, the rise of index concentration may create challenges in portfolio construction resulting from a manager's risk management limits. The goal of our analysis was to understand whether such stated risk management limits were indeed capping alpha potential.

In our analysis, we looked at the sixteen largest separately managed accounts (SMAs) by Morgan Stanley Wealth Management (MSWM) client assets on the Select UMA platform and covered by the MSWM Global Investment Manager Analysis (GIMA) team. GIMA conducts manager due diligence and provides a menu of investment options on either the Approved List or the more selective Focus List.

As mentioned previously, the technology sector in the S&P 500 Index was 28% and the largest stock position was 6.7%, as of September 30, 2020. The Russell 1000 Growth Index had nearly 45% in technology with 11% in its biggest position. Two of the six large cap managers that use the S&P 500 Index as the benchmark had position limits lower than the indexes' top constituents as of September 2020, meaning these managers were forced to hold a smaller allocation relative to the benchmark. Since the large cap growth indices had higher concentration than the large cap indices, six of the ten US large cap growth SMAs in our list are faced with position limits, while four were faced with limiting the technology sector to about 40%. This could be considered a form of risk management; however, if the largest stock in the index or the technology sector were to rally the most, these underweights could create a drag on performance.

### Exhibit 3: Position and Sector Limits of the Largest US Large Cap and US Large Cap Growth SMAs by MSWM Client Assets in Select UMA

| Manager | Asset Class | Maximum Position | Sector Guidelines | # of Holdings | Benchmark |
|---|---|---|---|---|---|
| Manager 1 | US Large Cap | 10% | No more than 2x the Index or 40% max | 40-60 | S&P 500 |
| Manager 2 | US Large Cap | 10% | 30% max | 25-35 | S&P 500 |
| Manager 3 | US Large Cap | 10% | No formal limit. 25% industry maximum | 25-40 | S&P 500 |
| Manager 4 | US Large Cap | 5% | No max (historical maximum has been 30%) | 40-50 | S&P 500 |
| Manager 5 | US Large Cap | 5% | No formal limit | 30-60 | S&P 500 |
| Manager 6 | US Large Cap | Typically +/- 25bps relative to benchmark weight | Typically +/- 25bps relative to benchmark weight | 300-400 | S&P 500 |
| Manager 7 | US Large Cap Growth | No max. Typically 10% | No formal limit | 30-60 | Russell 1000 Growth |
| Manager 8 | US Large Cap Growth | 10% | No more than 2x the Index or 40% max | 25-45 | Russell 3000 Growth |
| Manager 9 | US Large Cap Growth | 10% | 50% max | 15-25 | Russell 1000 Growth |
| Manager 10 | US Large Cap Growth | 10% | No more than 2x the Index or 40% max | 80-90 | Russell 3000 Growth |
| Manager 11 | US Large Cap Growth | 8% | No formal limit. 25% industry maximum | 35-45 | Russell 1000 Growth |
| Manager 12 | US Large Cap Growth | 4% | 40% max | 50-60 | Russell 3000 Growth |
| Manager 13 | US Large Cap Growth | 5% at cost | 40% | 50-70 | Russell 1000 Growth |
| Manager 14 | US Large Cap Growth | Greater of 5% or index weight +2.5% | +/- 10% vs. index | 55-65 | Russell 1000 Growth |
| Manager 15 | US Large Cap Growth | +/- 5% vs. index | +/- 50% vs. index | 40-50 | Russell 1000 Growth |
| Manager 16 | US Large Cap Growth | +/- 5% vs. index | +/- 50% vs. index | 40-50 | Russell 1000 Growth |

Source: Morgan Stanley Wealth Management

We've also assessed the broader US large cap growth SMA universe covered by GIMA to measure concentration in the top five holdings of the large cap growth indices, Facebook, Apple, Amazon, Microsoft, and Google's parent Alphabet. We found that, on average, our managers have fairly significant underweights to those stocks (~13%) as of September 30, 2020. As shown in Exhibit 4, these underweights have been increasing through the year, particularly following the reconstitution of the Russell indices in June 2020. Of the 34 unique large cap growth SMA strategies assessed by GIMA, there were only two strategies with an aggregate overweight to the top five holdings while two others had allocations close to the index.

**Exhibit 4: Increasing Underweight of the Top 5 Holdings versus the Russell 1000 Growth Index for Large Cap Growth SMAs at MSWM**

| Focus List Managers | # of Strategies | Average Weight (%) | | | | Average Active Weight vs Index (%) | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-19 | Mar-20 | Jun-20 | Sep-20 |
| Aggressive Growth | 4 | 19.8 | 20.0 | 19.6 | 18.9 | (10.0) | (12.0) | (17.2) | (17.9) |
| Conservative Growth | 4 | 16.4 | 19.7 | 22.5 | 21.6 | (13.4) | (12.2) | (14.3) | (15.3) |
| Traditional Growth | 8 | 20.5 | 22.7 | 23.0 | 22.1 | (9.3) | (9.3) | (13.9) | (14.8) |
| | 16 | | | | | | | | |

| Focus & Approved List Managers | # of Strategies | Average Weight (%) | | | | Average Active Weight vs Index (%) | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-19 | Mar-20 | Jun-20 | Sep-20 |
| Aggressive Growth | 10 | 22.0 | 23.4 | 23.7 | 23.5 | (7.8) | (8.5) | (13.1) | (13.3) |
| Conservative Growth | 7 | 17.7 | 21.2 | 24.4 | 24.1 | (12.1) | (10.8) | (12.4) | (12.8) |
| Traditional Growth | 17 | 20.8 | 23.8 | 24.5 | 24.1 | (9.0) | (8.1) | (12.3) | (12.7) |
| | 34 | | | | | | | | |

Source: Morgan Stanley Wealth Management, FactSet.

# Active Manager Outperformance Is Improving Despite High Benchmark Concentrations

Let's start with a discouraging statistic for active large cap mutual funds. From Morningstar's universe of approximately 3200 mutual funds (net of fund fees) 8% of active large cap core, 25% of active large cap growth and 49% of active large cap value mutual funds in the US outperformed their benchmarks in the last 3 years ending June 30, 2020 (Exhibit 5). Active management, particularly in large cap, has struggled at the back end of the last bull-market cycle. This led to the growth in passive products, with passive AUM eclipsing active products for the first time ever in 2019. We have seen the tides start to shift, as active has begun to perform better more recently. More recently, 23% of active large cap core, 41% of active large cap growth and 59% of active large cap value mutual funds in the US outperformed their benchmarks year-to-date through June 2020.

We find a similar pattern in the outperformance (gross of fees) of PSN's SMA universe where 24% of active large cap core, 25% of active large cap growth and 62% of active large cap value SMAs outperformed their index in the last 3 years ending June 2020. Conversely, during the first-half of 2020, the large cap core, growth and value SMA outperformance was a respective 32%, 35% and 65%, reflecting an improving trend. Given the high concentration in the Russell 1000 Growth Index of 37% cumulatively in the top 5 holdings and 45% in the technology sector, compared with the low concentration of the Russell 1000 Value Index with 10.2% in the top 5 stocks and 18% in financials, it is useful to compare the consistency of outperformance of active managers between growth and value styles. The data suggests that lower index concentration has, at least historically, been more beneficial for active managers. This makes intuitive sense given that a broader market allows for greater opportunity to select winners from losers, and hence greater chances for active managers to outperform.

**Exhibit 5: Percentage of Active Managers Outperforming their Benchmarks**

| Mutual Funds - net of fund fees and expenses | | | | | |
|---|---|---|---|---|---|
| Morningstar Universe | YTD | 1 Yr | 3 Yrs | 5 Yrs | 10 Yrs |
| Large Growth | 41 | 18 | 25 | 15 | 13 |
| Large Blend | 23 | 12 | 8 | 1 | 1 |
| Large Value | 59 | 58 | 49 | 41 | 25 |

| SMAs - gross of fees and expenses | | | | | |
|---|---|---|---|---|---|
| PSN Universe | YTD | 1 Yr | 3 Yrs | 5 Yrs | 10 Yrs |
| US Large Cap Growth | 35 | 23 | 25 | 19 | 24 |
| US Large Cap | 32 | 25 | 24 | 19 | 37 |
| US Large Cap Value | 65 | 67 | 62 | 58 | 64 |

Source: Morgan Stanley Wealth Management, Morningstar, PSN Informa as of June 30, 2020.

**Exhibit 6: Percentage of Focus List Large Cap Growth and Large Cap Value SMAs Outperforming their Benchmarks**

| Excess Return Statistics (gross of fees) | | YTD (%) | 1-Yr (%) | 3-Yrs (%) | 5-Yrs (%) | 10-Yrs (%) |
|---|---|---|---|---|---|---|
| US Large Cap Growth | % of managers outperforming the benchmark | 61 | 44 | 67 | 67 | 61 |
| | % of managers above peer median ranking | 67 | 61 | 78 | 78 | 72 |
| US Large Cap Value | % of managers outperforming the benchmark | 79 | 86 | 79 | 79 | 86 |
| | % of managers above peer median ranking | 57 | 64 | 71 | 71 | 64 |

Source: Morgan Stanley Wealth Management as of June 30, 2020.

Despite these broad performance statistics, managers on GIMA's Focus List have generated more competitive performance (Exhibit 6) but with a similar bias favoring the value style for the greatest consistency. Over the 3-year period ending June 30, 2020, 67% of the large cap growth SMAs on the Focus List outperformed the benchmark, gross of fees and expenses, and 78% of them ranked above the universe median. While for the value style, 79% of the large cap value SMA managers on the Focus List outperformed over a 3-year period, and 71% of them ranked above the universe median. It is noteworthy that, while the large cap growth SMAs on the Focus List were, on average, underweight the top 5 positions in the Russell 1000 Growth Index over the year-to-date period through June 2020 (Exhibit 4), they delivered favorable results with 61% outperforming the benchmark (Exhibit 6). According to GIMA's analysis, the primary driver for outperformance was strong stock selection.

Recent performance history suggests improvement in active management may have begun. Further, given the concentration of the top five positions in the Russell 1000 Growth Index, it may be prudent to allocate to an active manager in large cap growth with an underweight to these positions to offset risks associated with market concentration. For large cap value, market breadth remains supportive of active managers who have a higher probability of outperformance.

# Conclusion

The global pandemic, and resulting stock market decline and rebound, has been not only fast but also unusual in how it has divided winners and losers so clearly by stocks and sectors benefitting and suffering from the changes in consumer and commercial behavior. Add to that, the unprecedented fiscal and monetary stimulus that floated the market and targeted specific sectors and smaller businesses. Large cap stocks that had such a spectacular run-up in the last decade put into question whether active management could be worth continued consideration. Despite the historic weakness in active manager performance that suggests the answer was no, today's large cap index concentrations may suggest otherwise.

The high concentrations of the top five positions for both large cap and large cap growth benchmarks, including the S&P 500 Index and Russell 1000 Growth Index, respectively, have created a risky profile for passive investors today. Supporting evidence discussed in this paper shows that large cap active managers on GIMA's Focus List, while generally underweight the top 5 holdings whether through risk management limits or active management decisions, were generally able to generate alpha from favorable security selection and to intelligently design their portfolios to outperform.

Going forward, we anticipate continued improvement in alpha generation of active managers, particularly if market breadth improves beyond the narrow stock leadership dominated by top index constituents. We recommend investors consider MSWM's proprietary manager scoring tools that include Adverse Active Alpha 2.0SM (1), Value Score (2) and Risk Score (3), coupled with GIMA's qualitative insights and Focus List to help select managers that may outperform. For further information on MSWM's proprietary manager scoring tools, please reach out to your Financial Advisor. Finally, for large cap or large cap growth styles, investors should consider managers that are underweight the top index constituents to help offset risks associated with today's market concentration.

[1] Adverse Active Alpha 2.0: Scoring Active Managers According to Potential Alpha, MSWM GIC Special Report, June 23, 2020.

[2] Value Score: Measuring Fee Efficiency by Comparing Managers' "Fair Value" and Actual Expense Ratios, MSWM GIC Special Report, June 23, 2020.

[3] Risk Score: Ranking Managers on Upside Opportunity, Downside Mitigation and Consistency, MSWM GIC Special Report, June 23, 2020.

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programs. We have policies and procedures to help us meet this goal. However, our business is subject to various conflicts of interest. For example, ideas and suggestions for which investment products should be evaluated by GIMA come from a variety of sources, including our Morgan Stanley Wealth Management Financial Advisors and their direct or indirect managers, and other business persons within Morgan Stanley Wealth Management or its affiliates. Such persons may have an ongoing business relationship with certain investment managers or mutual fund companies whereby they, Morgan Stanley Wealth Management or its affiliates receive compensation from, or otherwise related to, those investment managers or mutual funds. For example, a Financial Advisor may suggest that GIMA evaluates an investment manager or fund in which a portion of his or her clients' assets are already invested. While such a recommendation is permissible, GIMA is responsible for the opinions expressed by GIMA. See the conflicts of interest section in the applicable Form ADV Disclosure Document for Morgan Stanley Wealth Management for a discussion of other types of conflicts that may be relevant to GIMA's evaluation of managers and funds. In addition, Morgan Stanley Wealth Management, MS&Co., managers and their affiliates provide a variety of services (including research, brokerage, asset management, trading, lending and investment banking services) for each other and for various clients, including issuers of securities that may be recommended for purchase or sale by clients or are otherwise held in client accounts, and managers in various advisory programs. Morgan Stanley Wealth Management, managers, MS&Co., and their affiliates receive compensation and fees in connection with these services. Morgan Stanley Wealth Management believes that the nature and range of clients to which such services are rendered is such that it would be inadvisable to exclude categorically all of these companies from an account. Morgan Stanley charges each fund family we offer a mutual fund support fee, also called a "revenue-sharing payment," on client account holdings in fund families according to a tiered rate that increases along with the management fee of the fund so that lower management fee funds pay lower rates than those with higher management fees.

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