



DISTILLATE CAPITAL

Concentration Risk

The weight of the largest five stocks in the S&P 500 has increased sharply in recent years (see **Figure 1**). The concentration of the market by this measure is greater than it has been and significantly higher than even during the bubble in 2000.

The largest 5 stocks in the S&P 500 Index (currently MSFT, AAPL, AMZN, GOOGL, & TSLA) make up a record portion of its overall value.

Figure 1: Weight of Biggest 5 Stocks in the S&P 500

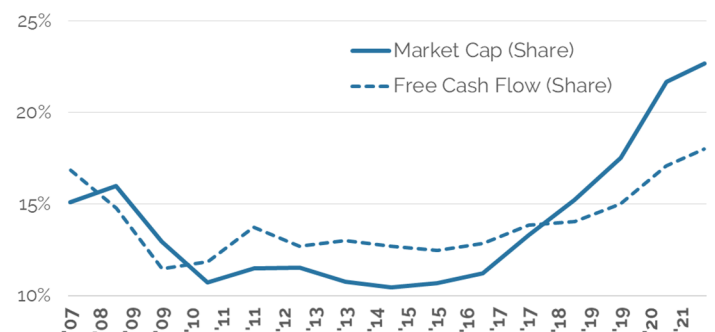


Source: FactSet; data as of 9/30/2021

To understand this recent change, it is important to look beyond the simple weight of the largest stocks in the market and to examine the underlying fundamentals as well. **Figure 2** attempts to do this by looking at five largest stocks' share of overall market value and expected next-twelve-month free cash flows relative to the S&P 500.² The chart, which looks at annual data historically and then as of October 31 for 2021, shows that the recent market value increase was much greater than the underlying gains in free cash flow. For much of the last decade, the opposite was true and the largest five stocks' free cash flow share of the index was larger than their market value share—implicitly suggesting their share prices expressed some disbelief in the sustainability of the underlying business models. Put plainly, the largest five stocks were previously less expensive than the overall market and traded with higher free cash flow yields. But with the recent movement, they are now substantially more expensive than the market with a free cash yield of just 3.3% compared to the overall market's 4.2%. This is evident in **Figure 3**.

The largest 5 stock's weight in the market is now much larger than their free cash flow share, whereas the reverse was generally true previously.

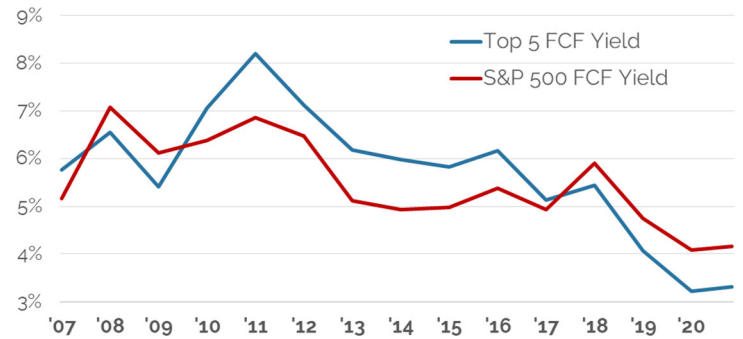
Figure 2: Top 5 Mkt Value vs. Free Cash Share of S&P 500



Source: FactSet; excludes stocks without data.

After being more attractively valued than the overall market, the largest 5 stocks are now considerably more expensive.

Figure 3: Free Cash Yield of Top 5 vs. the S&P 500



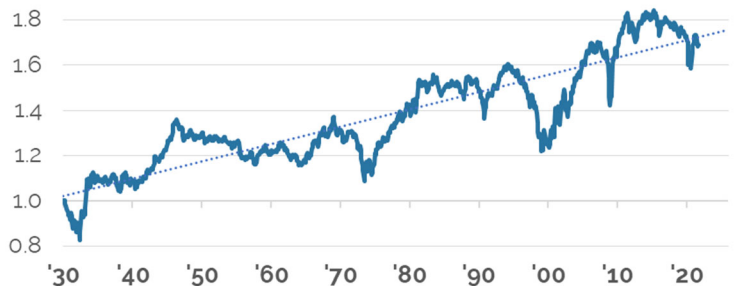
Source: FactSet; excludes stocks without data.

In addition to the concentration risk in the index from the significant weight of the largest five stocks and their corresponding current valuations, it is worth noting that there is a historical disadvantage in cap weighted indexes versus indexes with alternative weighting schemes. Inherent in their design, cap weighted indexes place more weight in stocks with high prices, and less weight in shares that are potentially less expensive. Over a very long period of time, note the upward sloping trend comparing an equal-weighted index of large U.S. stocks to a cap weighted version (see **Figure 4**). The long-term outperformance of the equal weighted index speaks to the difficulty of the biggest companies remaining so despite seeming advantages from scale and market power.

Today's valuations leave us with no exposure to the five largest U.S. stocks. Given their collective weight, near-term variability in performance of Distillate's U.S. FSV strategy versus the S&P 500 is likely. However, our priority remains long-term capital preservation and we believe the level of concentration risk in the benchmark is high, and that there are better value opportunities outside of these largest stocks.

An equal-weighted index of the largest U.S. stocks has outperformed a market-cap weighted one over time, though the reverse tends to occur around periods of economic weakness or valuation bubbles.

Figure 4: Performance of Equal vs. Cap-Weighted U.S. Large Stocks Over Time*



* Top 30% of all U.S. stocks which currently corresponds to ~540 stocks. Source: Ken French Data Library, data through Oct '21

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Figure 2 & Figure 3 Methodology notes:

1. *The A and C share classes of Alphabet, the parent company of Google, are combined.*
2. *In calculating the free cash flow and market cap share of the overall index, stocks without estimated free cash flows in any given period were excluded from both the free cash flow and market cap calculations and the rest of the index re-weighted accordingly.*

Free Cash Flow refers to a company's operating cash flow, less its capital expenditures. Data excludes the real estate sector.

The **S&P 500 Index** is an index of roughly the largest 500 U.S. listed stocks maintained by Standard & Poor's. The **Russell 1000 Value Index** is a stock index, managed by FTSE Russell, representing large capitalization U.S.-listed stocks that appear inexpensive on FTSE Russell's valuation criteria.

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