



Historic Concentration Forges Emerging Asset Class in Growth Equities

Key Takeaways

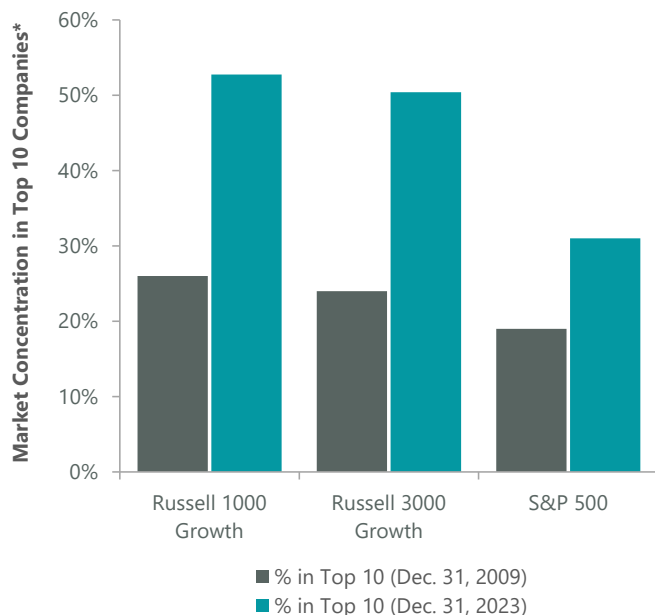
- ▶ The market for growth stocks defined by indexes and followed by most active strategies has morphed from a diverse, all cap universe to one increasingly concentrated in a handful of mega cap stocks. This shift has increased the average market cap while reducing the active share and diversification of most portfolios.
- ▶ The combination of mega cap concentration and capitalization limits for small and mid cap indexes has caused a wide gap to emerge between large cap and traditional mid cap growth asset classes.
- ▶ Such disparity has led to a cohort of high-quality growth companies from the upper end of mid cap to the lower end of large cap being less well represented in investor allocations. Characterized by stocks in the \$10 billion to \$100 billion capitalization range, we believe this “mid cap plus” segment merits inclusion.

Growth Market Has Become Increasingly Concentrated

Over the past few years, a small number of mega cap stocks have experienced a heroic rise in market value. The outperformance of the group, termed the “Magnificent Seven,” which includes Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla, has caused a dramatic change in the composition of major indexes. Broad-based market indexes like the S&P 500 Index and even more so growth benchmarks like the Russell 1000 Growth Index and Russell 3000 Growth Index have become increasingly concentrated due to their market-cap-weighted methodology (Exhibit 1).

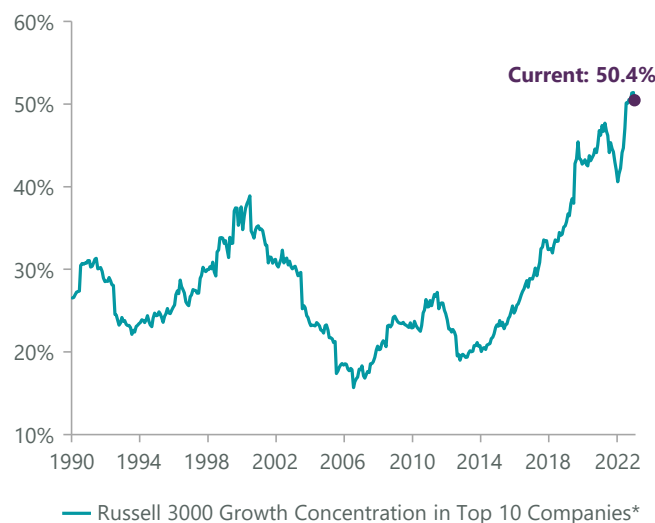
The top 10 names in the Russell 3000 Growth Index represented more than 50% of the index at the end of 2023, up considerably from 15 years ago and even compared to the dot-com bubble (Exhibit 2). The market for growth, as represented by these growth indexes, has morphed from what used to be a diverse, all cap universe of stocks to one increasingly concentrated in a handful of mega cap stocks residing in just a few industries.

Exhibit 1: Market Indexes Have Grown Top-Heavy



*Top 10 companies includes calculation of both Alphabet A & C share classes as one entity. Source: FactSet.

Exhibit 2: Russell 3000 Growth Concentration in Top 10 at Historic Highs



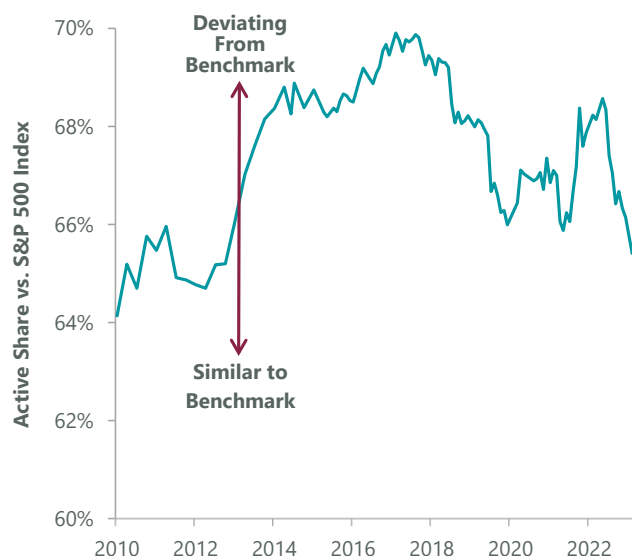
*Top 10 companies includes calculation of both Alphabet A & C share classes as one entity. Data as of Dec. 31, 2023. Source: FactSet.

Likewise, most all cap and large cap strategies have chased the Magnificent Seven. Cap-weighted passive strategies are required to track concentrated benchmark weightings while most active managers have become closet indexers to keep up from a relative performance standpoint. This has resulted in a peer group that looks increasingly top-heavy. Looking across the Morningstar

category for large growth, the average exposure of the peer group to these seven names was roughly 31% at the end of 2023, up from 15% just five years ago. Concentration has risen in lockstep, with top 10 names now representing 46% of large growth portfolios, on average, versus 29% five years ago.

With many managers crowding into the Magnificent Seven, we have also seen active share fall across active management. While this is true for core managers, who have shown less active share as compared to the S&P 500 in recent years (Exhibit 3), it is even more pronounced in the market for growth, as evidenced by active share of growth managers versus the Russell 3000 Growth Index.

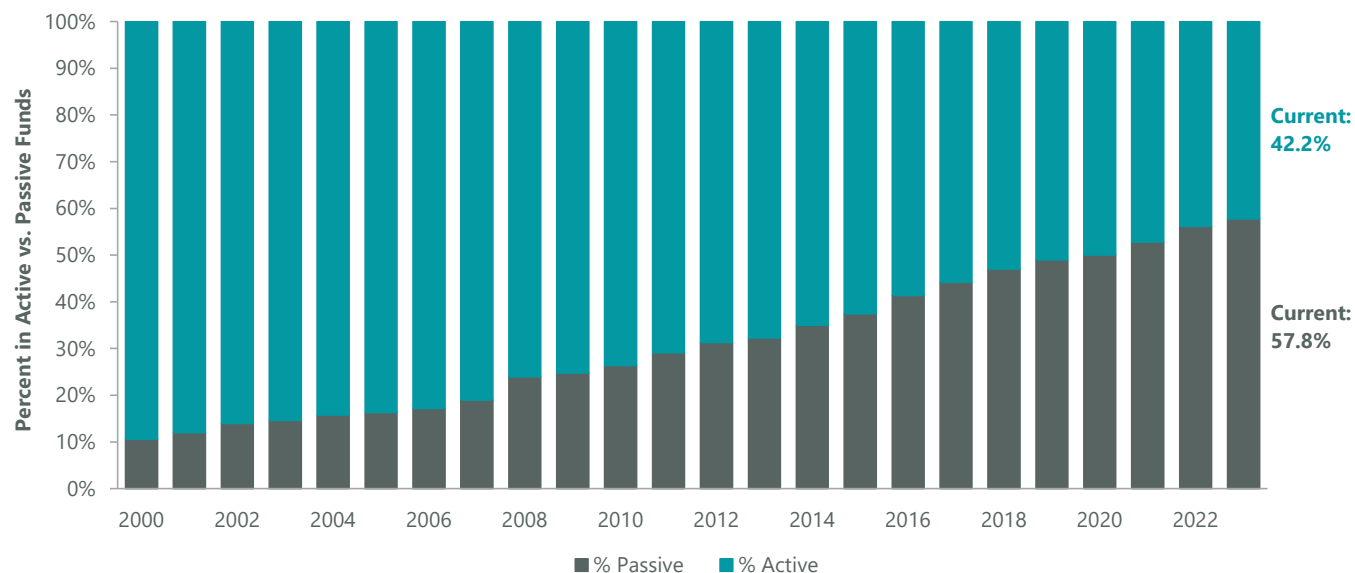
Exhibit 3: Large Cap Growth Active Share on the Decline



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The rise in passive assets under management only exacerbates this issue for clients. According to the Investment Company Institute, passive assets now make up 58% of industry assets (Exhibit 4), up significantly from 32% just 10 years ago. With increased allocation to passive vehicles, whether it be the Russell growth indexes or the S&P 500, all now have outsized exposure to a small handful of names. As a result, we believe investors are less diversified than ever.

Exhibit 4: Majority of Assets Reside in Passive Strategies



As of Dec. 31, 2023. Source: Strategas, based on an analysis of data from the Investment Company Institute. Assets represent U.S. equities only.

A Vacuum Between Large and Mid Cap Growth

Increased exposure to mega cap stocks across both passive and active strategies has resulted in a market (as defined by major indexes), as well as all cap growth and large cap growth peer sets, with significantly higher weighted average market caps than we have seen historically. The weighted average market cap of the Russell 3000 Growth is up more than 13x since 2009 as index concentration has become more extreme. Likewise, as illustrated well by Morningstar's traditional style map (Exhibit 5), most large cap growth peers now extend beyond the large growth style box.

Meanwhile, the weighted average market cap of small cap growth and mid cap growth indexes are limited by upper market cap thresholds and through annual rebalancing. By the same token, and in order to stay true to their category, small cap growth and mid cap growth strategies are often forced to sell securities that have appreciated above a certain market cap threshold to prevent their weighted average market cap from drifting too high and to stay style pure. This constrains mid cap growth indexes and strategies from moving larger in market cap.

As a result, we have seen a gap emerge between large cap growth and mid cap growth asset classes. This is evident in the widening disparity in weighted average market cap between the more traditional small cap growth and mid cap growth indexes and the large

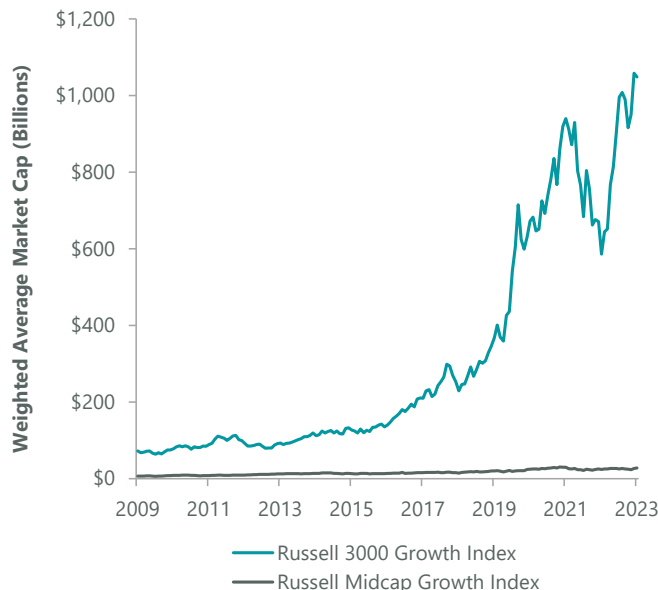
cap and all cap growth indexes (Russell 1000 Growth and Russell 3000 Growth) which are dominated by the Magnificent Seven (Exhibit 6).

Exhibit 5: Large Growth Strategies Have Grown Beyond Their Style Box



As of Jan. 30, 2024. Source: Morningstar (Equity Holdings Style Map).

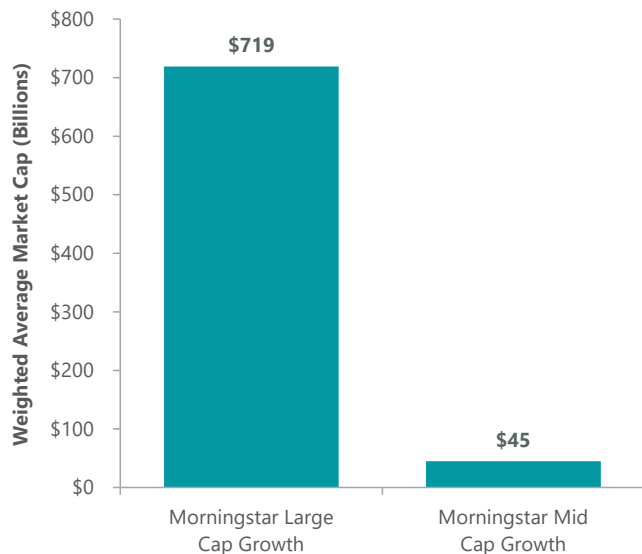
Exhibit 6: Size Gap Between Mid Cap Growth, All Cap Growth Has Soared



As of Dec. 31, 2023. Source: FactSet.

You can see the same dynamic when comparing the weighted average market cap of the Morningstar large cap growth and mid cap growth peer sets (Exhibit 7). A vacuum has been created between the exposures that these two more traditional asset classes now provide.

Exhibit 7: Wide Disparity in Average Market Caps Across Growth Universe



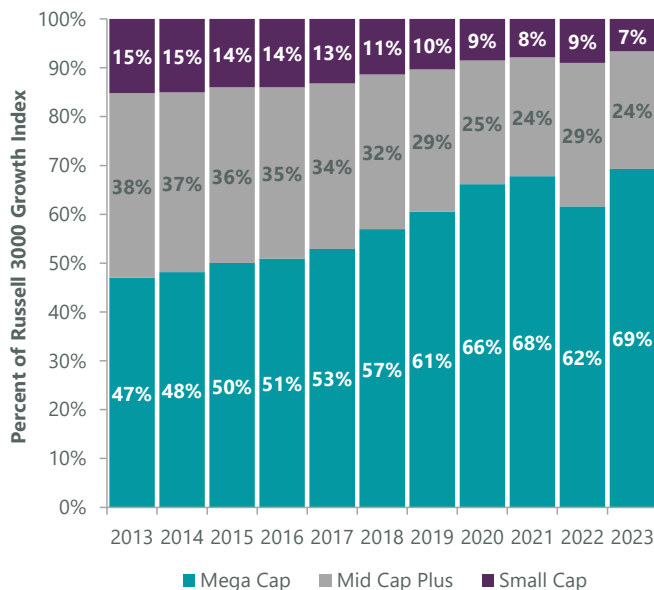
As of Dec. 31, 2023. Source: FactSet.

Mid Cap Plus: An Overlooked Asset Class

With both active management peers and passive indexes concentrating elsewhere, there are a number of high-quality growth companies in the upper end of mid cap and the lower end of large cap being less well represented in retail and institutional asset allocations today. Characterized by names in the \$10 billion to \$100 billion market cap range, we think about this “mid cap plus” universe in terms of market cap percentiles of the index, not a fixed range.

We analyzed how representation of this universe has evolved over time in a growth index like the Russell 3000 Growth. At the end of 2023, the mid cap plus segment of the market constituted less than a quarter of the index, down considerably versus a percentage in the mid to high 30s in the mid 2010s (Exhibit 8). This leaves all cap and large cap allocations with less exposure to this segment of the market than they have enjoyed historically.

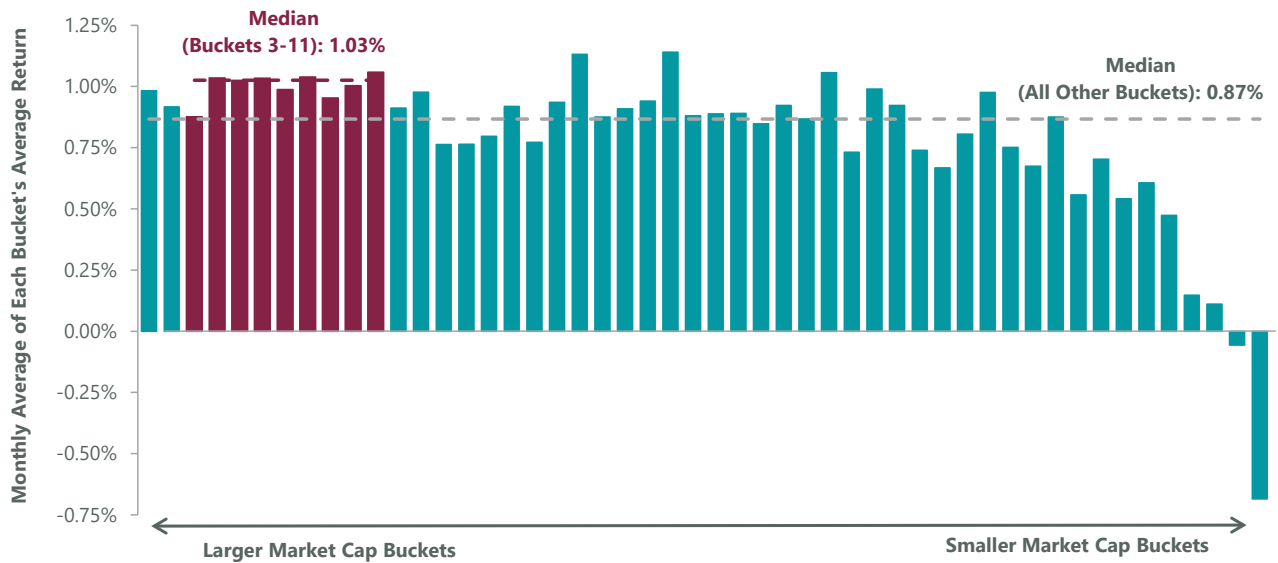
Exhibit 8: Mega Cap Crowding Out Everything Below



As of Dec. 31, 2023. Source: FactSet, Bloomberg, ClearBridge Investments. For this analysis, we divided the Russell 3000 Growth Index into three buckets each calendar year-end based on market cap percentiles, as follows: Small Cap below 80th percentile, corresponding to < \$10 billion, Mid Cap Plus from 80th percentile to 97th percentile, corresponding to a range of \$10 billion to \$127 billion, Mega Cap above 97th percentile, corresponding to > \$127 billion.

To prove out the merits of investment in the mid cap plus segment of the growth market, we took a cross-sectional look at the Russell 3000 Growth Index. We divided the index into 50 buckets based on monthly market cap back to 1985 with roughly an equal number of names in each segment. For each of these groupings

Exhibit 9: Superior Long-Term Returns for Mid Cap Plus



Source: FactSet, ClearBridge Investments. For this analysis, we divided the Russell 3000 Growth Index into 50 equal-sized buckets sorted by market capitalization (with around 30 names in each bucket) each month from January 1985 to December 2023, calculated each bucket's average monthly return, and then calculated a monthly average for the entire period.

of around 30 names, we calculated the cross-sectional mean return as a measure of expected return from investing in each bucket (Exhibit 9).

While returns at the top end of the investment universe in terms of market cap were not poor, average returns in the subsequent buckets (3–11) were consistently higher. This is true up until bucket 12, which corresponds to stocks with a market cap just below \$10 billion in today's terms. Overall, in the past 20+ years, names in the mid cap plus segment have had superior median returns than both larger cap and smaller cap companies. Yet with all cap and large cap active management peers and passive indexes bloated with mega caps, we believe investors remain under allocated to this attractive segment of the market.

Compounding this issue, investors are under allocated to the mid cap growth category more broadly. In terms of market representation, mid cap growth only represents \$316 billion in industry assets under management, as compared to large cap growth and small cap growth at \$2 trillion and \$222 billion, respectively. This is despite a strong return profile, with mid cap growth achieving excess returns as compared to both large cap growth and small cap growth over a long time frame. Over rolling six-month periods from January 1994 to March 2023, mid cap growth outperformed large cap growth 55% of the time with an average excess return of 6.0% in periods of outperformance, according to State Street Global

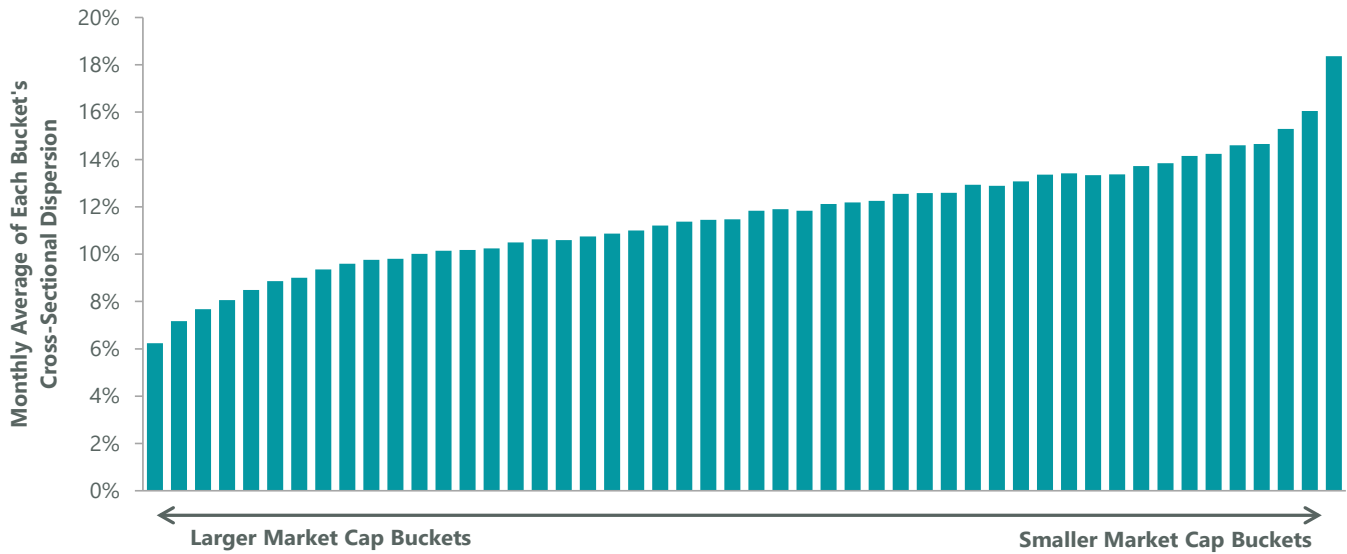
Advisors. Mid cap growth also topped small cap growth 52% of the time with an average excess return of 4.2% when outperforming. Increasingly underserved, we believe investors are missing out on exposure to this desirable asset class.

Active Management Can Capitalize in Mid Cap Plus

While returns in the mid cap plus segment of the market are superior on average, not all stocks in this group are created equal. In fact, as you move down the market cap spectrum, away from mega and larger cap companies, the value of active management increases.

Across the same stratification of the Russell 3000 Growth Index (50 market cap buckets going back to 1985), we calculated cross-sectional standard deviation as a measure of dispersion in returns (Exhibit 10). Dispersion steadily increases as you move down the market cap spectrum, with a noticeable difference between the first and second buckets, which represent mega cap companies (market cap greater than \$175 billion) and the lower end of large cap companies (market cap between \$96 billion and \$175 billion), respectively. Active management is uniquely positioned to help investors pick and ride the winners in this segment.

Exhibit 10: Dispersion Rises as Market Cap Falls

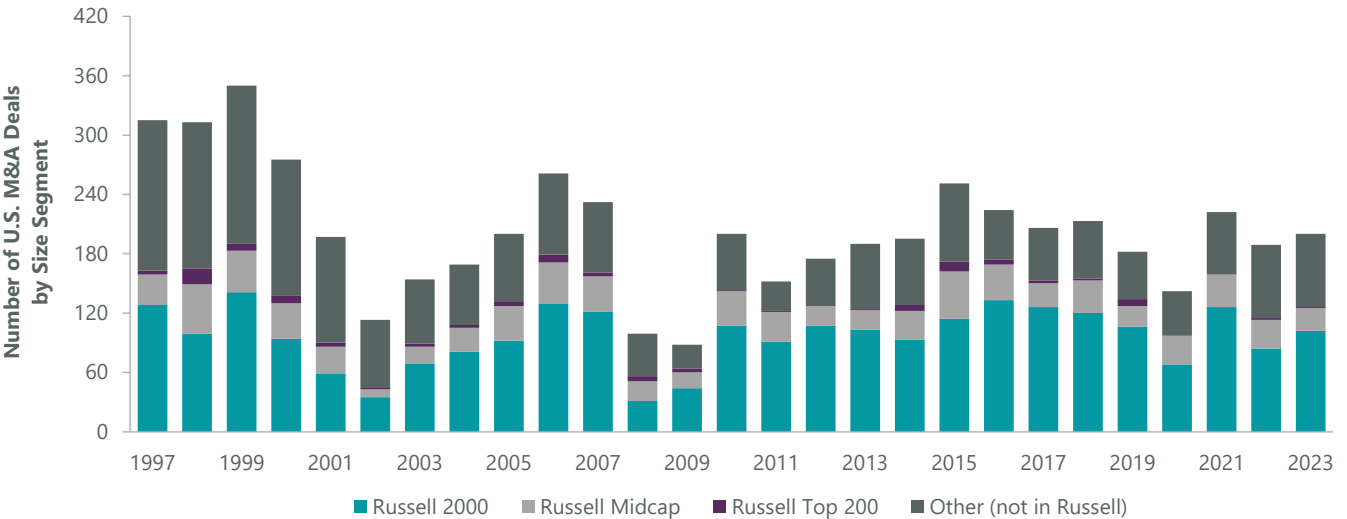


Source: FactSet, ClearBridge Investments. For this analysis, we divided the Russell 3000 Growth Index into 50 equal-sized buckets sorted by market capitalization (with around 30 names in each bucket) each month from January 1985 to December 2023, calculated each bucket’s average monthly return, and then calculated a monthly average for the entire period.

We believe merger and acquisition (M&A) activity is an important vector of outperformance for this area of the market. M&A is much more prevalent and therefore more likely a driver of alpha as you move down the market cap spectrum. This is clear when looking at the number of deals by size segment based in the Russell 3000 Index over the last 25 years. While deals in Russell’s Top 200 Index are few and far between, annual deal volume is significant as you move down in market cap (Exhibit 11).

We believe the attractive qualities of the mid cap plus segment of the U.S. equity market have been crowded out by the story stocks of the Magnificent Seven. As these mega caps have grown in size and prominence in widely tracked growth indexes, the case for owning mid cap plus companies has only grown, creating a compelling opportunity for active managers to exploit.

Exhibit 11: M&A More Pronounced Outside Large Cap



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