

# Differentiating in a Concentrated World

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## Abstract

Research for this paper encountered few challenges, as information on the growth of concentration of index holdings and the decline of active share was available online. The main difficulty was in finding specific numerical data, which was addressed by using Morningstar.

The objective of this paper is to demonstrate how concentration in the top holdings of indexes can limit managers' effectiveness and active share, while also highlighting ways they can differentiate themselves. The main takeaway is that even in the face of index concentration, managers can differentiate their strategies by focusing on niche sectors, emphasizing fundamental research, and employing tactical asset allocation.

## What Is Active Share?

Active share is a measure that quantifies the degree of difference between a portfolio's holdings and its benchmark index. Developed by academics Cremers and Petajisto in 2009, active share has become a pivotal metric in evaluating the extent to which a portfolio manager deviates from its benchmark. This deviation is crucial because it reflects the manager's active investment decisions and the potential for outperformance or underperformance relative to the benchmark.

In contrast to passive management, where portfolios aim to replicate the benchmark index, active management involves making active decisions to outperform the index. Active share provides a numerical representation of this active management strategy, offering investors and analysts a straightforward way to assess the level of active management within a fund.

Funds with higher active share typically charge higher fees because they involve more intensive management and research efforts compared to index-tracking funds. A high active share indicates that a fund's portfolio is significantly different from its benchmark, meaning the fund managers are making more strategic decisions and conducting extensive analysis to select investments that diverge from the index.

Active share is used and liked because it provides a clear, quantifiable measure of how much a fund's portfolio differs from its benchmark index, giving investors insight into how actively managed a fund really is. This metric helps distinguish between genuinely active funds, which aim to achieve returns that significantly deviate from their benchmarks, and those that merely replicate the index with minor tweaks.

## Active Share vs. Tracking Error and Information Ratio

Active share, tracking error, and information ratio are all measures used to evaluate the performance and risk of investment portfolios, but they offer different insights. Active share quantifies the percentage of a portfolio's holdings that differ from its benchmark, reflecting how actively a manager is deviating from the benchmark's composition. In contrast, tracking error measures the volatility of the portfolio's returns relative to the benchmark, indicating the extent of deviation in performance over time. The information ratio, on the other hand, assesses the portfolio manager's ability to generate excess returns relative to the benchmark per unit of tracking error, providing a ratio of active return to active risk. While active share highlights the degree of active management in portfolio composition, tracking error and information ratio focus on performance consistency and risk-adjusted returns. Together, these

metrics help investors gauge not only how different a portfolio is from its benchmark but also how effectively and efficiently the portfolio manager’s active strategies are implemented and how they translate into returns relative to risk.

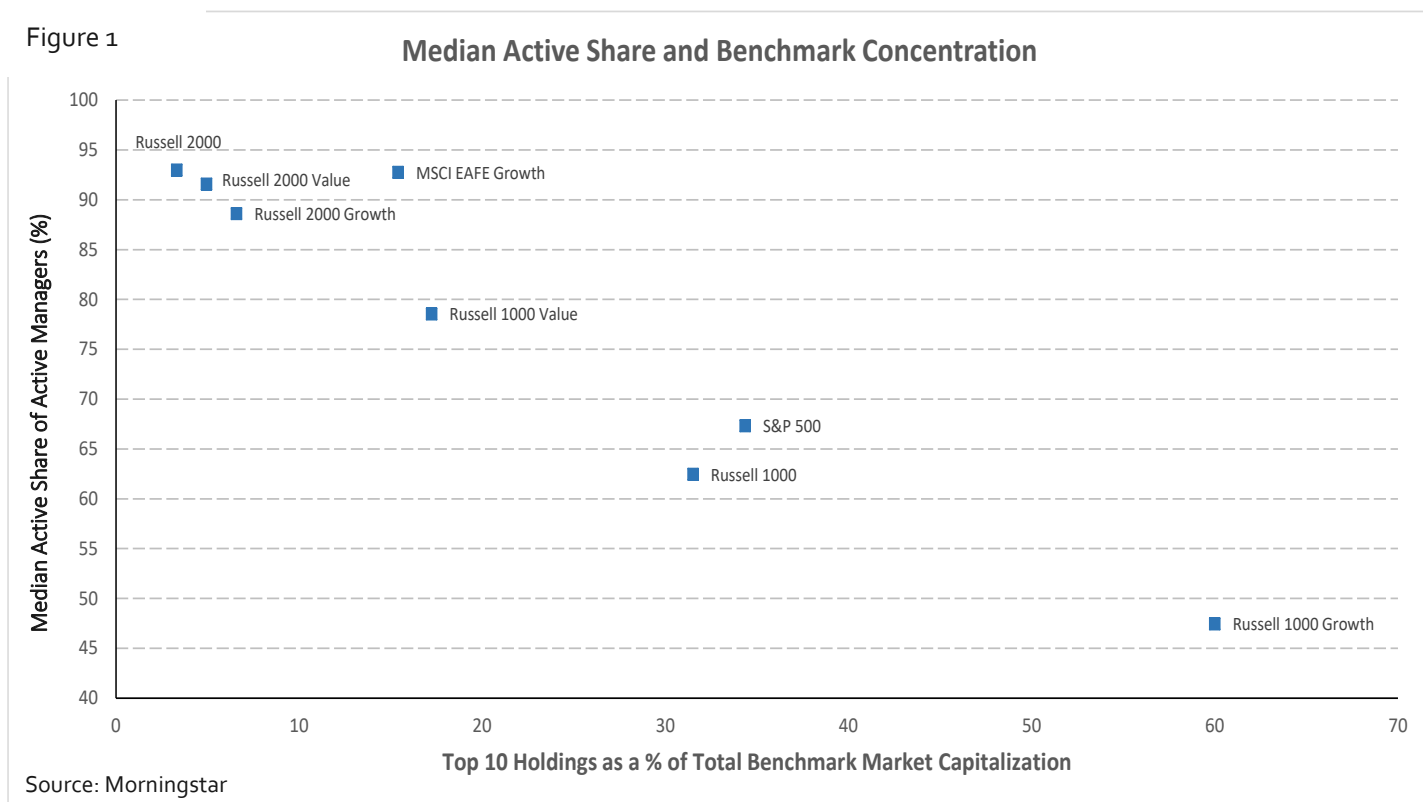
## Efficacy of Active Share

Active share, as a measure of how actively a fund manager deviates from a benchmark index, is facing challenges due to the increasing concentration within many major indexes. This concentration trend primarily stems from several factors in the financial markets:

**1. Dominance of Large Cap Stocks:** Many benchmark indexes, such as the S&P 500 or the Russell 1000 Growth, are heavily weighted towards a few large-cap stocks that have grown significantly over time. These stocks, known as the “Magnificent 7,” often represent a large proportion of the index. At the end of Q2 2024 the “Magnificent 7” made up about 31% of the S&P 500 and about 51% of the Russell 1000 Growth. This leads to a situation where fund managers have limited room to deviate.

**2. Passive Investing and ETFs:** The rise of passive investing and exchange-traded funds (ETFs) has reinforced index

Figure 1



concentration. ETFs typically replicate the composition of their benchmark indexes, meaning they invest in the same concentrated set of stocks. This replication by passive funds may limit the ability of active managers to significantly differentiate their portfolios from the index constituents.

## The Challenge of Maintaining Active Share

**1. Limited Opportunities for Differentiation:** With index concentration, there are fewer stocks and sectors outside of the index's dominant holdings where active managers can invest to create a significantly different portfolio. This limitation reduces the potential active share of a fund.

**2. Performance Expectations:** As index concentration increases, the benchmark's performance may be increasingly driven by a few top-performing stocks. Active managers aiming to outperform the index need to make bold, concentrated bets on other stocks or sectors, which can be risky and challenging to sustain over the long term.

## Portfolio Differentiation Is Still Possible

**1. Focus on Niche Sectors and Themes:** Active managers can explore niche sectors or emerging themes that are not heavily represented in the benchmark index. By investing in these areas, managers can potentially achieve higher active share while diversifying risk away from concentrated index sectors.

**2. Emphasis on Fundamental Research:** Deep fundamental research can uncover undervalued or overlooked stocks that are not part of the index's concentrated holdings. This approach allows managers to construct portfolios that differ significantly in composition from the benchmark.

**3. Tactical Asset Allocation:** Active managers can use tactical asset allocation strategies to adjust sector weights dynamically based on market conditions and valuations. This flexibility can help in managing active share while potentially enhancing performance relative to the benchmark.

While index concentration presents challenges for maintaining high active share, active managers can adapt their strategies by focusing on unique investment opportunities, conducting rigorous research, and employing dynamic asset allocation techniques. By doing so, they can continue to demonstrate their skill in adding value above and beyond passive investment strategies, despite the constraints imposed by increasingly concentrated benchmark indexes.

While a welcome addition to investor's "toolbox," the limitation of active share became apparent in a market that is awarding a small number of winners.

## Put Research To Work

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### Sources Utilized:

- Morningstar
- Fidelity
- William Blair
- Amundi
- VanEck
- Goldman Sachs