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Mutual funds | Perspectives

An innovative take on investing in tech

Key takeaways

- Investors with exposure to tech stocks saw gains in 2023—mostly attributed to the Magnificent 7's outperformance.
- While returns from the tech giants were impressive, they also increased concentration risk in indices like the S&P 500® and Nasdaq 100.
- Alternative approaches to indexing like price-weighting and sector diversification can help reduce concentration risk when certain stocks are impacted by volatility.

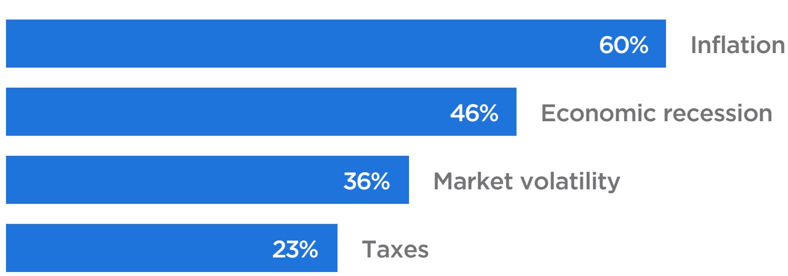
Inflation pressures drive need for equity returns

It's been a topsy-turvy ride for investors over the past 2 years. In 2022, rising inflation and significant rate hikes by the Federal Reserve to counter the spike in prices stoked widespread pessimism and fears of an imminent recession. Stock and bond markets both reeled, resulting in historically low returns for the traditional balanced 60/40 portfolio.

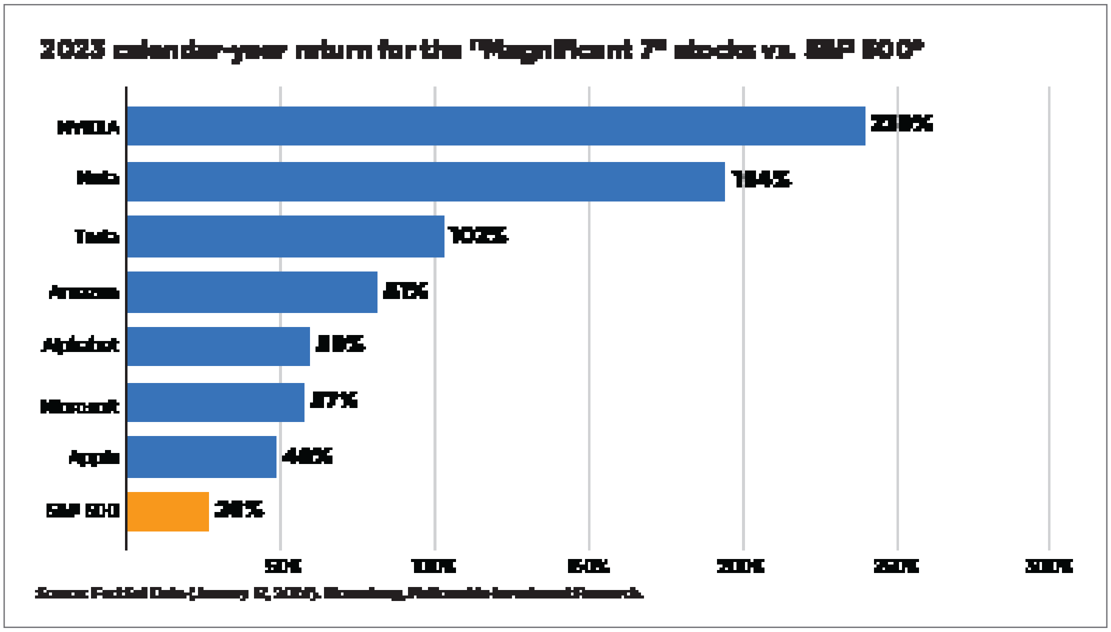
In 2023, the script flipped—inflation pressures eased, the Fed paused on further rate hikes, and the stock and bond markets rallied strongly. Sentiment among investors has improved as well, with expectations increasing for a "soft landing" for the U.S. economy heading into 2024.

Yet, inflation and recession fears have not completely abated, especially for investors who are nearing retirement. A recent Nationwide Retirement Institute® survey found that 60% of pre-retirees (age 55-65) viewed inflation as their biggest threat to a secure retirement. Because of economic pressures, one quarter of these investors said they plan to retire later than anticipated, with another 15% feeling unsure that they'll ever be able to retire. Moreover, nearly half of financial professionals (46%) see inflation as the most immediate challenge to their clients' retirement portfolios.

Pre-retirees identified the following immediate challenges to their retirement portfolios:



Source: Harris Poll for Nationwide (January, 2023).



Inflation is always a primary risk for long-term investors, but historically equities have offered the best opportunities for investors to outpace inflation over the long term. The stock market's rally in 2023, which saw the S&P 500 return more than 20% for the calendar year, encouraged investors, especially those concerned with the rising costs of living in retirement.

But it's important to acknowledge the outsized influence technology stocks had on the S&P 500's performance in 2023, particularly the contributions of the Magnificent 7 stocks, representing the largest and highest-profile tech and tech-related companies in the economy. Collectively, these 7 stocks (Alphabet/Google, Amazon, Apple, Meta Platforms/Facebook, Microsoft, NVIDIA and Tesla) represent roughly 30% of the market capitalization of the S&P 500 and gained 112% in 2023, far outpacing the benchmark large-cap index. Without the contribution of these seven stocks in 2023, the S&P 500 would have been up a more modest 13%.

Tech stocks and concentration risk

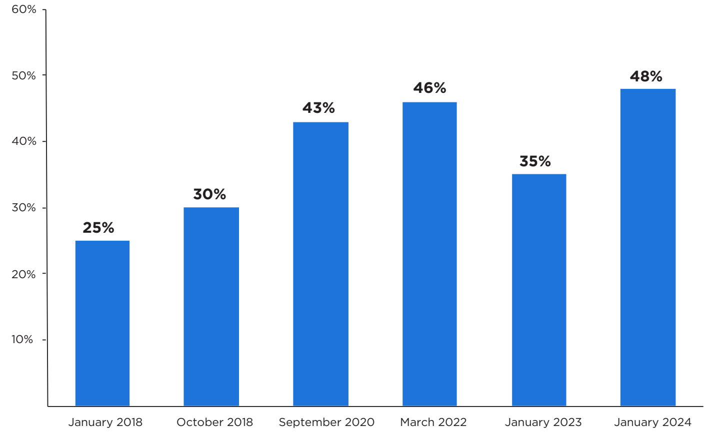
It's hard to overstate how essential technology stocks, and the Magnificent 7 in particular, were to stock returns in 2023. As of year-end, technology was the largest sector of the S&P 500, comprising 29% of the Index's capitalization-weighted value. When technology as a sector performs well overall—as it did in 2023, rising over 57% for the calendar year—these gains can have an outsized influence on the benchmark indexes too.

A company's size, as measured by the capitalization of its stock, matters to performance as well, especially within a cap-weighted index such as the S&P 500. To illustrate, the 10 largest stocks by capitalization in the S&P 500 (which include all Magnificent 7 stocks plus Berkshire Hathaway, UnitedHealth Group and a second share class of Alphabet/Google) contributed 134% of the benchmark's annual return for 2023. While this performance is impressive, it also highlights the problem of concentration risk within these indexes and for any investment strategy or fund tracking these benchmarks.

Concentration risk becomes a significant concern when outperformance is limited to the largest stocks; share price growth for these stocks increases their capitalization value, which in turn increases their weights within a benchmark index. For an example, let's look at another cap-weighted index, the Russell 1000® Growth. At the beginning of 2018, the Magnificent 7 comprised one-quarter of the Index, but this share grew to 35% of the Russell 1000 Growth by the start of 2023. Last year's surge for the Magnificent 7 stocks expanded their capitalization even more, to nearly half of the weight of the Russell 1000 Growth Index at the end of 2023.

Investors in index-tracking mutual funds or exchange-traded funds that are pegged to the S&P 500 or other large-cap stock indexes have been reliant, and perhaps, overly reliant, on technology and the Magnificent 7 stocks for the returns they achieved in 2023. As a result, investing in the Magnificent 7 has become an extremely crowded trade for fund managers. Many actively managed strategies include these stocks as well; many portfolio managers may feel they must include these stocks in order to deliver returns to fund shareholders, or else fall behind their benchmark indexes.

"Magnificent 7" historical % weight in the Russell 1000 Growth Index



Source: Bloomberg, Nationwide Investment Research

How concentration risk affects market volatility

Investors may discover they hold the same technology and Magnificent 7 stocks through different portfolios; for example, an index fund tracking the S&P 500 or Russell 1000 Growth plus an actively managed large-cap fund. They may be exposed to concentration risk without realizing it, until market volatility hits these holdings.

A spell of market volatility in 2022 highlighted the price investors paid for the exposure to concentration risk. The rise in valuations for these firms were based on expectations of significant earnings growth far into the future. Investors were willing to pay premiums for the potential growth of technology stocks under favorable inflation and interest rate circumstances. But this climate changed in 2022 as inflation spiked and the Federal Reserve shifted monetary policy by hiking rates. Tech stocks, led by the Magnificent 7, suffered losses during this period, with their market-cap weighting declining to around 20% by early 2023.

Among investors, the extended period of low inflation and low interest rates is considered effectively over. Many technology stocks will likely struggle to deliver the same level of returns should interest rates remain elevated, as expected. However, it's important to recognize that other stocks offer return opportunities, including many at attractive valuations relative to the indexes and the Magnificent 7. Within the S&P 500, it's not as if the 493 stocks outside of the top performers suffered losses last year. In fact, around 136 other stocks also outperformed the S&P 500 as a whole.

That's not to say the Magnificent 7 won't continue to deliver strong earnings and returns for investors. Many tech firms are in solid positions to weather a higher interest rate environment; they have healthy balance sheets, they'll likely have no need to finance future growth through borrowing or raising capital, and they're innovative companies firmly established as dominant players in their respective markets.

While the biggest stocks may get most of the attention, there are opportunities to invest in companies that are well-managed, attractively priced and poised to offer the potential for growth. To find these opportunities, investors must recognize the value in diversification for countering concentration risk and be willing to expand their horizons beyond the market's latest outperformers.

Price-weighted vs. cap-weighted indexing

One approach to minimizing the concentration risk found in many capitalization-weighted indexes is to use a price-weighted approach instead. Price weighting keeps the number of shares equal for each stock and uses the fluctuation in stock prices to drive the value of the index. Price-weighted indexes tend to reduce the skew toward the largest companies that can occur in market-cap-weighted indexes.

An example of a price-weighted index is the NYSE Arca Tech 100 Index, a widely recognized and broad technology benchmark for over 30 years. The Arca Tech 100's price-weighting methodology means the concentration of top holdings relative to the Index as a whole is lower, which reduces the likelihood that a small number of stocks will disproportionately affect performance.

One other unique aspect of the Arca Tech 100 is that it includes not only familiar tech firms but also companies that are deploying the innovative technologies created by the tech sector into their businesses. By not focusing on technology exclusively, the Arca Tech 100 offers the advantages of diversification across industry sectors, such as health care, which historically has not been correlated with technology.

The Arca Tech 100's price-weighting approach offers an innovative barometer for tracking the influence of technology in a way that's not limited to the tech sector and avoids the concentration risk presented by the returns of the Magnificent 7. Additionally, the benefits of diversification in different sectors can be valuable in times of heightened volatility for the largest technology names.

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NYSE Arca Tech 100 Index: An unmanaged, price-weighted index of at least 100 individual technology-related securities, consisting of stocks of companies from various industries that produce or deploy innovative technologies to conduct their business. "Archipelago®," "ARCA®," "ARCAEX®," "NYSE®," "NYSE ARCA℠" and "NYSE Arca Tech 100℠" are trademarks of the NYSE Group Inc. and Archipelago Holdings Inc. and have been licensed for use by Nationwide Fund Advisors on behalf of the Nationwide NYSE Arca Tech 100 Index Fund. The Nationwide NYSE Arca Tech 100 Index Fund is not sponsored, endorsed, sold or promoted by Archipelago Holdings Inc. or by NYSE Group Inc. Neither Archipelago Holdings Inc. nor NYSE Group Inc. makes any representation or warranty regarding the advisability of investing in securities generally, the Nationwide NYSE Arca Tech 100 Index to track general stock market performance.

Russell 1000® Growth Index: An unmanaged index that measures the performance of the large-capitalization growth segment of the U.S. equity universe; includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values.

Nasdaq-100® Index: A rules-based, market capitalization-weighted index of 100 of the largest non-financial companies, with certain rules capping the influence of the largest components. It is based on exchange, and it is not an index of U.S.-based companies.

S&P 500® Index: An unmanaged, market capitalization-weighted index of 500 stocks of leading large-cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

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