

## Mr. Market...Is That Really You?

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*“One must change one’s tactics every ten years if one wishes to maintain one’s superiority”*

Napolean Bonaparte

### IN A NUTSHELL

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- The US stock market has changed very meaningfully over the last several decades, and today it has higher concentration, and greater sector and style tilts than before.
  - For investors who believe that, even if this is the reasonable outcome of a market driven economy, there is still cause for concern, then diversifying across asset classes, geographies, styles, and market caps may be easy to do.
  - On the last of these, we look at the relationship between market concentration, and subsequent mid and small cap performance versus large caps. We find a positively correlated relationship.
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### You’ve Changed...

Sometimes, it is hard to spot change. Particularly when it occurs incrementally, over several years, and in something you think you know intimately. But, in our view, the simple truth is this – the US stock market today is an entirely different beast to what it was just a decade or two ago. How so? Well, consider these four metrics – market concentration, sector exposure, valuation, and style tilt.

Figure One shows the first of these, and confirms an intuition that many investors likely already have. It shows the market capitalization of the ten biggest companies in the S&P 1500 over the last thirty years or so. Stock market professionals know (or should know!) that the distribution of the size of companies in the US is not uniform. In fact, it follows a “pareto-like” curve with a relatively small number of giants, and a relatively large number of minnows (this is also known as a “Power Law” distribution, and, amongst other things, applies to earthquakes, city sizes, and serious crime, don’t ask us!).

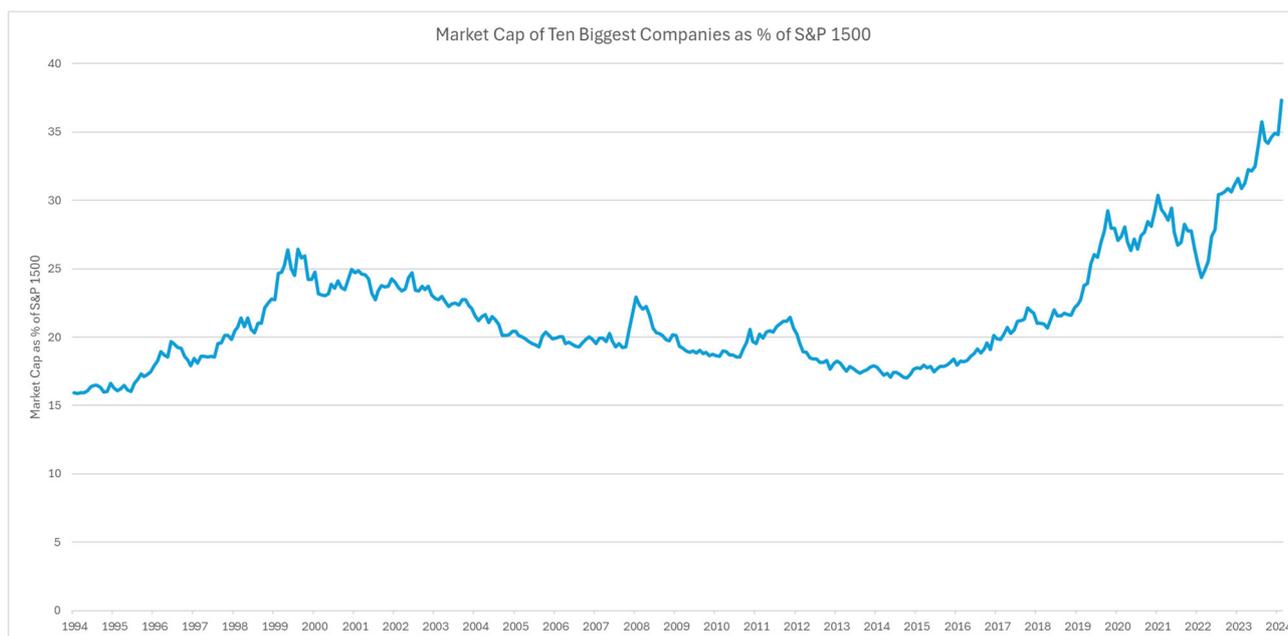
So, it shouldn’t be surprising that relatively few companies account for so much of the size of the equity market. But, crucially, note the move in that concentration over the last decade. As Figure One shows, it has gone from a plateau of somewhere between 15-25% to more than 35% at the end of 2024.

To be clear, we're not saying that this level of concentration is unsustainable, or that the market can't continue to become even more concentrated. But, it should at least be food for thought that, in the last thirty years, we have not seen a more dominant cohort of companies. And, in addition to their dominance, note that four of the top five largest companies are all in the same sector, Information Technology (IT), and seven of the top ten are either in IT or Communication Services (according to S&P Global, as at 11/5/2025).

So, this is not a question of several, massive companies that are at least diversified across business lines. This is a very technology – and AI – heavy market. Again, one that is quite different from 1995 when the top five companies by market cap were from the Industrials, Energy, Communications, and Consumer Staples sectors. Indeed, at that time the largest IT company was in eighth place (according to the American Business History Center, data as of March 31, 1995).

The technology-heavy weight at the top of the US market is symptomatic of the second metric we mentioned – sector exposure. At the time of writing, the IT sector was the largest of the 11 sectors of the stock market at around 34.8%. Indeed, at more than a third of the entire market, it is bigger than the next three sectors combined: Financials at 13.5%, Consumer Discretionary at 10.5%, and Communication Services at 10.1% (all sector data according to S&P Global, as at 09/30/25). And, by the way, there are one or two very large companies in those smaller sectors that some might argue could sit very comfortably in the IT sector. Our point is not to debate the taxonomic issues of sector classifications, it's simpler than that – not since the dotcom boom of the late 1990s has the stock market had such a large exposure to technology. It's a point that David Bianco, our Head of Active Equities in the US, and CIO for the Americas, has made several times - the US stock market appears increasingly tilted towards technology and growth characteristics.

Figure One: The Market Cap of the Ten Largest Companies in the S&P 1500 (as a % of all S&P 1500 Market Cap, 12/94-12/24)



Source: FactSet, DWS, as of 11/2025

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The latter point, around the growth tilt of the large cap US market, is shown in Figure Two. This charts the Price-to-Book (PB) ratios of the S&P 500, 400, and 600 over the last thirty years (so, essentially, large, mid, and small caps respectively). The PB is a classic valuation metric that quantifies for investors the relationship between the market value of equity, and its accounting value on the books. The idea is that the higher it is, the more “expensive” the market has become, and the lower the “cheaper.” Two messages stand out to us. The first is that, with an average large-cap PB ratio for the entire period in the chart of three, one can see that, at today’s value of more than five, it appears reasonable to characterize this segment of the market as being considerably more “growth-like”, than “value-like.”

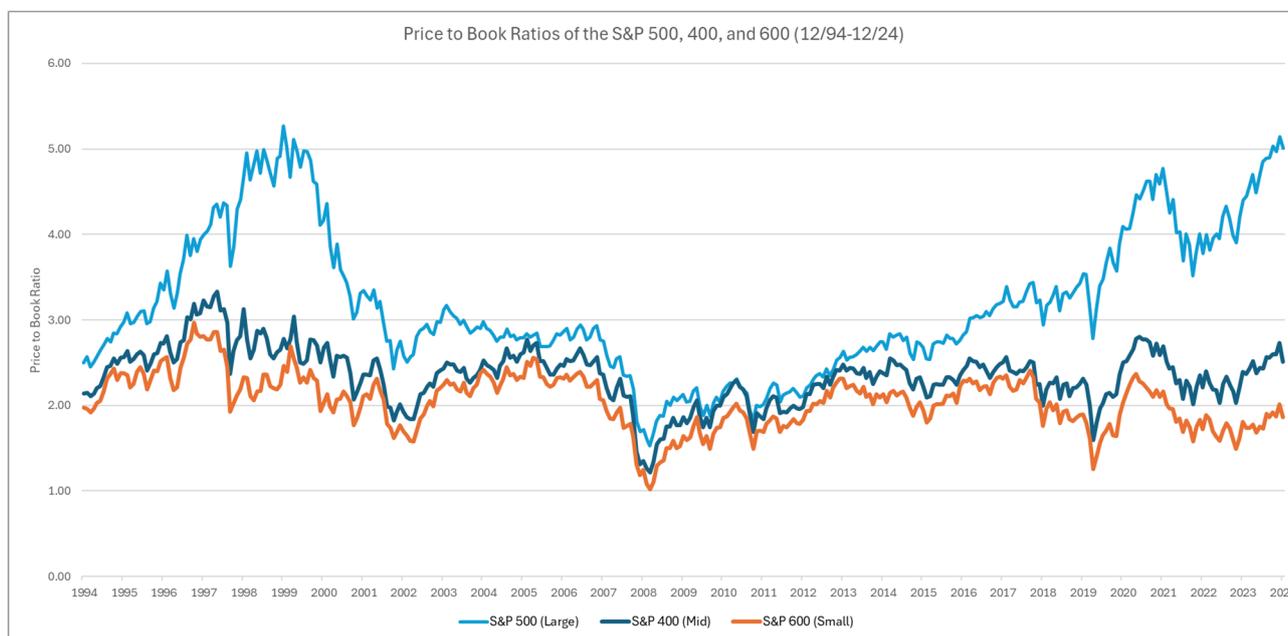
The second feature of note though, is that the run up in valuation is not a market-wide phenomenon. The valuation of both the mid and small cap segments shows a pretty tight range over the entire period. And, one of the consequences of this is that the relative valuation gap has widened significantly. Indeed, not since the dotcom boom of the late 1990s have large caps been so expensive, relative both to their own history, and to the mid and small cap segments.

Of course, astute readers will notice the similar shape in Figures One and Two, and it’s not by coincidence. The large, tech firms naturally tilt towards the growth style of high PB ratio as the market accounts for their significant opportunities for additional sales and earnings growth. Only once companies have matured into stable cash cows do markets typically start to lower their forward-looking expectations, and valuation metrics tend to reach more grounded levels.

Let’s pause for some caveats. We are not saying that the role that tech has played in the US economy and stock market is a bad thing. Indeed, it speaks to the innovative, dynamic, and entrepreneurial nature of America. It has also contributed to significant wealth creation (to put it mildly!), and to the extent it has helped to bolster pensions, college savings, and other wealth effects, it has arguably been a force for the good. Nor are we arguing that we need some sort of command economy that redresses the IT dominance. If the market has moved in that direction, it is likely for a good reason, and, as believers in the free market economy, we must accept market driven outcomes.

However, as investors, and stewards of capital, we must surely at least raise the question of how far these trends can go. How much more concentration, tech dominance, and growth tilting can the market bear? And, perhaps more importantly, are we comfortable with the risks that we are essentially forced to hold as owners of the US market? If we’re entirely comfortable adopting a laissez-faire approach, and simply riding these periodic gyrations, then you can stop reading here. But, we’d humbly submit that there are other markets, and other strategies, that the changing nature of the US large cap market appears to make worth considering. We’ll turn to one of these in the next section.

Figure Two: The Price to Book Ratios of the S&amp;P 500, 400, and 600 (12/94-12/24)



Source: FactSet, as of 11/2025

Past performance is not a guarantee of future results

### ...So, I'm Thinking of Leaving You

So far, we have discussed the concentration, sector exposure, valuation, and style tilt of the US market, and have pointed out that, on at least these four metrics, the nature of equity investing is different today than it was one or two decades ago. For investors who aren't concerned by this, and see it merely as the inarguable outcome of a market driven economy, then it's business as usual.

But, in our view, it's worth at least thinking about these developments, and, for those that aren't entirely comfortable, the good news is that there are several options to help diversify away from this exposure, including – across different underlying holdings, across different geographies, across different style tilts, and even of course across different asset classes. These may all be very reasonable avenues, but another one, that we think is worth highlighting, is to diversify across market caps. Specifically, to think about mid and small cap allocations in the US.

Figures Three and Four show why we think this could be of interest (and at this point we must acknowledge work by Franklin Templeton which gave us the idea to apply their analysis of equal weight performance versus market concentration, to mid and small cap performance). These charts show the historical relationship between market concentration on the x-axis, and the difference in five-year performance on the y-axis, for mid-caps in Figure Three, and for small caps in Figure Four. Essentially, the shape of the relationship shows that, historically, the more concentrated the market, the more often there has been subsequent relative outperformance from smaller companies.

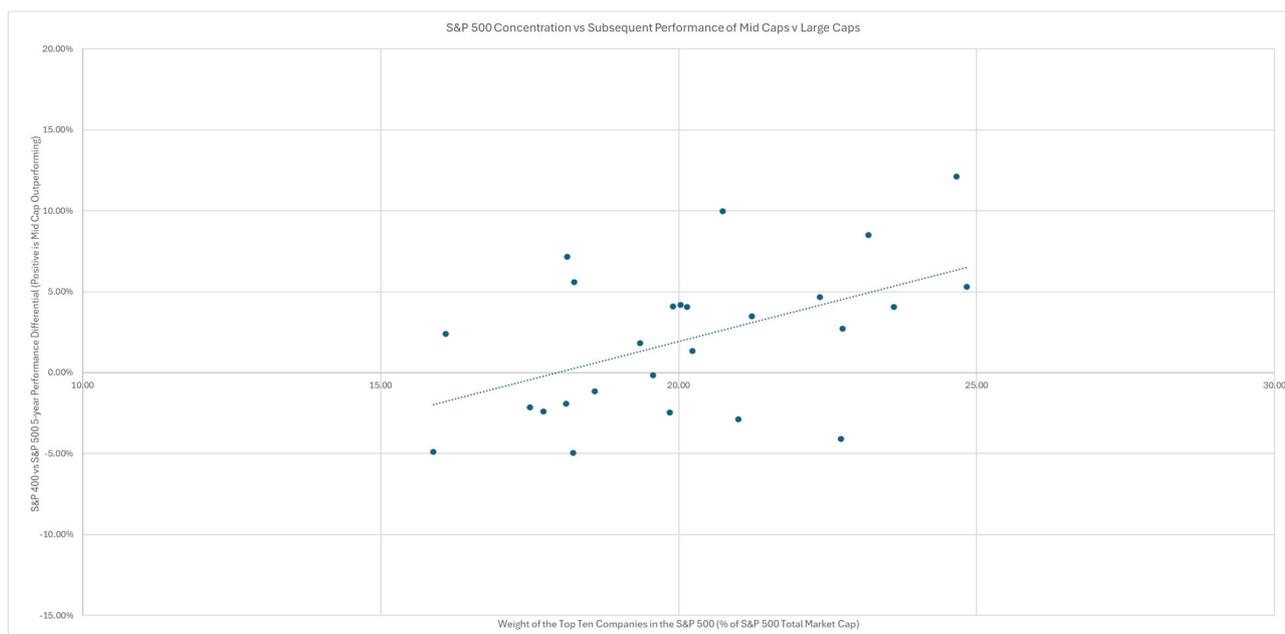
Of course, as ever, this is a historical relationship, and there's no guarantee that it will work in the future. Indeed, the relationships themselves only exhibited correlations of 0.50 in the case of mid-caps, and 0.65

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in the case of small. But that's the nature of finance. There are rarely guarantees, only relationships that investors may, or may not, put credence on. We note though, on a technical aside, that, in both cases, regressing mid and small cap outperformance on market concentration led to viable statistical models. Translating the outputs from these models, we would say that concentration only partly explained subsequent historical mid and small cap relative performance, but the relationships were statistically significant (i.e., likely to be meaningful, and not the outcome of chance). Let's discuss two last thoughts on these charts. The first is that, because we are looking at five-year differentials in performance, then the most recent market concentration number we can use is from five years ago, and this is the dot that corresponds to the 22.7% at the end of 2019. But, as we noted above, the concentration appears to have moved considerably higher from that point and, at the time of writing, sits at about 36%. According to the historical statistical model that the chart represents, this could suggest the potential for higher small and mid-cap relative performance.

Again, we strongly caveat applying a backward-looking statistical relationship to any sort of prediction or forecast about the future, and emphasize that regression models are tools for analysis rather than guarantees of outcomes. Also, keep in mind that the y-axis reflects historical relative performance to the large cap market, and not absolute performance. If an asset class were down -35% in a year when another market was down -40% we leave readers to judge for themselves how they would feel about that (we suspect they might feel relative happiness, and absolute sadness!). In our view, the economics also appear to make sense in this case. After all, market concentration is, to an extent, an indication of the performance of the very largest companies. For those to dominate market cap, they must be growing in size, and therefore performing well. That could potentially lead to both heightened competition, and overvaluation that might revert over time. It is similar in nature to the theory behind value investing, that cheap and neglected assets are believed to offer higher expected returns over the long run.

Figure Three: S&P Concentration vs Subsequent Performance of Mid-Caps v Large Caps (1994-2024)

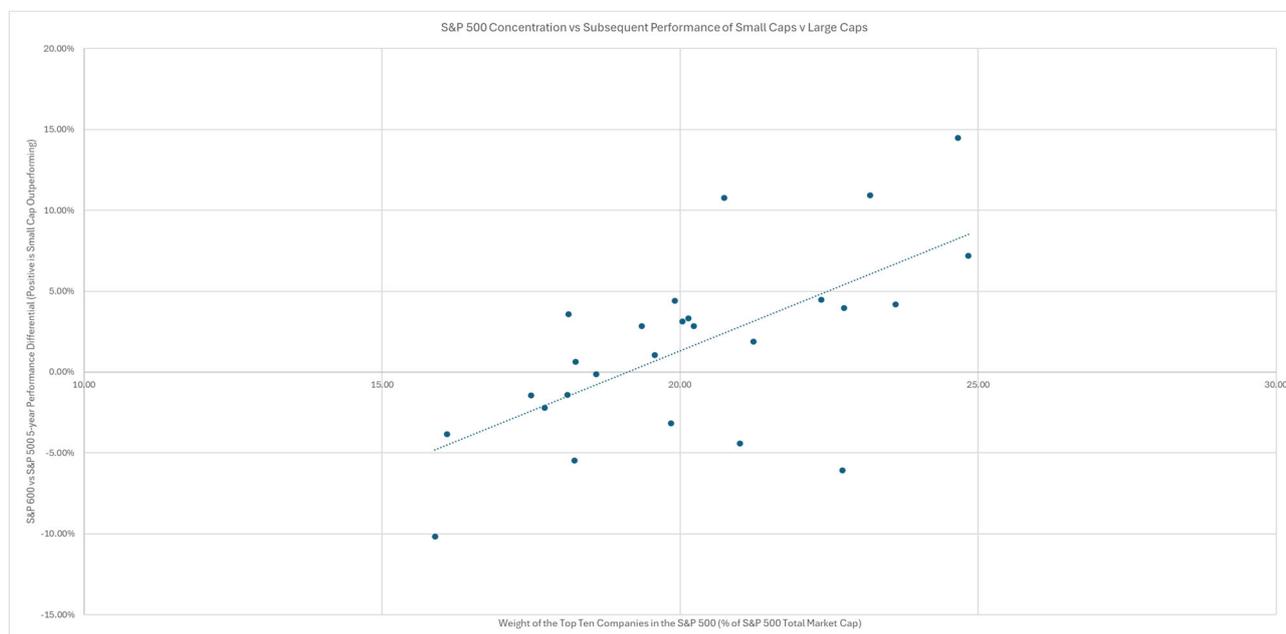


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Figure Four: S&amp;P Concentration vs Subsequent Performance of Small Caps v Large Caps (1994-2024)



Source: FactSet, DWS, as of 11/2025

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## Conclusions

We believe the US equity market has changed in some very fundamental ways over the last decade or so. Specifically, it has become increasingly concentrated in a small cohort of tech-heavy names, the weight of the IT sector overall has increased very substantially, and, largely because of these first two phenomenon, it has become very much a growth play, with relatively high valuation.

A laissez-faire investor can argue – quite reasonably – that this is simply the way the market has organized itself. At DWS, we take a more nuanced view. If the goal of equity investing is widescale exposure to a broad swathe of characteristics then the state of the US market today brings into focus other, additional, alternatives – changing the underlying mix of holdings, looking at international markets, considering the role of other asset classes, and moving down in market cap to include small and mid-cap stocks.

With the last of these options in mind, we looked at the relationship between equity concentration and historical small and mid-cap performance. Historically, there has tended to be a positive correlation, meaning that higher concentration has often coincided with higher small and mid-cap relative performance versus large cap equities. It is by no means a guaranteed path for success. But, like many financial relationships, there is a statistical underpinning, and an economic intuition. For us, these are strong enough to make this something investors should think about.

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## Glossary

**Asset Class:** a group of financial investments that exhibit similar characteristics, such as equities or bonds.

**Correlation:** the statistical relationship between two variables, indicating to what extent they tend to be away from their means at the same time.

**Equal Weight:** an investment strategy that assigns the same weight to each asset in a portfolio.

**Growth Strategy:** is an investment style that is focused on an investor's capital appreciation through capital gains. Investors following this strategy seek to invest in companies whose earnings are expected to grow at an above-average rate compared to the industry or the overall market.

**Laissez Faire:** is a system advocating minimal government intervention in the economy, allowing free markets to be self-regulated by supply and demand.

**Market Capitalization:** in the context of an individual firm, is the number of shares issued multiplied by the value of the shares.

**Market Concentration:** a measure of how much of a market is controlled by its biggest companies.

**Pareto Principle:** an idea invented by the Italian economist, Vilfredo Pareto, which states that roughly 80% of effects come from 20% of causes.

**Power Law:** is a mathematical relationship where a change on one quantity results in a proportional change in another, regardless of the initial size.

**Price to Book Ratio:** the market price of a firm's equity divided by its accounting value.

**Regression:** is the statistical procedure to identify the co-movement between different variables

**Sector:** a broad industry grouping into which the component securities of an index or portfolio can be classified, e.g., Financials, Industrials, Energy etc.

**Small, mid, and large capitalization:** small caps are firms that generally have a market cap of less than \$2bn, mid cap of between \$2-10bn, and large cap greater than \$10bn.

**Style Investing:** refers to an investor's overall investment approach (for example a preference for certain types of stocks).

**S&P 500:** an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

**S&P 400:** an index that includes around 400 mid cap companies.

**S&P 600:** an index that includes around 600 small cap companies.

**S&P 1500:** an index that combines the S&P 500, 400, and 600

**Value Investing:** is an investment strategy that favors assets perceived to be "cheap" according to particular metrics, in the hope that they provide higher risk adjusted returns in the future.

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