

The megacap problem

CONCENTRATION

The share of an index accounted for by its largest constituents. When a handful of companies carry a large fraction of the weight, index analysis becomes analysis of those companies, and a conclusion about the market is a conclusion about a few firms wearing the market's name.

Module 1 established that a cap-weighted index can move on one company. This lesson is about what to do when that stops being an occasional quirk and becomes the normal state.

What concentration does to your analysis

If the largest few constituents account for a large share of the index, then a technical read of the index is substantially a technical read of those companies. The other constituents are along for the ride at whatever weight they carry.

That is not a reason to stop analysing the index. It is a reason to know what you are actually analysing, and to be suspicious of a market-wide narrative built on a move that a small number of firms produced.

The consequences worth carrying

Index-level support and resistance can be levels in one or two shares, transmitted. A rate-sensitive megacap makes the whole index rate-sensitive, whatever the other constituents do. Diversification inside the index is smaller than the constituent count implies - the same counting error as module 4 lesson 7, one level down. Sector exposure arrives through the back door: a heavily weighted sector is a position you did not choose.

How to check rather than assume

Concentration is published. Index providers give the weights of the largest constituents, and the top-ten share is the number that matters most.

It changes over time, sometimes quickly. A conclusion drawn from last year's concentration is a conclusion about last year's index, and unlike most things in this module it is a fact you can simply look up rather than infer.

The equities boundary

Analysing those companies individually is the equities track's job, and doing it well is a different skill from index analysis. What belongs here is knowing which companies matter to the index, by how much, and therefore how much of your index view is really a view on them.

What follows

The rest of this module reads the index chart. Keep this lesson in view while doing it: the chart is a weighted sum, and the weights are not even.

Check your understanding

1. What does high concentration do to a technical read of the index?

- a. Nothing, the chart is the chart
- b. It makes the read substantially a read of a few large constituents
- c. It makes the index more predictable

Answer: b. If a handful of companies carry much of the weight, index levels are largely their levels transmitted. Worth knowing what you are actually analysing.

2. How should you establish an index's concentration?

- a. Infer it from how the index moves
- b. Look it up - providers publish constituent weights
- c. Assume it matches other indices in the region

Answer: b. It is published, it changes over time, and it is one of the few things in analysis you can check rather than infer.