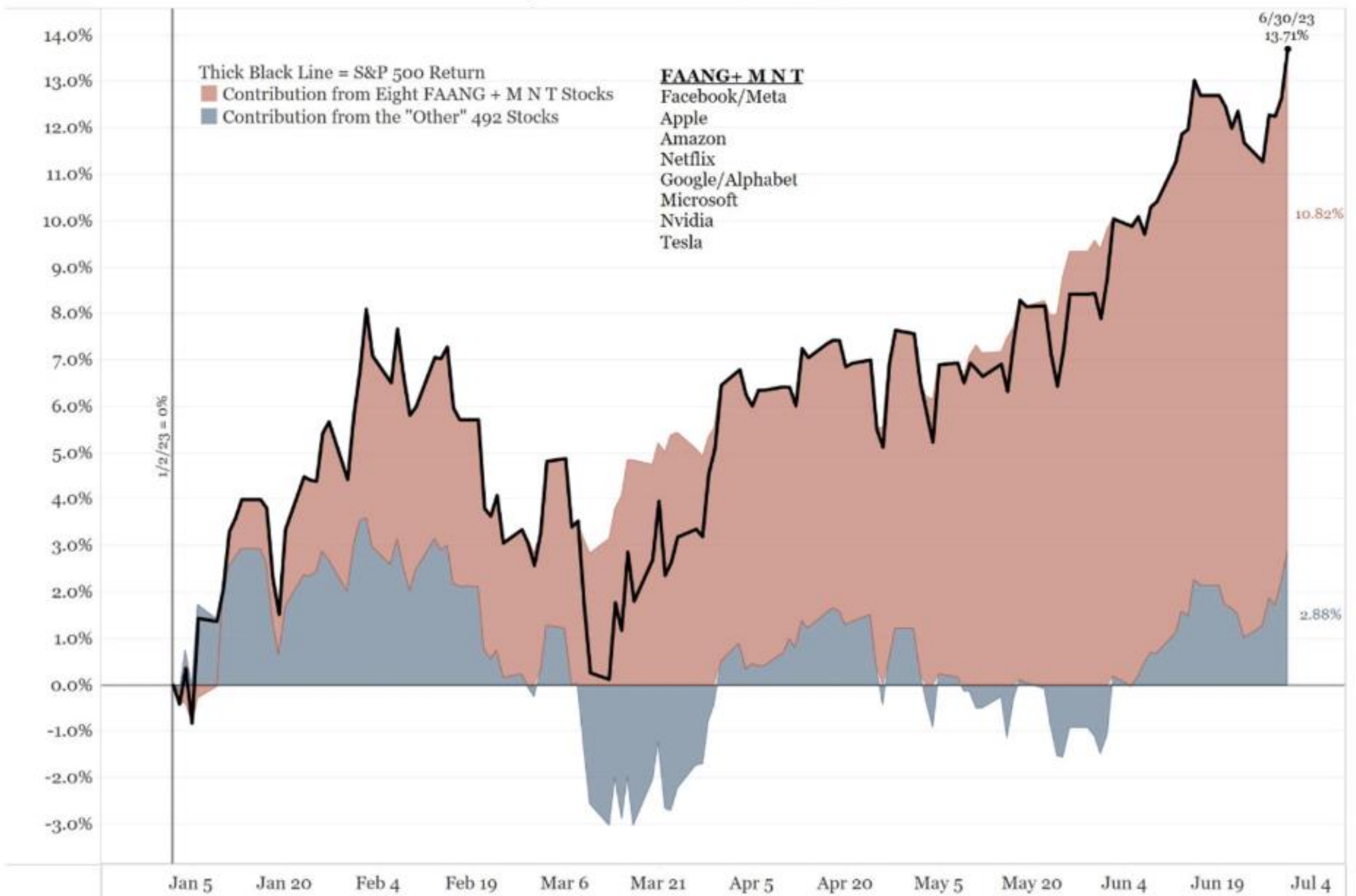
A Picture is Worth a Thousand Words

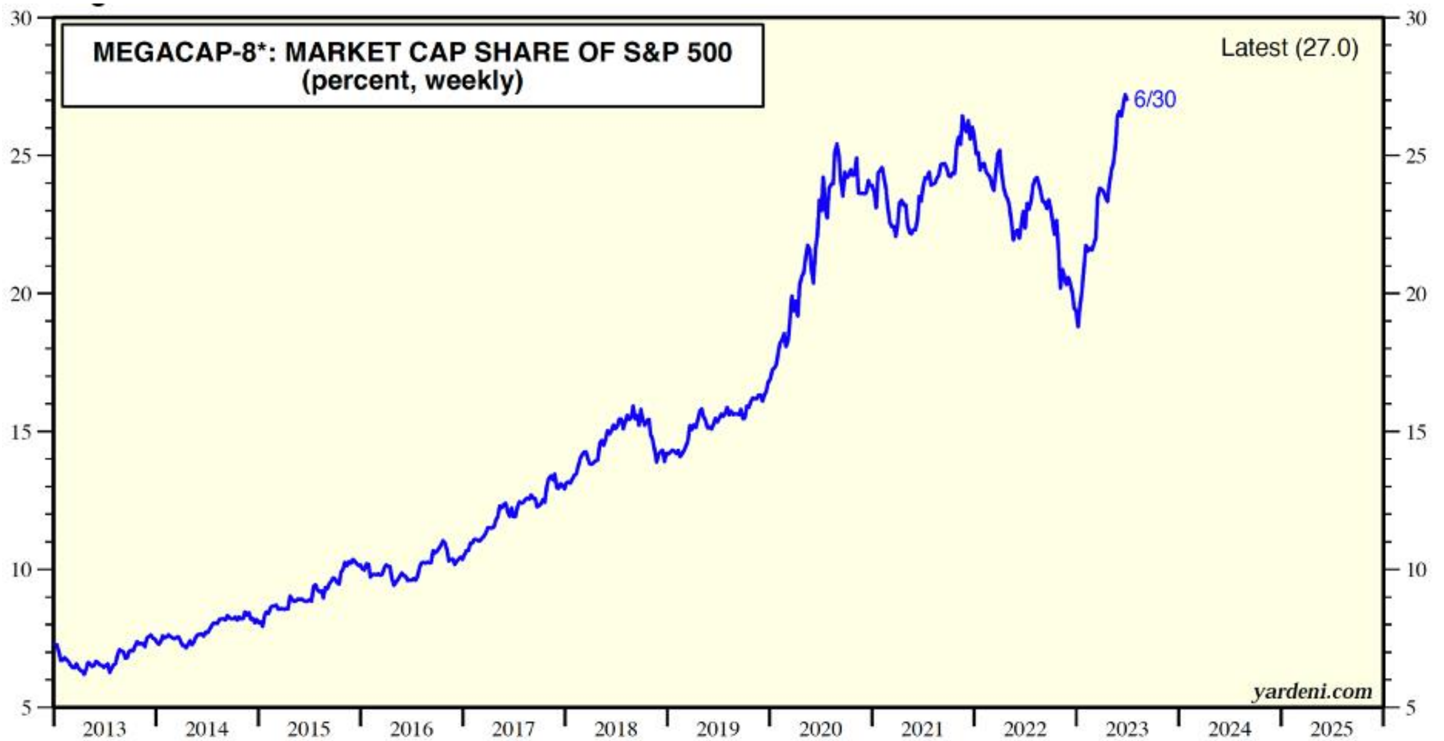
Curt R. Stauffer
July 14, 2023

This commentary will build on the subject matter of a very concentrated equity market during the first half of 2023, which I discussed at length last month. It has been a very strong first half of the year for the S&P “Big 8” and a modestly good first half for the S&P 492. Bianco Research L.L.C. created the chart below, and it clearly shows what happens when you measure “the market” with an “undiversified” market cap-weighted index where the top eight largest companies, which happen to all be technology-driven businesses significantly outperform the average return of the other four hundred and ninety-two constituents.

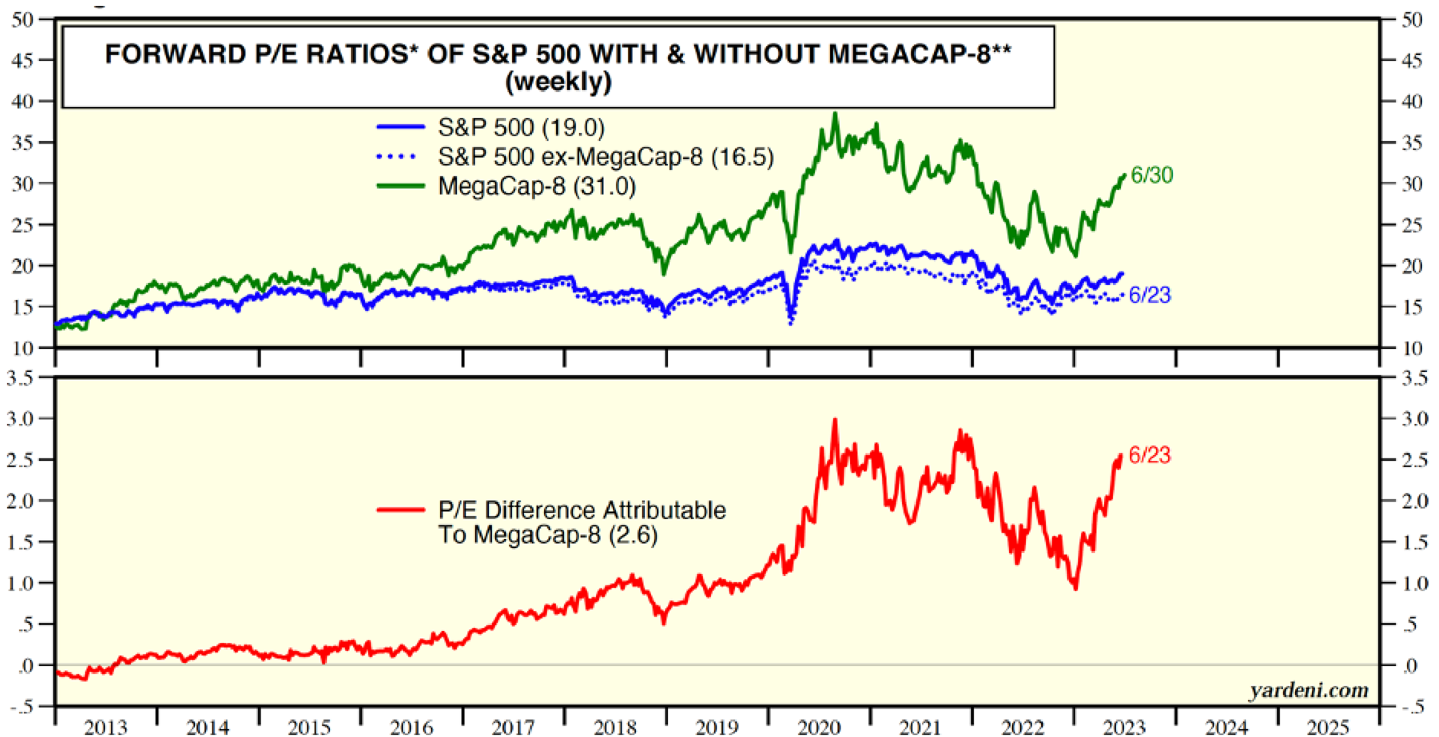


The eight stocks broken out in this graph represent, in terms of "weight" within the S&P 500, roughly 30% of the S&P 500 price, and this jumps to around 50% for the Nasdaq 100. It is the nature of a market capitalization-weighted index to represent the largest constituents disproportionately. Still, in our opinion, this dynamic has been amplified by the increased popularity of index-linked products such as ETFs, Mutual Funds, Index Options, and Variable Annuities combined with the prevalence of these cash-heavy companies to buy back their shares aggressively.

The "MEGACAP-8," as labeled in the Yardeni Research graph below, now represents a greater share of the market cap value of the S&P 500 than ever before. Between 2012 and 2019, this percentage steadily increased from 7% to 15%, which was not outside the bounds of historical norms for the largest companies within the index. Still, following the significant market sell-off in early 2020, the concentration within the index went parabolic, rising from 15% to over 25%. With last year's Bear Market, the concentration of the MEGACAP once fell to under 20%, only to see it go parabolic again during the first half of 2023 to new highs.



Yardeni Research provides insightful and timely graphs illustrating the inner workings of the markets that go unnoticed and unmentioned by most casual market observers. As one could imagine, if eight mega-cap technology stocks represent nearly 30% of the aggregate market value of the S&P 500, it only follows that such a concentration would distort the valuation metrics reported for the index. The graph below illustrates these distortions:



The above graph clearly shows that the overall S&P 500's Forward P/E ratio sits at an elevated level just shy of 20X as of June 23, 2023, while the average Forward P/E ratio for the MEGACAP-8 was over 30X as of June 30, 2023. With the largest eight companies within the S&P 500 having a Forward P/E ratio that is 133% higher than the overall index, it only follows that the Forward P/E ratio of the index would be distorted to the high side by these companies. This is illustrated by the dotted blue line above that show that the average Forward P/E ratio of the S&P 500 without the MEGACAP-8 is a much lower 17X. That difference is charted over time in the bottom graph, where the red line shows that the current 2.60 difference is very close to the recent highs seen in 2020 and 2021. But more importantly, the 2.60 variance is significantly higher than it was for the eight years preceding 2020.

As an asset manager who has professionally managed money and analyzed individual securities for the last 25 years, one must both see market conditions as they are and, at the same time, remain true to the foundational discipline that an asset manager chooses to underpin his or her process. We choose to focus on bottom-up security selection (we focus on companies, not stocks, sectors, and market factors). We seek opportunities created by market events, panicked investors/traders, and momentum/money flow price distortions. Lastly, to make such a discipline and process work, we operate with a long-time horizon and strive to remain patient enough to give our investments the time they need to prove our thesis. Some of these investments will get too much love from the market and far overshoot fundamental valuation norms; some will mismanage their growth opportunities and prove to be disappointments, and others will execute well and slowly gain investors' attention. Over time, this last category of securities will make up a meaningful percentage of our client portfolios. These initially under-appreciated durable growers should drive a disproportionate share of a portfolio's appreciation over time.

We currently have several of what we believe will be such durable growers that have proven themselves over the last 1-2 years. These are Axsome Therapeutics (AXSM), Valmont Industries (VMI), Dick's Sporting Goods (DKS), ASML Holdings N.V. (ASML), Vertex (VRTX), Elli Lilly (LLY), and CAVCO Industries (CVCO). We build our process to uncover and cultivate holdings such as these. Unfortunately, along the way, we encounter disappointments from promising ideas that do not meet our expectations. In the middle, we have investments that encounter challenges that adversely impact their market value and share price but are challenges that we deem temporary. We use such temporary share price weakness as a buying opportunity. Prime examples of these "temporary set-back" holdings are GoodRx (GDRX), Trupanion (TRUP), Hannon Armstrong (HASI), and Tandem Diabetes (TNDM).

This brings me back to the MEGACAP-8, which is driving the returns in the market so far in 2023. We are not going to simply cast our discipline and process aside to attempt to keep up with such a concentrated and distorted market. But we will apply our discipline by seeking to find large-cap technology stocks in the broad, large-capitalization technology space. For instance, we broadened our holdings of META Platforms (META) late last fall when it was very unloved, only to see its share price more than triple over the last nine months. Although we have trimmed META, it is still a core holding in many accounts. We also broadly own Alphabet (GOOGL), and we hold some legacy positions in Apple (AAPL) and Amazon (AMZN). Regarding those large-cap technology stocks that we believe are under-appreciated due to being in the shadow of the MEGACAP-8, we broadly own Airbnb (ABNB) and Broadcom (AVGO).

Our process is purpose-built to deliver long-term capital appreciation for our clients, satisfying their unique wealth accumulation and preservation objectives adjusted for inflation over the long term (5, 10, and 15+ years). We see investing as seeking value opportunities within the market, not simply making the binary choice to own or not own the market. We are not market timers; we simply buy when we see value relative to our longer-term thesis for a particular company and the security through which it is bought and sold in the market. Sometimes I hear confusion among some clients regarding our assertion that we are active managers and the statement that we are not market timers. Just this month, Howard Marks, Co-Founder and Co-Chairman of Oaktree Capital Management, wrote, in his memo titled "Taking the Temperature," about what it means

when he says that Oaktree Capital Management does not engage in market timing. Here is what he wrote, and it lines up very well with how we feel about the difference between being active and market timing:

We don't sell things we consider attractive long-term holdings to raise cash in expectation of a market decline. *We usually sell because (a) a holding has reached our target price, (b) the investment case has deteriorated, or (c) we've found something better. Our open-end portfolios are almost always fully invested; that way we avoid the risk of missing out on positive returns. It also means buying usually necessitates some selling.*

We don't say, "It's cheap today, but it'll be cheaper in six months, so we'll wait." *If it's cheap, we buy. If it gets cheaper and we conclude the thesis is still intact, we buy more. We're much more afraid of missing a bargain-priced opportunity than we are of starting to buy a good thing too early. No one really knows whether something will get cheaper in the days and weeks ahead – that's a matter of predicting investor psychology, which is somewhere between challenging and impossible. We feel we're much more likely to correctly gauge the value of individual assets.*

Active management does not necessitate active trading or "getting the market right." In terms of value creation, active management means following a process and a discipline that seeks out the opportunity to create value not simply from being in the market but derived from market mispricing. In terms of risk management, active management identifies and attempts to mitigate risks arising from the market structure and the psychological component of market pricing.

To conclude, it is important that our clients and readers understand what lies underneath the top-line reporting of the daily, monthly, and annual returns of market averages. At the same time, we believe that there is significant value in contrasting how we approach investing in the markets versus passive participation and various types of active trading strategies.

Disclosure:

Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.

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Exchange-traded funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus provides a balanced analysis of the investment risks and benefits. Read it carefully before you invest.

- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.
- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock

markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.

- The Dow Jones Industrial Average (DJIA), also known as the Dow 30, is a stock market index that tracks 30 large, publicly-owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.