

INVESTMENT STRATEGY UPDATE

Provided by the BTR Team

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THE OTHER 493

Last year, the stock market experienced a strong rebound in performance after declining double digits in 2022. The gain was slightly ahead of the typical return that occurs after a large drawdown.¹ What was not typical was the level of concentration within the S&P 500. During any given day over the course of 2023, the seven largest constituents within the index, dubbed the Magnificent 7 or “Mag 7,” accounted for 27-28% of the index’s market cap. It was one of the most concentrated stock markets in history. When the market becomes too concentrated, it tends to get more volatile and more susceptible to large downturns. This year, however, there are signs that the performance of the market is broadening to include more stocks and industry sectors, and with good reason. The U.S. economy has been resilient, unemployment remains low, and short-term interest rates look likely to come down at least a little this year. Furthermore, while some of the Mag 7 struggle with growth, there are a number of stocks amongst the “Other 493” constituents of the S&P 500 that are expected to grow earnings over the next five years at a faster rate than the weighted average of the Mag 7. In this *Investment Strategy Update*, we place some well-deserved focus on them.

How We Got Here

The S&P 500 tracks the performance of the 500 largest publicly traded companies in the U.S. and is widely regarded as a benchmark for the performance of the overall U.S. stock market because it represents 80% of total available market capitalization, with exposure to all sectors of the economy. Since the index is size-weighted, the performance of bigger companies and sectors has greater influence over total index performance than smaller positions. Evaluating the weightings of individual companies and sectors within the index provides insight into the market’s composition and potential risks and opportunities.

The concentration of S&P 500 performance in a small number of stocks developed over years, driven by investors’ desire to own shares in high-quality companies with strong financials and superior growth outlooks. The Mag 7 companies have dominant industry positions within cloud computing, e-commerce, social media, and software as a service (“SaaS”), cornerstones of the “digital transformation” megatrend. As such, they were deemed relatively safe to own in the uncertain economic backdrop following the pandemic, which was plagued by persistent supply chain constraints, rising inflation, and plunging commercial real estate prices. Also, two of the Mag 7 we would describe as true “cult” stocks. The final boost came with the advent of generative AI in late 2022. Naturally, the Mag 7 benefited from the market’s excitement over AI since most of the underlying companies are major players in one or more layers of the generative AI technology stack (infrastructure, learning models, and services/applications).

Separately, there is a high positive correlation between market liquidity and S&P 500 returns.² The excess liquidity that could not be absorbed into the real economy from the \$4.8 trillion³ expansion of the

Fed's balance sheet during Covid and the \$381 billion² net capital infusion from the Fed's Reverse Repo Purchase account during the regional bank crisis of 2023 provided additional impulse to push the S&P 500 Index higher. The prevalence of index investing and programmatic trading meant the Mag 7 disproportionately benefited from this excess liquidity given their already high weighting within the index.

Risks of High Market Concentration

U.S. stock market concentration, as measured by the largest 10 stocks in the S&P 500, is the steepest it has been since the early 1970s. Furthermore, the number of S&P 500 stocks actually outperforming the index is the lowest it has been since 2000. A key risk associated with an overly concentrated market is the potential for higher market volatility. The fact is that the volatility of the Mag 7 stocks is not only twice as high as the volatility of the S&P 500, but it has been increasing over time. As concentration in the Mag 7 has increased, so has the volatility of the overall market. Higher volatility means greater fluctuations in both the frequency and breadth of share price movements.

Another risk associated with high market concentration is the potential for a significant overall drawdown. As concentration rises, the market becomes more dependent upon the underlying fortunes of a smaller group of companies. The market's ability to mitigate adverse events and/or negative sentiment shifts related to the concentrated stock cohort is diminished. This is due to the reduced influence of offsetting positive fundamentals from other parts of the market. The magnitude of downside may be even more pronounced if the market concentration was propelled by a unifying catalyst, such as AI's impact on the Mag 7.

In the Tech Bust of 2000-2002, the market overall went down significantly because the Technology and Communications sectors had an overwhelmingly net negative impact, whereas the Consumer Staples and Financials sectors were overwhelmingly positive. There are likely few market participants who lived through the demise of the "Nifty Fifty" in the mid-1970s, but that era has perhaps even more relevant lessons to impart to today's investors. Like today's Mag 7, the Nifty Fifty stocks had much higher earnings growth and returns on equity than the overall market. Consequently, their stock performance was superior. Ultimately, their valuations also far exceeded the overall market, which meant that even though operational performance stayed good, it wasn't good enough to justify the valuations, so the Nifty Fifty underperformed for years.⁴

Currently, the biggest uncertainty is over the sustainability of the meteoric rise in demand for AI chips/accelerators. Specifically, are the Mag 7 just experiencing a temporary investment cycle related to the buildout of platforms for developing AI learning models that will eventually power the development of generative AI solutions and services? Or, has an AI megatrend already begun? If the former, future financial results for some of the Mag 7 could disappoint market expectations, leading to a correction in their share prices.

Is This Tech Bubble 2.0?

There are many similarities between the runup to the dot-com stock market crash in 2000 and the current market environment. Much like today's exuberance over the endless possibilities of AI, including accelerating innovation and expanding economy-wide productivity, there was substantial euphoria over the potential of the internet and its impact on the economy. The information technology sector experienced a major capital equipment investment cycle between 1990 and 2000 (sound familiar?). That investment cycle was generated by advances in microprocessors (GPUs today), software

applications (Gen AI), and mobile device technology (AI at the Edge), as well as from Y2K preparedness activities (okay, no obvious parallel here).

There was also a large amount of liquidity injected into the U.S. economy by the Fed during the late 1990s to stave off the impact of the financial crises in Asia and Russia and the collapse of Long-Term Capital Management. The excess capital not put to work into the economy helped to perpetuate the demand for information technology stocks, along with typical investor biases that fuel asset bubbles, such as the **Fear Of Missing Out**.

Even given these similarities, we do not think the U.S. stock market is on the cusp of an extended bear market, like what occurred after the dot-com crash. First, current valuations (20.9x earnings), while high, are not as extreme as in 1999 (27.7x). Should the AI-infrastructure spending boom turn out to be cyclical, the slowdown in AI-related spend should not materially impact traditional corporate IT spending. The latter is poised to expand given a recovery in demand for PCs, smartphones, and servers as well as from continued spending on cloud migration, digital transformation, and cybersecurity.

Where to Turn? (Investment Implications)

There is evidence that the rally in U.S. stocks is beginning to broaden out and the dominance of the Mag 7 starting to fade. Although there is still a meaningful differential in year-to-date returns between the S&P 500 Equal Weighted Index and the S&P 500, it does appear that the market is becoming more comfortable with the notion of a resilient U.S. economy that has endured the worst of an interest rate hiking cycle. This is further confirmed by the rotation out of a portion of the Mag 7 since the beginning of the year. The S&P 500 is up 10% even though two of the Mag 7 stocks (the cult stocks) are trading in negative territory. That suggests rational behavior. Any disruption caused by the reduced contribution from these stocks has been mitigated by nine out of eleven industry sectors within the S&P 500 posting positive returns thus far this year.

Relying upon a broadening out of market leadership to reduce risk is still, well, a risky endeavor, but an active strategy to reduce portfolio risk while pursuing above market returns is to focus investment on the Other 493. This does not mean to avoid all Mag 7 stocks. Rather, focus on owning a diversified portfolio of assets, including some Mag 7 stocks, with attractive growth opportunities but at more reasonable valuations.

This strategy is most aptly implemented by obeying Wayne Gretzky, whose advice to other hockey players rings true in the investment world. It's a popular adage but worth reminding others to skate to where the puck is going, not where it has been. In other words, anticipate future trends and positioning, rather than chasing overcrowded stocks that may be priced for absolute perfection. There are 103 stocks within the Other 493 that offer expected future earnings growth rates higher than the weighted average annual expected growth rate of 18% for the Mag 7. While some are found in the IT and Communications Services sectors, many can also be found within Industrials, Health Care, and Financials.

The U.S. economy remains firmly set in the late phase of its current business cycle. There is a high likelihood of a prolonged late cycle expansion due to the underlying resilience of the U.S. economy. Improving growth coupled with stable or falling inflation and stable employment appear to have convinced the Fed that it can ease financial conditions later this year, which will also serve to extend economic activity. This backdrop is supportive for the growth prospects of stocks within cyclically oriented sectors and should lead to a more inclusive market rally.

As the economy nears the end of its current growth cycle, investors will begin to shift their exposures away from cyclical stocks to ones that are less impacted by an economic downturn. These traditional defensive sectors include consumer staples, healthcare, and utilities. Historically, defensive sectors outperform the broader market during the transition from the late phase of an expansion cycle to a recession.

Industrials and materials are two notable cyclical sectors that have the potential to outperform over the intermediate term. These sectors will directly benefit from a potential resurgence in manufacturing activity as new orders gain steam. Long-term earnings growth within each sector is also supported by the “reshoring/near-shoring” of manufacturing operations and recent legislative actions, namely the Infrastructure Investment and Jobs Act (11/15/21) and the Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Science Act (08/09/22).

The continuation of investors’ preference for the perceived safety of high quality, large cap stocks with durable growth outlooks is apt to continue considering the economy is in the late phase of its business cycle. As investors look outside of the Mag 7 to get exposure to these types of stocks, they will likely shift their attention towards more reasonably priced stocks within the information technology sector as well as healthcare sector stocks. Technology stocks leveraged to traditional IT spending stand to benefit from a recovery in demand for computing hardware. From an AI perspective, SaaS companies are attractive stocks since they are uniquely positioned to drive AI-based productivity solutions given their large pools of proprietary data, such as email and data about customers, operations, employees, financials, and cybersecurity posture. The growth outlook for healthcare stocks is underpinned by aging demographics and expanding insurance coverage (due to the Affordable Care Act). Constant innovation within therapeutics, diagnostics and the delivery of care further contribute to the favorable growth profile of this sector.

Lastly, the Mag 7 stocks leveraged to the buildout of generative AI platforms should continue to fetch premium valuations. These stocks do not need higher valuation multiples to generate positive returns. Their performance can still keep pace with the market, if not continue to outperform the market, if any future contraction in their valuation multiples is more than offset by their underlying earnings growth.

Conclusion

Successful long-term investing involves not only knowing what you own but also diversifying among several industries and types of stocks to reduce overall risk. Reducing risk allows a portfolio to compound returns more efficiently over time, thus increasing the chances of achieving one’s financial goals. Successful investing also involves the patience to let an investment thesis play out and diligence to ensure the investment thesis for each stock remains intact. Holding investments for the long term allows them to grow and ride out short-term market fluctuations. While one or more portfolio positions may be underperforming the broader market, or the concentrated set of stocks driving market returns, allowing time for other investors to “skate” to a particular investment opportunity typically yields better results than trying to time the market.

Footnotes:

1 McGeever, J. (2024, March 13). Peak US stock concentration doesn't mean steep drawdown. Reuters. Retrieved from <https://www.reuters.com/markets/us/peak-us-stock-concentration-doesnt-mean-steep-drawdown-2024-03-12/#:~:text=S%26P%20500%20returns%20in%20the,in%20the%2012%20months%20after.>

2 Siddiqui, R. (2024). Equity Market Outlook 1Q 2024. Neuberger Berman. Retrieved from <https://www.nb.com/en/global/equity-market-outlook/equity-market-outlook-1q2024>

3 St. Louis Federal Reserve. (2024, March 13). U.S. Federal Reserve Total Assets [Graph]. FRED (Federal Reserve Economic Data). Retrieved from <https://fred.stlouisfed.org/series/RESPANWW>

4 Berkin, PhD Andrew (2021, December 28). Party Like It's 1972: What Can the Nifty Fifty Teach Us About Today's Market. Bridgeway Capital Management. Retrieved from <https://bridgeway.com/perspectives/party-like-its-1972-what-can-the-nifty-fifty-teach-us-about-todays-market/>

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