Gigantism

Quick Look

» The S&P 500 Index has gained more than 40% over the last six quarters, yet, more than half of the stocks in the Index still trade below their Year 2021 highs.

» The Magnificent-7 stocks have returned nearly 110% on average over the last six quarters, while the other 493 stocks in the Index are up on average just 13%.

» Apple, Microsoft, and NVIDIA, all three of which are tech sector stocks, now account for more than 20% of the S&P 500, 25% of the NASDAQ, and 33% of the Russell 1000 Growth.

» Last quarter, the Mag-7 grew earnings by 50% compared to Q1 of 2023. Conversely, the remaining 493 stocks in the S&P 500 saw their earnings decline by 9%.

» Historically, index concentrations tend to rise during of above-average return periods, and fall during low-return periods.

» After a decade of meaningful multiple expansion, the 10 largest stocks now trade at 30x earnings, a noticeable premium to the broad Index.

» While we are thankful for the returns, historically speaking, the past decade of outperformance from the ten largest stocks is the exception rather than the norm.

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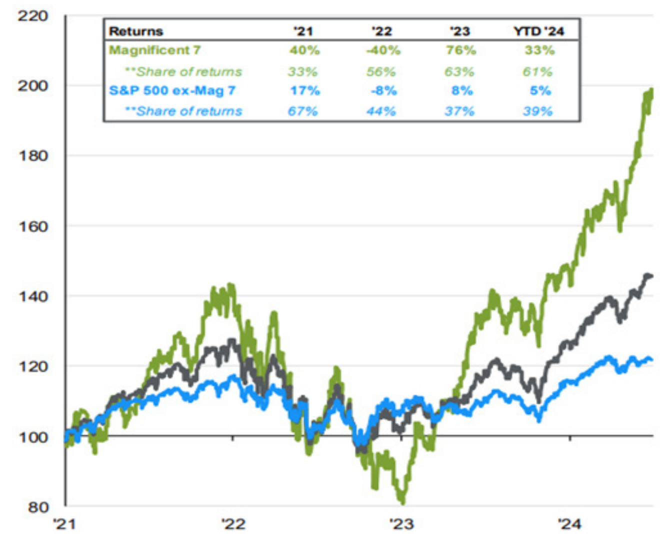
We are independent and transparent in all aspects of investment management decision making and financial planning. We selectively partner with like-minded individuals and families, endowments, foundations, and 401(k) plans in over 30 states.

Quarterly Investment Letter, Q2 2024

Acromegaly is the very rare condition in which too much growth hormone causes large adults to continue to keep growing, most notably the bones of the face, hands, and feet. The U.S. stock market is experiencing its own form of gigantism, with growth concentrated within just a subset of its largest holdings.

U.S. large caps, as measured by the S&P 500 Index, reached the halfway point of the year up 15%. Over the last six quarters, the S&P 500 Index is up more than 40%, seemingly tracking new ground each day, with more than 30 new all-time highs reached already this year. Volatility has been low, as the S&P 500 has gone nearly a full year without a daily decline of more than 2%. Despite this, more than half of the stocks in the Index still trade below their Year 2021 highs.

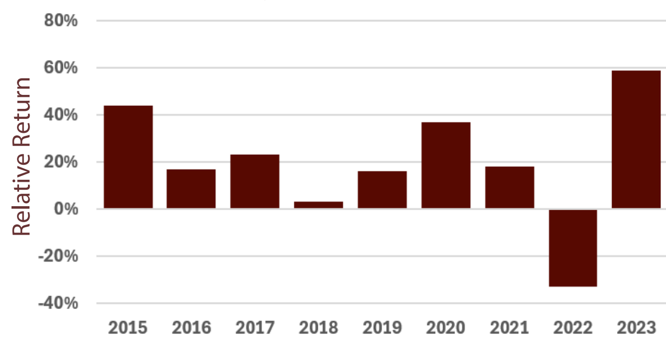
Performance of "Magnificent-7" stocks in S&P 500



Source: JPM

Index gains continue to be powered by a handful of stocks. This group of Technology (or Tech-proxy) stocks– Apple, Microsoft, NVIDIA, Amazon, Google, Meta, and Tesla – are widely known as the Magnificent-7. Last year, these seven stocks gained 76% on average, accounting for more than 60% of the Index's 26% gain; the other 493 stocks in the Index gained 8% on average. While this year's individual returns amongst the seven have been more dispersed, they have gained 33% on average, more than doubling the broad Index return. The remaining 493 stocks in the Index are collectively up 5%. Added together, the Mag-7 have returned nearly 110% on average over the last six quarters, while the other 493 stocks in the Index are up 13%.

The Magnificent 7 vs The S&P 500



Source: GMO

The dominance of the Mag-7 is now a decade long. Starting in 2015, these seven stocks have outperformed the S&P 500 Index every year, save for 2022. The rationale for their dominance has gone through at least three different iterations. The initial driver was the TINA market, which was the acronym to describe that there was no alternative to growth stock equities when cash rates were at zero and bond yields were at historic lows. Then, when COVID arrived, mega-cap tech became considered safe stocks that could offer tech stability during the shutdown. The rapid rise in interest rates in 2022 prompted a 40% drawdown in the Mag-7, but investor enthusiasm regarding data centers and generative AI has turbocharged the Mag-7 over the last six quarters.

Since OpenAI's unveiling of ChatGPT in late 2022, AI-related stocks have been on an astounding run, with investors betting on a gold rush of earnings coming from mega-cap Tech. NVIDIA has been the biggest winner of the bunch thanks to an insatiable demand for their chips from the other mega-cap tech names. NVIDIA opened the year with a $1.2 trillion market cap. By June, it became the third company in history

U.S. EQUITY RETURNS (%)

As of 6/30/2024	Q2 2024	YTD Return	1-Year	3-Year	5-Year	10-Year
S&P 500	4.28	15.29	24.56	10.01	15.05	12.86
Russell 1000 (Large Cap) Growth	8.33	20.70	33.48	11.28	19.34	16.33
Russell 1000 (Large Cap) Value	-2.17	6.62	13.06	5.52	9.01	8.23
Russell 2000	-3.28	1.73	10.06	-2.58	6.94	7.00
Russell 2000 (Small Cap) Growth	-2.92	4.44	9.14	-4.86	6.17	7.39
Russell 2000 (Small Cap) Value	-3.64	-0.85	10.90	-0.53	7.07	6.23

Source: Morningstar

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to reach a $3 trillion market cap, joining Microsoft and Apple. To put this in perspective, consider that at $3 trillion, NVIDIA is now larger than the entire U.S. oil and gas industry. In separate weeks this past month, NVIDIA gained and then lost $500 billion in market capitalization, which is more than the total value of ExxonMobil or Procter & Gamble. Apple, Microsoft, and NVIDIA have become the face, hands, and feet of the U.S. stock market, growing disproportionately larger than the rest of the body.

Climbing to $3T Market Cap

Source: Wall Street Journal

In the table below, you can see the gigantism of these stocks in proportion to the major indices. Apple, Microsoft, and NVIDIA, all three of which are tech sector stocks, now account for more than 20% of the S&P 500, 25% of the NASDAQ, and 33% of the Russell 1000 Growth. If we combine Technology with its close cousin Communication Services (home to Alphabet and Meta), the two sectors account for more than 40% of the S&P 500, 60% of the Russell 1000 Growth, and nearly 70% of the NASDAQ. You have to go back to the early 1960's to find the U.S. stock market as concentrated as it is today.

Company Concentration (%)

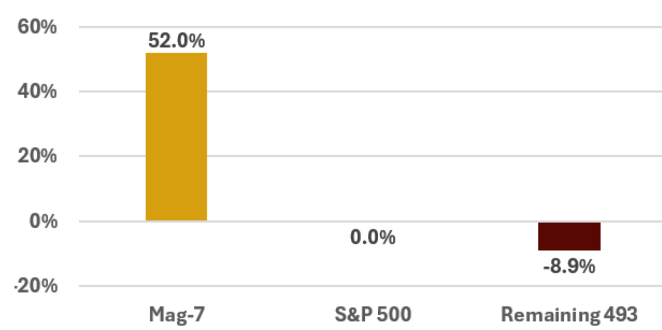
Company	S&P 500	Russell 1000 Growth	NASDAQ
Microsoft	7.3	8.6	11.8
Nvidia	6.8	8.5	10.6
Apple	6.5	8.4	10.7
Total	*20.6*	*25.5*	*33.1*

Sector Concentration (%)

Sector	S&P 500	Russell 1000 Growth	NASDAQ
Technology	32.5	46.9	52.3
Communication	9.2	12.5	15.4
Total	*41.7*	*59.4*	*67.7*

A case can be made that the Mag-7's gigantism is warranted. The mega-cap Tech of today is not the unprofitable Dot-Com bubble of 25 years ago. These companies are cash flow kings, funding future investment through profits rather than borrowing, which in part is why higher interest rates have done little to slow their momentum. Five of the seven have had the tailwind of aggressive stock buyback plans to boost earnings per share. Apple repurchased more than $80 billion in stock over the past year and authorized an additional $110 billion in share buybacks this past quarter. Perhaps most importantly, the Mag-7 has been the rare source of earnings growth. NVIDIA's profit has risen in lockstep with its share price, an incredible feat given the stock's 200% gain over the past 12 months. Last quarter, the Mag-7 grew earnings by 50% compared to Q1 of 2023. Conversely, the remaining 493 stocks in the S&P 500 saw their earnings decline by 9%.

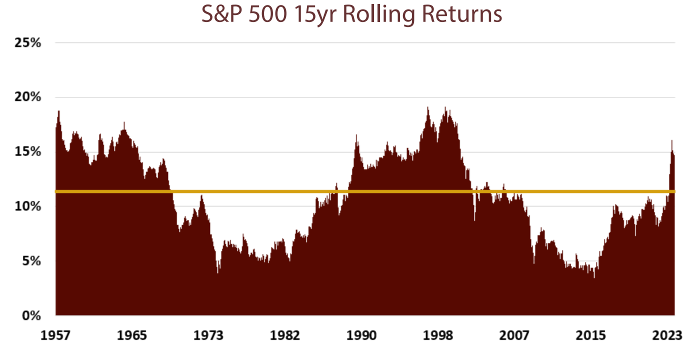
S&P 500 Q1 2024 Net Income Growth (Y/Y Pct. Chg.)



Source: Strategas

The past decade of concentrated returns has been to the benefit of index investors. This is the third such period of rolling 15-year returns exceeding 15% since the index's inception. In all three of these periods, concentrations were rising. Most active managers, either by mandate or intention, try to avoid single-stock positions greater than 5% as a risk mitigation technique. These size limitations to active strategies have made it nearly impossible to keep up with the S&P 500 Index, as evidenced by the fact that according to Morningstar, only 2% of U.S. large cap blend managers have outperformed the Index over the time period. Indexing is hard to beat during good market periods and has been a great, low-cost, tax-efficient way for Opus clients to ride the Mag-7 wave.

S&P 500 15yr Rolling Returns

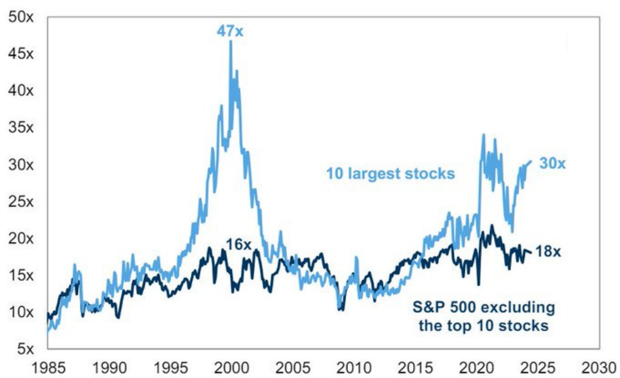


Source: Schiller & Portfolio Visualizer

When and where the Index concentration ultimately peaks is anyone's guess; predictions for a top in the Mag-7 were already being made seven to eight years ago. That said, here are some best guesses as to what could usher in the pivot.

Valuations: At the onset of the Mag-7 rally, the top 10 largest stocks (which included Apple, Microsoft, and Alphabet at the time) traded at a P/E valuation that was about 25% cheaper than the broad index. After a decade of meaningful multiple expansion, the 10 largest stocks now trade at 30x earnings, a noticeable premium to the broad Index. The other 490 stocks in the S&P 500 trade at a more reasonable 18x earnings. Excessive valuations eventually played a role in halting the other two periods of above-average 15-year returns.

Median Company P/E Multiple



Source: Goldman Sachs

Earnings: Over the last six quarters, earnings growth has been essentially confined to the Mag-7, but analysts are optimistic that earnings should broaden out to the rest of the market in the second half of the year, with EPS growth differentials narrowing between the Mag-7 stocks and the rest of the Index. Should the Fed follow though on the forecast to cut rates over the coming quarters, small cap stocks would naturally stand to benefit. In fact, current bottom-up Street forecasts expect earnings growth for small-cap stocks to exceed large-cap stocks in both 2025 and 2026.

Law of Large Numbers: As a company grows, it becomes more difficult to sustain its previous growth rates. Given the substantial market share and wide profit margins the Mag-7 has already captured, is there enough opportunity for above-average EPS growth to persist?

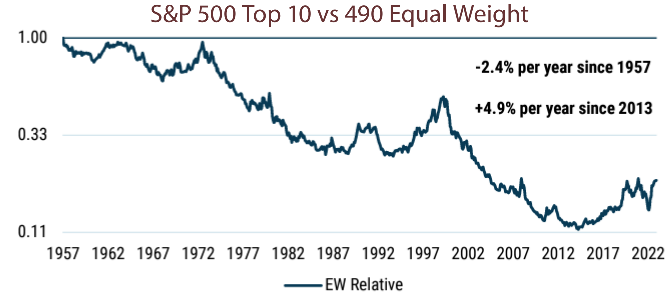
INTERNATIONAL RETURNS (%)

As of 6/30/2024	Q2 2024	1-Year	3-Year	5-Year	10-Year
Int'l Developed ex US	-0.42	11.54	2.89	6.46	4.33
Emerging Markets	5.00	12.55	-5.07	3.10	2.79

Source: Morningstar

Historically speaking, outperformance from the ten largest stocks is the exception rather than the norm. Per GMO's graph below, since the Index's inception, the ten largest stocks in the S&P 500 have underperformed an equal-weighted index of the remaining 490 stocks by 2.4% per year. The Nifty-Fifty and the Dot-Com eras were the two other exceptions, both of which were also periods of rising concentrations and above-average rolling 15-year returns.

S&P 500 Top 10 vs 490 Equal Weight



Source: GMO

Mean Reversion: The last 15 years of bull market returns for mega-cap U.S. growth has coincided with a bear market for diversification, as nearly every other asset class has materially underperformed U.S. large caps. Any exposure to bonds has weighed on portfolio returns; bonds have trailed U.S. stocks by more than 12% annualized over this time period. International stocks have produced returns less than half of their U.S. counterparts. Within U.S. equities, the valuation discrepancies of Small Cap to Large Cap as well as Value to Growth are both more than one standard deviation below their averages. Since time immemorial, markets have been cyclical, impacted by both economic cycles and investor behavior, and asset class returns eventually drift to (or fall below) their mean.

Going forward, our recommended strategy is to combine core-indexing with tilts towards evidence-based factors like value, profitability, and shareholder yield. This results in Apple, Microsoft, and NVIDIA as our largest U.S. stock holdings, but at position sizes below their current index weight. Odds are favorable that the next decade of returns will differ in leadership from the past decade, and portfolio diversification will again prove valuable.

FIXED INCOME RETURNS (%)

As of 6/30/2024	Q2 2024	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	0.07	2.63	-3.02	-0.23	1.35
Muni	0.25	3.68	-0.77	1.01	1.90
Int'l Bonds	-1.11	2.02	-4.25	-1.63	-0.64
High-Yield	1.11	9.92	1.63	3.54	3.51
Short-Term	1.05	5.96	0.67	1.59	1.64
90-Day T-Bill	1.37	5.60	3.28	2.26	1.57

Source: Morningstar

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