February 2024

Does the S&P 500 Still Represent a Diversified Portfolio?

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Executive Summary

- **Once thought to be safe, portfolios indexed to the S&P 500 present risks in today's market**
- **Recent performance has been driven by a small number of stocks in the Technology Sector**
- **Opportunities exist to find attractively valued stocks down the size spectrum**

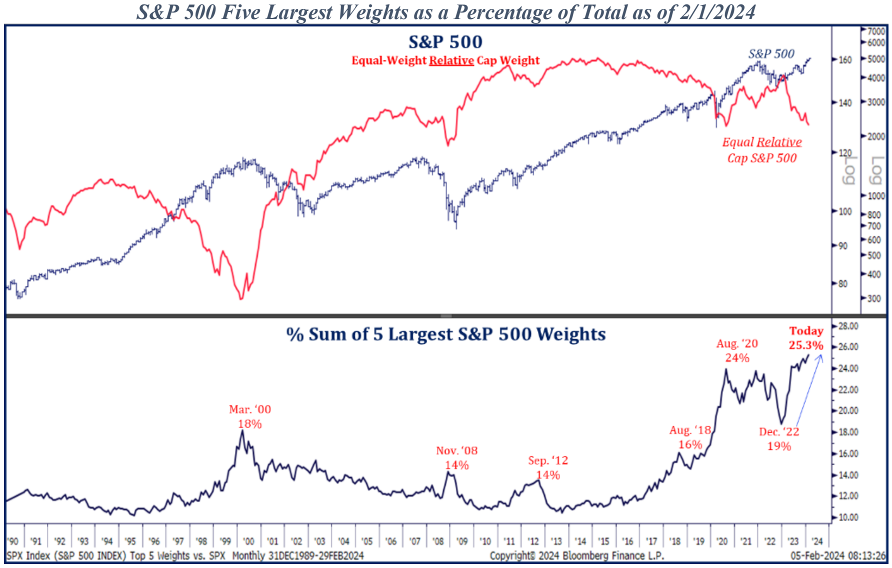
In 1973, Dr. Burton Malkiel published, "A Random Walk Down Wall Street," a book that is generally regarded as one of the most important works on investing in the stock market ever written. Dr. Malkiel expresses the opinion that stock prices are basically random, and that it is a fool's errand to try to pick stocks that will beat the market. Instead, investors wishing to have a diversified portfolio of stocks should simply buy the S&P 500 Index. In theory, a portfolio that consists of the Index will be well-diversified across sectors and individual stocks. This provides the safety of diversification with exposure to the high, long-term returns offered by the U.S. equity market.

In our opinion, today's market conditions make it safe to ask whether the arguments made in the book still apply. As active managers, we at NBW Capital think that it is possible to beat the Index over a long period. We believe that stock prices are not random. By investing in companies with good and improving fundamentals and avoiding stocks with weakening prospects, portfolios can be constructed that will outperform a broad index over time.

Having addressed the out/under performance question, the next part of the argument is diversification. Given that over the last five years, the S&P 500 Index has increasingly come to be dominated by the largest five stocks, it is fair to ask, "Does the S&P 500 still represent a diversified index?"

Historically, the largest five stocks, individually, represented no more than 2% of the Index. Therefore, no individual company could have an outsized impact on the overall performance of the S&P 500 Index. However, over the last five years, this has changed. Today, the largest five stocks represent over 25% of the S&P 500 Index. As the Index became more concentrated, the relative performance of the equal-weighted index to the cap-weighted index, as represented by the red line in the top panel of the chart below, began to worsen (when the slope of the line is upwards to the right, the equal-weighted index is outperforming). The last time the Index experienced an increase in concentration like this was in the late 1990's and early 2000's. As the technology bubble burst, the equal-weighted index reasserted its relative performance advantage.

S&P 500 Five Largest Weights as a Percentage of Total as of 2/1/2024



Source: Strategas

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Compounding the issue is that these five stocks are concentrated in two sectors, Technology and its close cousin Communications Services, as well as Amazon.com that is officially in the Consumer Discretionary sector. This leads to a real diversification problem for investors that are indexing to the cap-weighted S&P 500 Index. These investors are making a very large bet on a single sector, Technology. They also have a high level of single stock risk with two stocks each exceeding 5% each--and almost 14% combined--of their total portfolio.

Top Five S&P 500 Weights as of 2/1/2024

Stock	Index Weight	Sector
Microsoft	7.28%	Technology
Apple	6.63%	Technology
NVIDIA	3.78%	Technology
Amazon.com	3.52%	Consumer Discretionary
Alphabet (two classes)	3.75%	Communications Services
Total	24.96%	

Source: Bloomberg

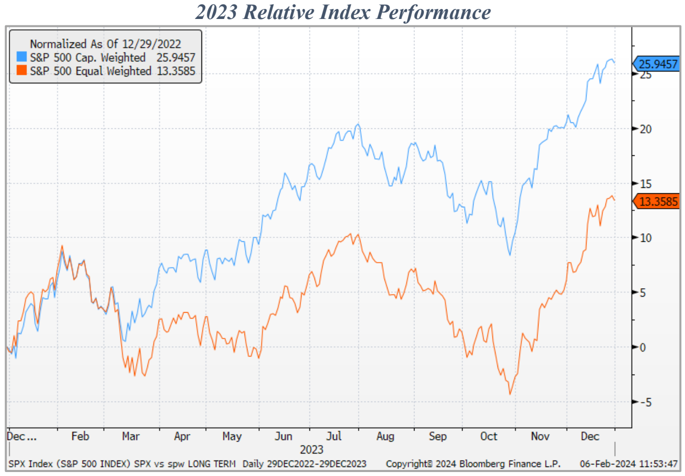
S&P 500 Sector Weights as of 2/2/2024

Sector	Index Weight
Information Technology	29.6%
Financials	12.9%
Healthcare	12.6%
Consumer Discretionary	10.5%
Communications Serevices	9.1%
Industrials	8.6%
Consumer Staples	6.1%
Energy	3.7%
Real Estate	2.3%
Materials	2.3%
Utilities	2.3%

Source: Bloomberg

In these times of heavy index concentration, it has been frustrating for investors that want to create diversified portfolios across sectors and market capitalizations because the returns have been so heavily skewed toward the large cap technology leaders. The chart below compares the performance of the cap and equal-weighted indexes in 2023.

2023 Relative Index Performance



Source: Bloomberg

The mega cap technology stocks asserted themselves in March of last year as investors began chasing the idea that Artificial Intelligence (AI) will create a huge and enduring wave of demand for their products and services. At that time, the technology leaders that came to be known as the magnificent seven (Apple, Microsoft, NVIDIA, Amazon.com, Alphabet, Facebook and Tesla) began an ascent that carried on throughout the year and resulted in a return of over 100%. The average stock, as represented by the equal-weighted S&P 500 Index, appreciated by slightly under 12% in 2023.

We believe that as the cap-weighted index continues its ascent, it is creating opportunities to find smaller stocks that are growing earnings per share (EPS) at healthy rates but are more attractively valued. As the following chart demonstrates, the cap-weighted S&P 500 Index is trading at over 20 times the estimated 2024 EPS. In contrast, the average stock in the equal weighed S&P 500 Index is trading at just over 16 times 2024 EPS.

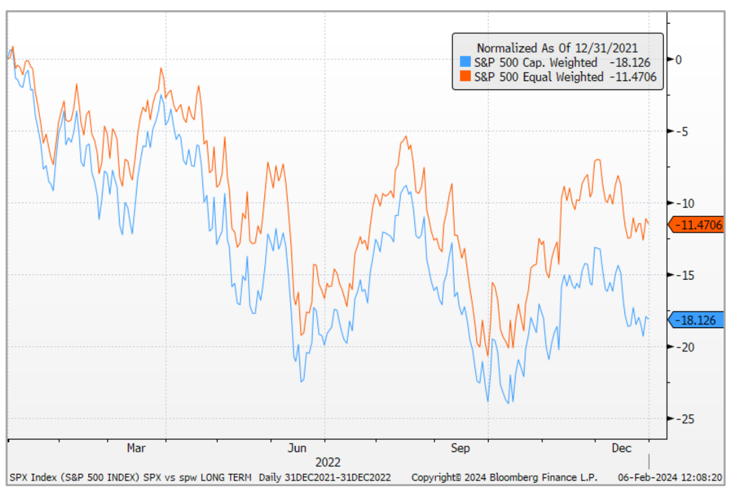
Relative 2024 P/E Ratios

Source: Bloomberg

In our opinion, there is no doubt that AI will certainly change the way we all work and interact with the world around us. And the mega cap technology companies are very well positioned to be the early beneficiaries of this trend. However, markets periodically go through periods of falling in love with "hot themes" only to have them end as growth expectations prove to be too far ahead of the realities. In the recent past themes like clean energy, big data and genomics have all had similar waves of investor enthusiasm. In our experience, buying stocks after they explode to the upside when the market decides they are related to a hot theme is "chasing performance," and is not a long-term winning formula for investing success. Instead, investors should continue to seek out opportunities to acquire quality small, mid and large cap stocks at reasonable valuations.

Mega cap performance domination cuts both ways. If we recreate the index performance chart for the year 2022, the negative impact of the Technology overweight is obvious. In that year, technology dominated, and the S&P 500 Index lost over 18%, while the equal-weighted index was only down by slightly more than 11%.

Mega caps led the decline in 2022



Source: Bloomberg

There are trillions of dollars invested in products indexed to the S&P 500 Index. Many of the investors utilize these mutual funds and Exchange Traded Funds in the belief that they own a diversified index that will limit risks associated with large exposures to a single stock or sector. They need to understand that we are currently in a different world than when Dr. Malkiel first wrote his book. In fact, the index investing world has changed significantly over the last five years and the equal-weighted index of today looks more like the market cap-weighted version that he wrote about in his book. This concentration risk should be discussed as part of annual meetings between advisors and clients.

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