

February 07, 2022

Dear Client:

After rising a stout 28.7% in 2021, the stock market powered into the new year, closing at an all-time high in the first few trading days. Since then, however, the growth stocks that led the markets higher have seen their relative momentum turn lower. While the selling was limited in its breadth, the result was a sharp market decline, before a kick-save, buy-the-dip rally into the month-end close. Our recent quarterly letter ended with an observation on market concentration and what we described as the illusion of performance. This concentration impacted equities markets in January, so we thought to examine it more in depth here.

To begin, the main source of recent stock market volatility has been the Federal Reserve: the uncertainty around monetary policy, and the timing of their stated intentions to cease quantitative easing and raise interest rates. Higher future rates take a bite out of discounted cash flows, and the higher multiple growth stocks were repriced lower accordingly. This is where the illusion we refer to comes into play: many stocks outperformed the market in January, but because a handful of the largest market capitalization-weighted stocks were sold, positive outcomes were lost in the anxiety. Currently, of the stocks in the S&P500, the 10 largest represent ~34% of the entire index and ~23% of earnings, with a combined market capitalization equal to the bottom 432 stocks.

According to data from S&P Global and economist Ed Yardeni, what has been termed the “Mega Cap 8” (Amazon, Tesla, Apple, Microsoft, Nvidia, Alphabet, Facebook, Netflix) accounted for 40% of the decline in the total return of the S&P in January. And this makes sense since just five of those eight (Microsoft, Apple, Alphabet, Nvidia and Tesla) accounted for an astounding ~35% of the 2021 advance in the S&P500. There have been past instances of market concentration in the past -- the 90s tech bubble and Nifty Fifty come to mind -- but not at this level and not with the ease and access that passive exchange-traded funds (ETFs) offer. Indeed, the shift from active to passive management has exacerbated capital flows to the largest companies for years so that, when things turn, the outflows can become significant in a hurry. According to Bloomberg, the world’s biggest ETF -- the SPDR S&P 500 ETF Trust (SPY) -- just posted its worst monthly redemption since launching in 1993.

From our perspective as active managers, a dilution in market concentration isn’t a negative as active performance is inversely correlated with the rising and falling share of S&P 500 concentration. We look to add value through active share, meaning we’re disinclined to just hold the largest names in the index at market weight, and prefer instead to find interesting idiosyncratic names that will set the portfolio apart. When the share of the top names in the index are falling, portfolio returns are rewarded for looking outside these top holdings. But when the reverse is true, as it has been since 2015, then it is difficult to participate lest we give in and allocate commensurately with the increasing concentration, which not our process. As the earnings season is in progress, we are pleased with the fundamental performance of our portfolio companies, with both sales and earnings growth outpacing the benchmark once again. We can’t control the present stock market rewards system, but should January’s trend continue, we are hopeful that it will become a great time for active participation once again.

Regards,



Adam S. Abelson
Chief Investment Officer
U.S. Large Cap Equity Strategy