ZWJ
INVESTMENT COUNSEL

MARKET OUTLOOK Third Quarter 2024

The stock market continues to astound, as the overall index performance looks good while the average stock is not having the same experience. This is somewhat analogous to the top-heavy distribution of income in the U.S., in which the top 1% and the bottom 50% have very different experiences. Concentration, whether it is income or investment portfolio weight, carries with it latent risks that must be considered.

Concentration can sneak up on one, especially investors in mutual funds or ETFs who are unclear about what is in their portfolio. Passive funds were designed originally to track a broad market index because their promoters argued there was no way to beat the index performance when the market efficiently processed all available information in real time. These strategies certainly made sense for large pensions with infinite investment horizons and were unwilling to pay management fees to investment firms that did not consistently generate "alpha" to outperform the assigned benchmark. Passive funds were next sold to individual investors as a low-cost vehicle for their savings, and these passive strategies grew over time until they recently accounted for more than half of all the assets under management.

Financial academics are no longer as sure about the efficiency of investment markets, but the spread of "passive" funds tied to an index has continued nonetheless. In competition for assets, corporate sponsors create new funds that track more specialized indices. For example, one can invest in the Russell 1000, a broad market index, or the Russell 200, the largest of those 1000 in a different index, or even the Russell 1000 Growth, a subset of the 1000 selected according to Russell's methodology for marking a company as growth or value. One can see how the proliferation of indices and index-tracking funds benefits the investment industry. How much it truly benefits the client is less clear.

ZWJ has consistently identified itself as an active manager. We are active in the sense that we actively decide which stocks to hold in client portfolios; we do not outsource portfolio construction to a committee at Russell or Standard and Poors. We are also active in the sense that we decide how much weight to assign to each position in the portfolio; we do not let the weight of the index drive our decisions. Why would those be important?

We've discussed frequently the concentration of the S&P 500 Index, and it has become even more concentrated. As of late June 2024, the top 10 stocks constitute 37.5% of the total index market weight, and the top 5 account for 29%. Both numbers are all-time highs. One wonders how the market can get so concentrated. We think there are two contributing factors.

The first factor is what is known as "capitulation." In this scenario, the investment manager decides he might get replaced if he does not match the index weight in a popular name. Lately, the most popular name is Nvidia, and it is currently about 7% of the S&P 500 Index. Even though the manager might have no particular viewpoint about the company, the stock is bought in his portfolio to nullify its impact on returns, and the firm lives to have another meeting with the client. You can see how this is more of a business decision than an investment decision. ZWJ strongly objects to this kind of reasoning, especially for an active manager.

The second factor is the proliferation of "passive index" funds that have been designed to attract investor dollars. Let's track the weight of Microsoft in an array of "passive index" funds. In the SPY (tracks the S&P 500), it is about 7%. In the Vanguard Total Market fund (3600 stocks), it is about 6%. In the QQQ (not really an index, but basically the non-financial NASDAQ stocks, 102 in total), it is 8.6%. In the Russell 1000 Growth fund (440 names picked by Russell computers and a committee), it is 11.7%. In the Vanguard Growth fund (200 names with a black-box selection system), it is 12.5%. The S&P Growth Spyder ETF (233 names picked by another black box), the S&P 500 Growth (232 names from a black box), and the Schwab Large-Cap Growth ETF (248 names from a black box) all show a weight for

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Microsoft around 12.5%. From the proliferation of black boxes used to set index membership, one can see these passive funds are not really passive; they deliver the stock tickers identified by their algorithms, and they block the unwanted stocks.

This is a contributing factor to how the market gets concentrated. There are simply too many buyers for a limited set of names. The result is outsized valuations because the marginal buyers do not care what price they pay to participate in the popular theme. ZWJ cares about the price we pay for growth, so outsized valuations are a red flag for us. There are many ways to value a company, but one of the simplest is the price-to-sales ratio. Investors of a certain age will remember one of the Dot-Com darlings was Sun Microsystems, and that stock reached the 10x sales valuation level. Sun's CEO, Scott McNealy, famously rebuked investors for paying such a high price for his company's stock by explaining the extraordinary means that would be necessary to pay investors back.

He said:

> *At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate.*

Today, thanks to this trend of market concentration, three of the "Magnificent Seven" have a price-to-sales ratio above 9.5x. Prudent active managers who are making investment decisions look at those ratios, and they could reasonably come to the conclusion that a 12% weight in a discretionary diversified client portfolio might be too risky.

ZWJ broadly owns four of the Magnificent Seven, but each one was found through our research process well before they became today's darlings. If we do not actively compare the price of the company's stock to the company's economic performance, then we are really little more than a surfer trying to guess when to get off the wave. That is not investing; it is market momentum surfing. ZWJ is ultimately unwilling to play that guessing game.

There are many other factors that go into investment performance, but risk management is one of the most important. Part of risk management is identifying the right risk. Concentration is a risk, and we think it is increasingly one of the most important risks. The same momentum factors that contributed to the rise of these tech-growth stocks can work in the other direction. As insiders start selling (and they have been all year), and near-insiders like large hedge funds follow (as they have lately), then the wave can begin to roll over and suddenly everyone is trimming their exposure. Any general rush for the exits will disproportionately affect these stocks.

The math inherent in unwinding these very large positions suggests that passive investors could be actively harmed because their fund managers have so little say in the constitution of their portfolios. Active investors who managed their weights by trimming during the buildup are more likely to handle a broad market retreat much better because they are less exposed to stocks that are falling so steeply. ZWJ is an active investment manager.

Charles L. Abney III, CFA • Tres R. Carpenter, CFA, CFP® • Krista L. Cosgrove, CFA
Stacey D. Ewing, CFA • Edwin J. Feinour • Casey J. Flanagan, CFA • Emilie D. Hill, CFA • Clayton F. Jackson, CFA
William B. Miller • Blaire Parlo, CPA • Kevin C. H. Yang, CFA • Bradford S. J. Young, CFA

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