Q4 IN REVIEW
2024 IN PREVIEW

Issue 4 / January 2024

HAPPY NEW YEAR!

As we head into 2024, we anticipate the main themes will be a steadily humming economy, along with a more inclusive market rally as other names play catch-up.

Chief Investment Officer, Nick Nejad, CFA®, and the BHPW Investment Committee share their thoughts.

If you would like to discuss any of these topics in more detail, please call us at 310-388-3800.

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FOURTH QUARTER OVERVIEW

2023 came in like a bear but went out like a bull, with stocks and bonds both contributing significantly to gains during the 4th quarter. The catalyst: a newfound sense of optimism among investors after new data signaled inflation was cooling and that the Fed might cut interest rates sooner than many had anticipated. The 10-year treasury yield tumbled quickly as a result, falling from a high of 5.0% during the quarter to 3.9% by year end. Stocks reacted positively to this, with the MSCI ACWI index of global equities finishing up +11.0%.

This time, the gains in the market weren't just limited to a handful of mega cap names. Rather, most stocks in the index saw returns near or above double digits, which provided a welcome boost to the overall market breadth. The highest regional returns were in Latin America and the US, with gains of +17.6% and +11.7%, respectively. In contrast, China was the biggest detractor, falling by -4.2% on concerns over its geopolitics and property markets. Sector-wise, Technology and Real Estate led the quarter, as each area benefited from falling rates. Meanwhile, defensive sectors such as Energy, Health Care, and Consumer Staples lagged in this risk-on period for the markets.

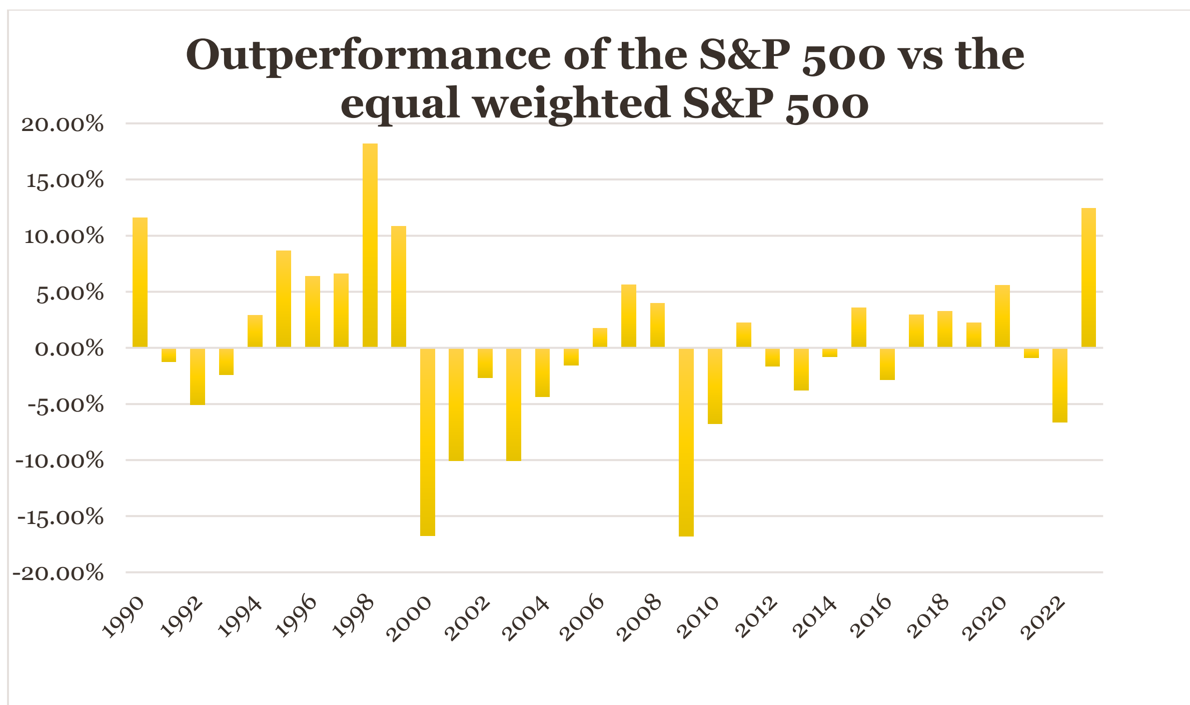
Fixed income also experienced a late year surge, as the decline in interest rates directly translated to higher bond prices. As a result, the asset class returned a hefty +8.1% gain for the quarter, ranking it as one of the best quarters for bonds since the 1980's. Longer-dated maturities saw the largest returns, but corporate and high yield bonds also performed well in this benign economic environment.

Overall, the 4th quarter results capped off a strong 2023 for both equities and fixed income, a comforting turn of events for investors still suffering from a gut-wrenching 2022. Global stocks finished the year up +22.2%, fully recouping their losses from the prior year. Bonds, meanwhile, enjoyed a healthy gain of +5.7%, although they still remain down as an asset class since 2021.

"...but the lopsided nature of the market still persisted, with 70% of companies underperforming the index for the year."

THE MAGNIFICENT SEVEN…AND EVERYBODY ELSE

Markets rarely fall two years in a row, and in that respect, last year did not disappoint. But things were not looking so rosy as recently as two months ago. For example, while the S&P 500 was up to start November, more than half its constituents were down by an average of -15%. November and December brought many of these back into the green, but the lopsided nature of the market still persisted, with 70% of companies underperforming the index for the year. It was the biggest outperformance of a size-weighted S&P 500 to its equally weighted counterpart since the late 1990's.



Sources: Bloomberg Finance L.P., DWS Investment GmbH

The tech bubble was the obvious factor in the 90's. This time, the cause was a bit more concentrated. A "Magnificent Seven" group of stocks, comprised of the seven largest public companies in the US, finished the year up by a whopping +85% on a weighted average basis. We all know the companies: Apple, Microsoft, Alphabet, Amazon, NVIDA, Meta and Tesla. They trounced the returns of the typical name, and because of their absolute size, these seven securities ultimately accounted for over 80% of the gains last year. That sounds nice, but it's worth pointing out that those same names fell by -40% in 2022, accounting for most of the losses then.

Regardless, we do admire almost all these businesses, and even listed several of them out as opportunities in our prior letters. But after nearly doubling in value this past year, we are no longer sanguine about the overall basket. Some of the companies will surely continue to do well. But as a group of common stocks, we think they are destined to disappoint us going forward at these starting values, for the reasons we will dive into below.

SEVEN-FOOT HURDLES

We mentioned that the last time size so mightily outperformed the average constituent was during the late 90's tech bubble. Here's what Warren Buffett had to say at the time about all the mega cap valuations flying around:

"When we buy a stock, we always think in terms of buying the whole enterprise, because it enables us to think as businessmen rather than as stock speculators.

So, let's just take a company that has marvelous prospects, is paying you nothing now, and you buy it at a valuation of $500 billion. Now, if you feel that 10% is the appropriate rate of return — and you can pick your figure — that means that if it pays you nothing this year, but starts paying next year, it has to be able to pay you $55 billion in perpetuity, each year. But if it's not going to pay until the third year, then it has to pay you $60.5 billion in perpetuity — in perpetuity — to justify the present price. Every year that you wait to take a bird out of the bush means that you have to take out more birds. It's that simple." – Warren Buffett

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When you combine expensive earnings multiples with sky high dollar valuations, it becomes very difficult to catch "the target" for attractive expected returns. Natural limits in the economy start to become a factor. You start requiring things that have never been done before. Warren goes on to say: *"Now, you might look around at the universe of businesses in this world and see how many are earning $80 billion pretax, or $70, or $60, or $50, or $40, or $30. And you won't find any. So, it requires a rather extraordinary change in profitability to give you enough birds out of that particular bush to make it worthwhile to give up the one that you have in your hand."*

Buffet made those remarks in 2000, and 23 years later, we have just 3 public companies in the world that clear his original $80 billion figure. And they don't beat it by very much. So, almost all the most richly valued companies of 1999 turned out to be poor investments.

We think something similar may be in store now for the Magnificent Seven, as these 7 companies have a combined 2.5 million employees, $320 billion net income, and a staggering $13 trillion market valuation. Together, these seven companies are valued at about 12% of world GDP.

For an investor targeting a 10% return, these companies will need to accomplish 3 monumental feats: first, quadruple their earnings; second, achieve $1.3 trillion of net profit in a $100 trillion economy; and third, do this quickly. The urgency is paramount because every year that they fall short increases the ultimate target. It's a daunting trifecta for a group of businesses growing their sales by only 8% per year. As Buffett might put it, making the math work on these is like trying to jump a seven-foot hurdle.

Maybe this time will be different. More likely though, we think investors in these companies should expect lower returns than the ones experienced recently.

“THE S&P 10 INDEX”

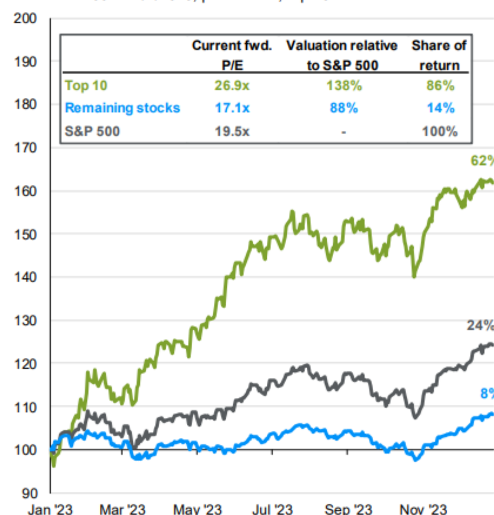
The good news is very few investors are allocated directly to the Magnificent Seven index. The bad news is that the average investor is still more exposed to this than they likely realize.

The S&P 500 has become the quintessential choice for most people's passive equity portfolios. For a long time, it provided a proposition that made a lot of sense. By formulaically weighing by size across 500 of the largest companies in the country, its goal was to emulate the actual returns of the overall US market, while also providing exposure to a diversified and representative cross-section of the entire economy.

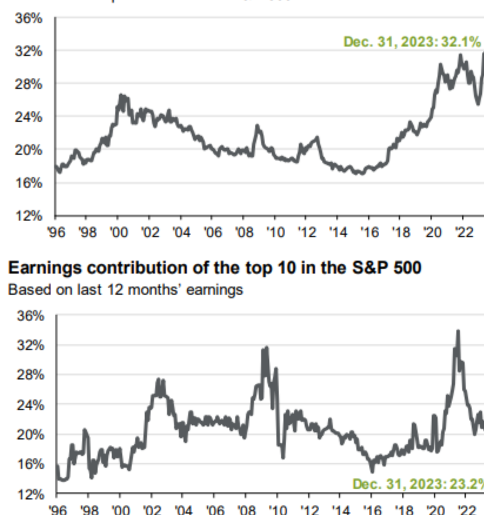
Only today, that portfolio is not very diversified nor representative. The top ten stocks, including the Magnificent Seven, now account for 32% of the S&P 500's weight. These companies skew almost entirely towards Technology, with a valuation that is 57% more expensive than the next 490 names.

S&P 500: Index concentration GTM | U.S. | 10

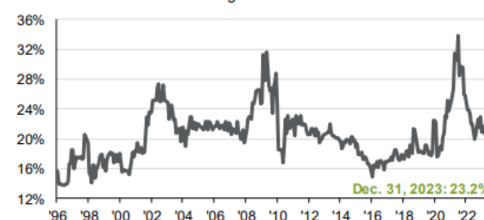
Performance of the top 10 stocks in the S&P 500
Indexed to 100 on 1/1/2023, price return, top 10 held constant



Weight of the top 10 stocks in the S&P 500
% of market capitalization of the S&P 500



Earnings contribution of the top 10 in the S&P 500
Based on last 12 months' earnings



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
(Left) The top 10 companies used for this analysis are held constant and represent the S&P 500's 10 largest index constituents at the start of 2023. The top 10 stocks are: AAPL, MSFT, AMZN, NVDA, GOOGL, BRK.B, GOOG, META, XOM, UNH, and TSLA. The remaining stocks represent the rest of the 494 companies in the S&P 500. (Right) The top 10 companies used for these two analyses are updated monthly and are based on the 10 largest index constituents at the beginning of each month. As of 12/31/2023, the top 10 companies in the index were AAPL (7.0%), MSFT (6.9%), AMZN (3.5%), NVDA (3.0%), GOOGL (2.1%), META (2.0%), GOOG (1.8%), TSLA (1.8%), BRK.B (1.6%), AVGO (1.2%) and JPM (1.2%).
Guide to the Markets – U.S. Data are as of December 31, 2023.

J.P.Morgan ASSET MANAGEMENT

Making a big bet on ten of the largest companies in the world may feel like the safe thing to do. But, the history of the S&P 500 is littered with top ten companies that have fallen from grace, some even spectacularly so. The table below shows the leading public companies across several time periods. Each name marked in red indicates its final instance before falling out of leadership. As you can see, staying at the top has been no easy feat.

S&P500 Top 10 (1980 – Current)									
1980	1985	1990	1995	2000	2005	2010	2015	2020	Current
IBM	IBM	IBM	GE	GE	GE	Exxon	Apple	Apple	Apple
AT&T	Exxon	Exxon	AT&T	Exxon	Exxon	Apple	Alphabet	Microsoft	Microsoft
Exxon	GE	GE	Exxon	Pfizer	Microsoft	Microsoft	Microsoft	Amazon	Alphabet
Standard Oil, Indiana	AT&T	Philip Morris	Coca-Cola	Citigroup	Citigroup	GE	Exxon	Alphabet	Amazon
Schlumberger	GM	Shell	Merck & Co	Cisco	Procter & Gamble	Chevron	GE	Meta	Tesla
Shell	Shell	Bristol-Myers	Shell	Wal-Mart	Wal-Mart	IBM	J&J	Tesla	Meta
Mobil	DuPont	Merck & Co	Philip Morris	Microsoft	Bank of America	Procter & Gamble	Amazon	Berkshire Hathaway	Nvidia
Standard Oil of Cal	Amoco	Wal-Mart	Procter & Gamble	AIG	J&J	AT&T	Wells Fargo	J&J	Berkshire Hathaway
Atlantic Richfield	Bell South	AT&T	J&J	Merck & Co	AIG	J&J	Berkshire Hathaway	JP Morgan Chase	J&J
GE	Sears	Coca-Cola	Microsoft	Intel	Pfizer	JP Morgan Chase	JP Morgan Chase	Visa	United Health

Data Source: S&P Dow Jones, Spheria

Empirical data would support *underweighting* the ten largest companies, if anything. For example, research has shown that once a company reaches top ten status, it typically goes on to underperform the index over the next 5 and 10 years. Furthermore, higher concentration in the top ten companies of the S&P 500 has historically been a predictor of better returns in the other 490 names.

High Concentration Has Preceded Poor Performance from the Biggest Stocks

Subsequent Five-Year Outperformance of Equal-Weighted S&P 500 Index vs. Market-Cap Weighted S&P 500 Index

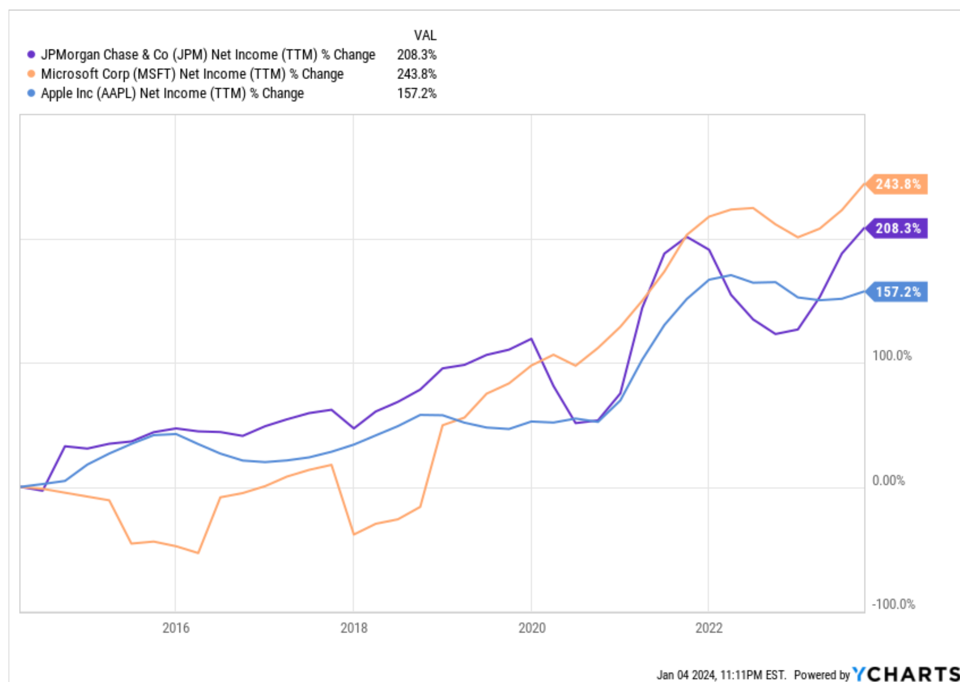
As of 12/31/89-10/31/23. Values above zero mean equal-weight is outperforming. Constituent weights are available monthly since May 1996 and annually previously. For those earlier periods, we've linearly interpolated between the annual figures to generate a monthly series. Redoing the analysis but only using annual figures for earlier periods doesn't impact our conclusions. Return data is available for the S&P 500 Equal-Weighted Index since December 1989. Rolling 60-month returns have been analyzed. Statistical note: The rolling 60-month analysis includes overlapping periods, and serial correlation is present in the data. These bias the standard errors in regular statistical tests, which can result in a false positive result i.e., a conclusion of relationship when there is none. We have applied a Newey-West adjustment to the standard errors to correct for this. The conclusion of statistical significance is robust to this adjustment.

Putting it all together, the S&P 500 now carries a weighted average market capitalization of $730 billion, which is up from $120 billion just eight years ago. That seems simply too top heavy for us, and it eliminates one of the index's greatest strengths in the past, which was its vast representativeness. Even if the top ten companies would go on to typically underperform, something new was always rising from the depths to lead the markets higher. At a weighted average size of

$120 billion, those newcomers would make an impact. At a starting price of $730 billion, we're just not sure that they'll be able to make a dent.

ONE-FOOT HURDLES

Investment math doesn't have to be so challenging. Easier opportunities do exist if, as Buffett suggests, you're willing to look for birds in the hand instead of the ones in the bush. Consider J.P. Morgan, which currently trades at a 10% earnings yield. It's a best of breed company in its industry and, as far as we can tell, doesn't face any major threats from the likes of Tesla or NVIDIA. The business has also demonstrated impressive growth, tripling its earnings since 2014 and putting its growth rate right in-line with that of Apple or Microsoft. For those aiming for a double-digit return, reaching it with J.P. Morgan sure feels like a one-foot hurdle in comparison.

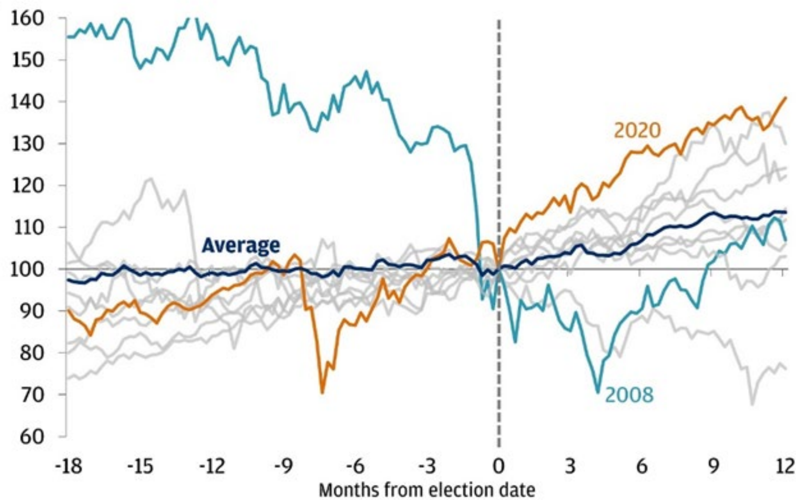


What if instead of investing in everything, and weighing those positions exclusively based on their size, we structured a different portfolio comprised of one-foot hurdles? That gets to the very core of our process, as we combine expertise and bottom-up analysis with more sensible diversification and position guidelines than ones based solely on size. The goal: to build well-diversified portfolios for our clients that not only target attractive returns, but also embody investment strategies where we would be confident placing our own wealth for the long term.

ELECTION MUSINGS

No analysis of the year ahead would be complete without delving into the upcoming elections, a topic that promises to add a layer of volatility to the year. This presidential race is sure to be one of the most important in recent history. President Biden's bid for a second term appears unchallenged from the Democratic side, while on the Republican side, President Trump continues to be a commanding presence in the GOP primaries, his influence undeterred, or perhaps even amplified, by his ongoing legal troubles.

From an investment perspective, the strongest performance is often seen in the third year of a presidency – the milestone we've just passed. Returns in presidential election years typically fall *below the average*, and the trajectory of the market during these years is also very telling. Historically, stocks have shown a tendency to remain stagnant in the ten months leading up to an election, with the bulk of gains in such years typically materializing after the results. We could see a similar pattern unfold this year.



THE ROAD AHEAD

While last year's surge has left many beaming with optimism, history suggests a bit of caution is warranted. Booming market conditions and widespread enthusiasm have rarely been the precursors for further strong gains. And looming elections in the US cast a shadow, as we just noted how equity returns have typically been subdued in the run up to the vote.

That said, 2023's exuberance was not universally shared. The lion's share of the rally was concentrated in a select group of high-growth US stocks, as these names bounced back from particularly steep 2022 declines between them. For those willing to look beyond this narrow area, the landscape was markedly different last year, with the average global stock posting a much more modest return of +9%. That suggests to us that ample opportunities still exist amongst the names that were neglected.

So, just as the fallen angels of 2022 were the shining stars of 2023, we believe 2024 will be the year of "everybody else". These other names will benefit from starting valuations that are a full 38% less expensive than the S&P 500. In such an environment, diversification beyond last year's dominant stocks will be crucial, and passive strategies may struggle in that regard versus more active ones that can be discerning about their allocations.

Overall, we are cautiously optimistic. Valuations are reasonable in most names, and we believe the economic backdrop will remain stable as long as job demand outpaces demographics (see our last letter for more detail). This should lay the groundwork for mid to high single-digit gains in stocks as a whole. Bonds, meanwhile, start the year with interest rates that are still attractive relative to recent history, and we expect returns of about 6% are attainable for those willing to take on modest credit risk. For our own part, we are positioned for a year where careful selection and strategic diversification could yield rewarding outcomes, and we think this will serve us well in what will surely be a very interesting year ahead.

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