Q&A: This is not your father's index…

…the market of stocks is healthier than the concentration at the top suggests

May 2024

No matter where you turn, it's impossible to avoid hearing about concerns facing the market, from valuations to stubborn inflation to elevated interest rates to a lack of breadth.

And it's easy to see why when looking at some of the anomalies that just keep getting more extreme. Enthusiasm around artificial intelligence (AI) and the incredible top-line growth we're seeing across many of the semiconductor and software beneficiaries has led to significant price gains and consequently valuation inflation. Increasing concentration at the top of the market has also significantly narrowed the top contributors to market performance in broader indices like the S&P 500 Index, leading to extreme divergences from the average stock.

But beneath the surface, Matt Orton believes the market of stocks is meaningfully healthier than these anomalies would have us believe, and there is a stealth broadening that has been, and will likely continue, taking place. He said this should be welcome news for investors as it creates plenty of opportunities for those who take the time to look.

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Matt Orton serves as Senior Vice President, Head of Advisory Solutions and Market Strategy, overseeing Raymond James Investment Management's client portfolio managers, portfolio specialists, RFP group, and Strategic Accounts channel. In this capacity, he helps align firm resources to best serve the firm's most sophisticated clients. Orton is also responsible for developing and delivering market commentary, strategy, and analysis, appearing on CNBC, Bloomberg TV, Yahoo! Finance, among others. He has been quoted in the Wall Street Journal, Barron's, Bloomberg News, Investments & Pensions Europe, and other financial news publications.

Orton has 14 years of investment experience and joined Raymond James Investment Management from BNP Paribas in New York where he was a Vice President in the Global Equity & Commodity Derivatives group, focusing on hedge fund and asset manager structuring and sales. Prior to that, Orton worked for Goldman Sachs Asset Management within the Quantitative Investment Strategies team where he focused on volatility research.

He earned a Master's of Business Administration with a concentration in Capital Markets and Asset Management from Cornell University and a Bachelor's degree from Vanderbilt University. He is a CFA charterholder.

Q: What are the biggest risks from index concentration, and should investors be concerned?

A: As an index becomes more concentrated, the small handful of companies at the top will naturally have a disproportionate impact on returns. That is certainly the case right now where the "Magnificent Seven" – seven of the largest stocks by market capitalization in the S&P 500 Index – are contributing approximately 47% of the returns of the index year to date, and that's after contributing over 60% in 2023.[1]

However, what goes up can also come down — and unfortunately these large companies can provide meaningful headwinds to index performance, just like they provided tailwinds on the way up. Part of the fear around today's market concentration is compounded by a similar narrowness in sectors and growth drivers of these top companies. While these are certainly risks, we cannot forget that many of these largest companies have incredibly well-diversified businesses with a myriad of product verticals, strong earnings, and cash balances bigger than many of the constituents within the S&P 500.

Overall, concentration certainly poses a risk, should all the mega caps roll over, but the likelihood of this is low given the current economic backdrop. Positioning might be stretched and there are risks of near-term consolidation, but the underlying fundamentals for these companies are incredibly strong — much more so than at any other point when we've seen similar levels of index concentration. Additionally, we have a recency bias and forget about the challenging 2022 that many of the largest stocks experienced. In many cases, these companies have only recently moved into the green.

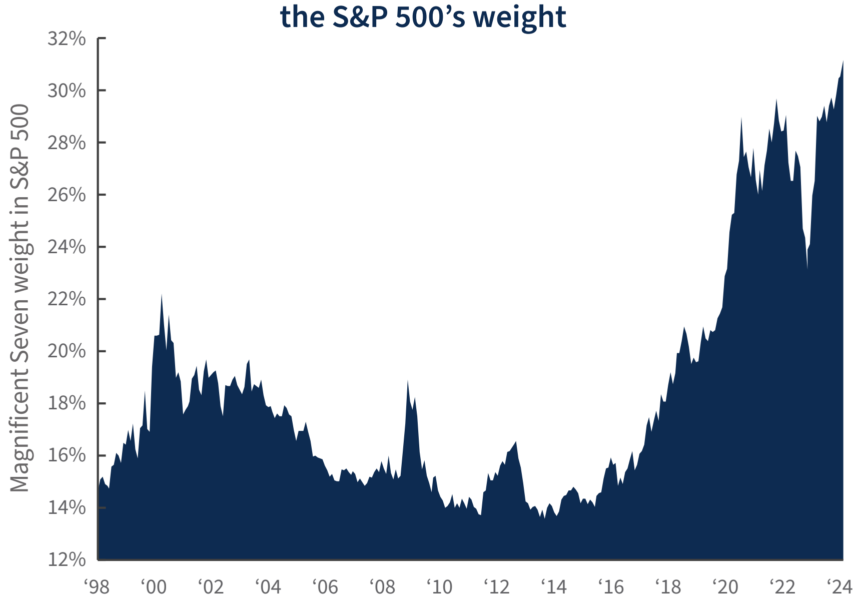
Q: Is the average stock still worth owning?

A: I would be remiss not to acknowledge some of the extreme moves this year in heavily weighted technology stocks, but there are actually a growing number of stocks that are doing well, supported by strong earnings and fundamental outlooks. In fact, approximately 61% of S&P 500 constituents are positive year to date, 40% of constituents are outperforming the index, and nearly 27% are up more than 10%. Clearly, there is a lot going on right underneath the surface and we've specifically seen a steady improvement in the absolute performance of the average stock throughout earnings season. Unfortunately, anomalies with respect to index weighting mask this when just looking at the surface. More sectors and industries look to be approaching inflection points in their earnings cycles, which could provide further support throughout 2024.

Q: Is index concentration making the market expensive?

A: We need to reframe the discussion around valuation. Following an incredible "pivot rally" that began with U.S. Federal Reserve (Fed) Chair Jay Powell's dovish comments in December, the S&P 500 is trading at 24.1x its trailing 12-month (TTM) price-to-earnings ratio and 20.8x on a 12-month forward multiple. That's back toward the peak of 2021 on a forward multiple basis, and the average stock (i.e., the S&P 500® Equal Weight Index) is meaningfully cheaper at 19.7x TTM and 17.2x forward price to earnings (P/E). With such a large gap between the index and the average stock (five points above its TTM median P/E and three points above its median forward P/E), it's clear that the concentration in the largest names, many of which have rallied significantly over the past year, are inflating market valuations. It is worth noting that as we see earnings revisions increase for the broader market and the inflection across sectors excluding information technology and communication services, this valuation gap will likely start to shrink regardless of the market's direction.

Magnificent Seven account for roughly 30% of the S&P 500's weight

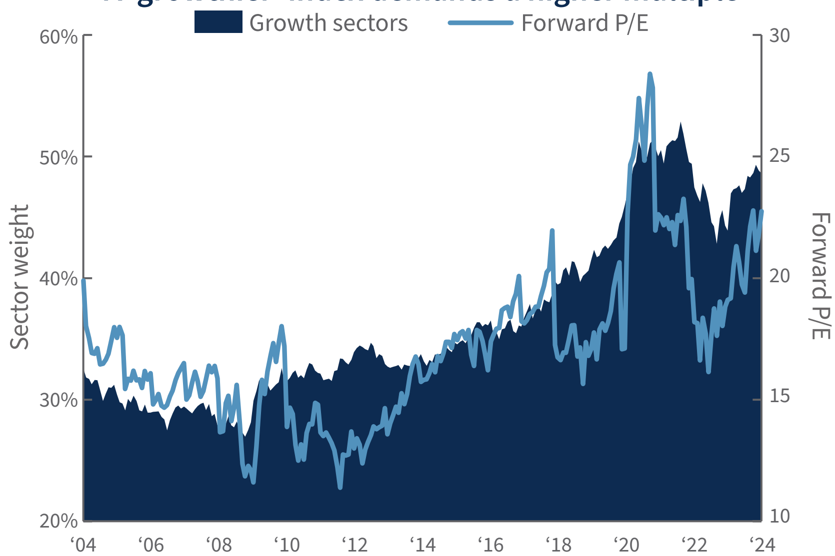


Source: Bloomberg, as of 4/30/24

[1] Unless otherwise indicated, all data cited is sourced from Bloomberg as of April 30, 2024.

While it's easy to point to index concentration and to generalize the market as expensive, I would push back against this notion. Is the market really expensive just because the long-term medians or averages tell us so? I actually would argue that the market is so different today that there isn't much value in utilizing these longer-term metrics. Just since the Global Financial Crisis (GFC), both the U.S. economy and the market have become much "growthier" in nature.

A 'growthier' index demands a higher multiple



Source: Bloomberg, as of 4/30/24

The S&P 500 today has a vastly different composition

Source: Bloomberg, as of 4/30/24

Pre-GFC, the sectors like financials and energy were among the largest weights. That is much different from today. And growthier companies command a higher multiple (see chart below, which tracks growth sector weights in the S&P 500 and their forward P/Es). This isn't to say that the market might be stretched right now, but it's not because a historical multiple tells us so.

Q: Are there other indices that suffer from concentration issues?

A: With so much noise surrounding the S&P 500's concentration, most would be surprised to learn that a vast number of international indices have an even worse concentration problem. It makes sense when you think about it, right? The largest companies in the world operate internationally, and the United States boasts the biggest and best companies in the world with the largest geographic reach. When you look at smaller countries (all of them), they have a fewer number of these international powerhouses and thus they make up a large portion of their respective country indices. The market is the most efficient allocator — the biggest companies are the biggest because they are the best.

Q: Where should investors look to find opportunities now?

A: I believe there are plenty of opportunities for investors who are willing to be selective: Industrials, healthcare, small caps, and dividend growth all offer diversification appeal worth considering. Small and mid-cap biotechnology has started to outperform, driven by Big Pharma's cash windfall from obesity drugs, while the rest of the healthcare sector is reporting earnings well ahead of estimates. Even energy might be starting to show some signs of life outside of the refiners, and the sector offers a nice complement to the ever-growing weights in technology and semiconductors. At the end of the day, the current manifestation of market narrowness isn't something by itself that is all too concerning. To the contrary, I believe it offers plenty of opportunities.

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Investing involves risk, including risk of loss.

Diversification does not ensure a profit or guarantee against loss.

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Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Investing in small cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. The prices of small company stocks may be subject to more volatility than those of large company stocks.

International investing presents specific risks, such as currency fluctuations, differences in financial accounting standards, and potential political and economic instability. These risks are further accentuated in emerging market countries where risks can also include possible economic dependency on revenues from particular commodities or on international aid or development assistance, currency transfer restrictions, and liquidity risks related to lower trading volumes.

Definitions

Breadth describes the relationship between the median and the mean of a market index. When a few data outliers result in a mean that is substantially larger (or smaller) than the median of the full data set, then the performance of the entire index is being driven by a "narrow" selection of companies. An index supported by "broad" market movements is one where the median is closer to the mean.

Concentration is a term used to describe the extent to which investments in a portfolio, group of portfolios, industry, sector, index, or particular geography or clustered in groups that share specific factors or other characteristics.

Consolidation is a term used in technical analysis to describe when stocks reverse previous gains (or losses) to stay within well-defined trading levels.

Dividend payers are the companies that distribute a portion of their profits to shareholders in the form of a dividend.

Dovish, hawkish, and centrist are terms used to describe the monetary policy preferences or expectations of central bankers or market participants. Doves tend to support maintaining lower interest rates, often in support of stimulating job growth and the economy more generally. Hawks prioritize controlling inflation and may favor raising interest rates to reduce it or keep it in check. Centrists tend to occupy the middle of the continuum between tight (hawkish) and loose (dovish) monetary policy.

Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability.

Forward price-to-earnings (forward P/E) is a version of the ratio of price to earnings that uses forecasted earnings for the P/E calculation. The earnings used in this ratio are an estimate and therefore are not as reliable as current or historical earnings data.

Growth investing is a stock-buying strategy that focuses on companies expected to grow at an above-average rate compared to their industry or the market.

Growth sectors within the S&P 500 index include information technology, healthcare, consumer discretionary, and communication services.

Headwind is a term used to describe events or market forces that hinder the prospects for performance in an individual investment or group of investments.

The Magnificent Seven refers to the seven largest stocks by market capitalization in the S&P 500 Index primarily during 2023, when their returns overshadowed the broader market. As of Dec. 29, 2023, they were Alphabet, Amazon, Apple, Meta Platforms, Microsoft , NVIDIA, and Tesla. As of April 30, 2024, Tesla had dropped out of the top seven by market capitalization, though the others remained.

Market capitalization, or market cap, refers to the total dollar market value of a company's outstanding shares of stock.

Market of stocks is a term market participants use when referring to the diversity of technical or other characteristics that may exist at any given time within the overall stock market. For example, the stock market as a whole may rise or fall on the fortunes of a small number of very large and thus very influential stocks. But within the broader market of stocks, there can be many companies with performance, risk, or opportunities that vary significantly from what market participants may find at the index level.

Mega-cap stocks are the largest publicly traded companies as measured by market capitalization. Generally, this refers to companies with market capitalizations of more than $200 billion.

A multiple, sometimes referred to as the price multiple or earnings multiple, is a measure of a company's value based on the ratio of its current share price to its earnings per share. This ratio is known as the price-to-earnings ratio, or P/E.

Positioning refers to assessments of whether professional investors are, on the whole, bullish or bearish on a particular security, industry, sector, market capitalization or other area of the market, as reflected by the extent to which they are invested in the area of the market in question.

Price-to-earnings (P/E) ratios measure a company's current share price relative to its earnings per share. The ratio is used to help assess a company's value and is sometimes referred to as the price multiple or earnings multiple.

Recency bias occurs when individuals over-emphasize the importance of recent events as a predictor of future outcomes, leading them to ignore or downplay the possibility of other possible outcomes that have demonstrably occurred in the past.

Roll over, as it relates to investment returns, sector performance, or economic data, describes a widespread and unfavorable change in prices or data that begins slowly and picks up speed.

Tailwind is a term used to describe events or market forces that exert a positive influence on an investment's performance. The opposite of a tailwind is a headwind, which contributes to an investment's underperformance.

Trailing indicators are data or measurements that reflect events, trends, results, or developments that took place in the past. Trailing indicators typically refer to a specific time period for which the data in question is aggregated, summed, or averaged. Trailing indicators help reflect trends that occur over specified periods of time.

Value investing is an investment strategy that involves picking stocks that appear to be trading for less than their intrinsic or book value.

Value sectors within the S&P 500 Index include financials, industrials, consumer staples, energy, real estate, materials, and utilities.

Verticals refers to a line of business operations focused on a specific market or niche group of customers.

Indices

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

The S&P 500® Equal Weight Index is the equal-weight version of the S&P 500. It includes the same constituents as the capitalization-weighted S&P 500, but each company in the S&P 500 Equal Weight Index is allocated a fixed weight, or 0.2% of the index total at each quarterly rebalance.

Contact us at **800.521.1195** or visit **RJInvestmentManagement.com** for more investment insights.

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