Is It Different This Time?

For the better part of the past seven years, the broad indexes have been driven by the strength of a handful of mega-cap technology-oriented businesses, namely: Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla. The narrow focus is beginning to cause some investors to question if there has been a permanent shift in the investment environment, a shift that is so noticeably different from the past that we need to discard the traditional rules of investing and conclude that "this time is different." That last phrase is credited to Sir John Templeton, investor and philanthropist, who often stated that those are the four most dangerous words for investors. Heeding Sir John's advice, one should be wary of assuming that current market conditions and trends will persist indefinitely. The failure to recognize underlying similarities to past events may lead to irrational expectations and imprudent investment decisions. This *Value Equity Insights* report strives to offer some perspective on the bifurcation that has occurred in the current market and provide some historical context in order to help investors navigate the investment landscape more safely.

Background

The market cap-weighted indexes, such as the S&P 500, have been heavily influenced of late by the mega-cap names, and more specifically, the seven technology-oriented businesses mentioned earlier which have been referred to in the media as the Magnificent Seven (M7) due to their recent stellar returns. While the M7 businesses have benefited from a handful of trends centered around a more connected, intelligent, and mobile society (not to mention the COVID lockdowns), their relative stock performance has created a bifurcated and very concentrated market, one that has parallels to many of the past periods of excessive exuberance.

For example, the current weight of the top 10 stocks in the S&P 500 reached 32.8% at the end of November, exceeding the highs of the top 10 during the dot-com bubble of the late 1990s (see *Figure 1*).

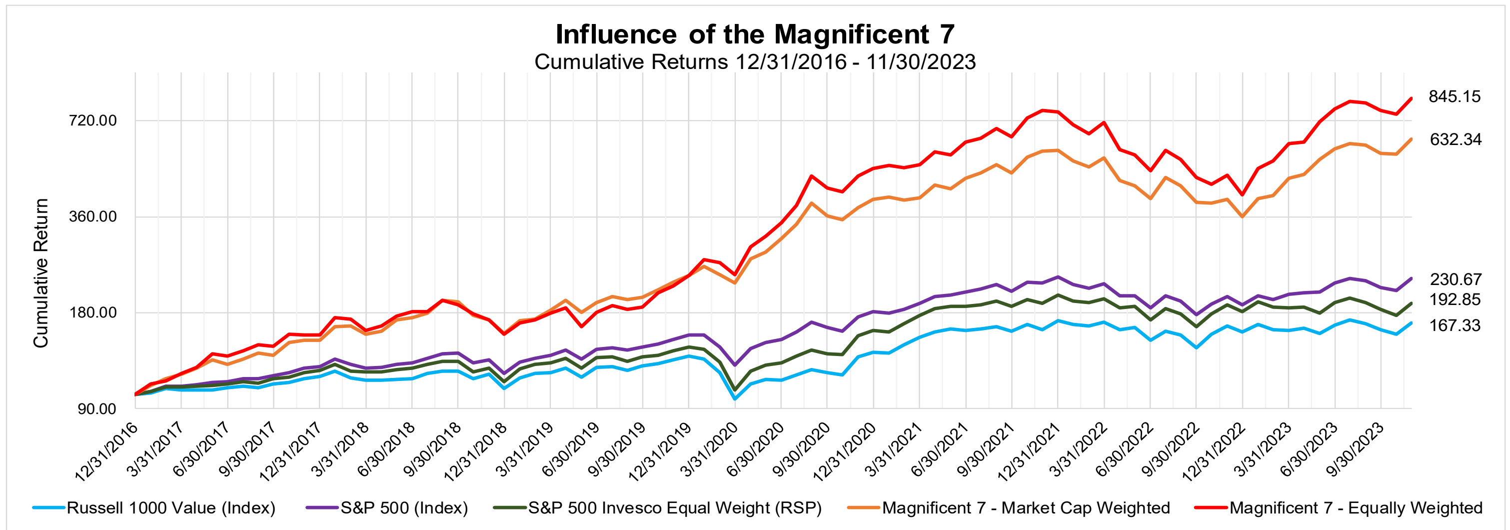
The dot-com frenzy peaked in early 2000 and subsequent periods would see the top 10 stocks' weighting decline on a relative basis through 2016.

Figure 1

(Source: J.P. Morgan Asset Management; Guide to the Markets®, as of November 30, 2023)

The M7's relative strength began in 2017 with the S&P 500 outperforming the equally weighted S&P 500 as the weightings of the M7 in the capitalization-weighted index grew ever more concentrated. The influence of the M7 is illustrated in *Figure 2*: the S&P 500 has outperformed the equally weighted S&P 500 by a cumulative 38%, or 2.9% per year, since the end of 2016. To put the numbers in a different perspective, from 12/31/2016 to 11/30/2023, the market capitalization of the S&P 500 grew by $21 trillion to $40.3 trillion, with the M7 growing by $9.2 trillion to $11.5 trillion. Thus, 44% of the increase in the market cap of the S&P 500 was attributable to just seven businesses! The M7 now comprise 29% of the S&P 500, up from 12% at the end of 2016 (Tesla was added to the S&P 500 in December 2020). ***Paradoxically, the concept of passive investing with indexes is thought by many to enhance diversification and smooth returns, yet the opposite occurred in the late 1990s and may be repeating itself.***

Figure 2



(Sources: Confluence, FactSet, and Bloomberg)

What Causes Sentiment to Change?

Investors seek businesses that have shown an ability to execute for the benefit of shareholders and/or have the potential to enhance their prospects and shareholder value going forward. Successful execution attracts investors and subsequent success attracts more investors. But it also attracts competition and, all too often, the regulatory scrutiny that follows introduces obstacles that impede their prospects. While high valuations may indicate risks have increased, they have not historically proven to be good signals of an imminent peak. Unfortunately, there is no warning bell, and a top generally occurs from a lack of additional interest as the concentrated trade tends to become overcrowded and expectations become too lofty. This makes it difficult to predict the timing of the peak.

A rebalancing of the concentration would not require the M7 to come crashing down. Instead, with a bifurcated market the M7 could move sideways, with growing earnings but shrinking P/E multiples, for five to 10 years, and the other 493 stocks in the S&P 500 could outperform. While this would not be an exact repeat of the periods following the late 1990s dot-com mania or the 1970s "Nifty Fifty," it will probably rhyme!

Our Perspective

It can be tempting to extrapolate a trend into a permanent shift (especially the longer its duration); however, it is prudent to view each trend within historical context. While no two environments will be exactly the same, there are parallels that can be drawn as the economy is bound by the principles of capitalism and human nature. As our economy evolved from an agrarian base to an industrial base, and then to one founded on intellectual property and services, we experienced periods of excess exuberance. From the buildout of the railroads, to the Roaring 1920s and the growth of radio, to the Nifty Fifty of the 1970s, to the dot-com craze at the turn of the century, and through the housing bubble of the 2000s, it was wise to adhere to an investment discipline despite the temptation to jump on the popular trend of the moment. At Confluence, we remain committed to a disciplined approach of seeking competitively advantaged businesses trading at attractive valuations. It is an approach we have deployed since 1994, guided by the same leadership which has served our clients well through previous uncertain periods, including the dot-com era and housing bubble.

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