Please Practice Portfolio Distancing!

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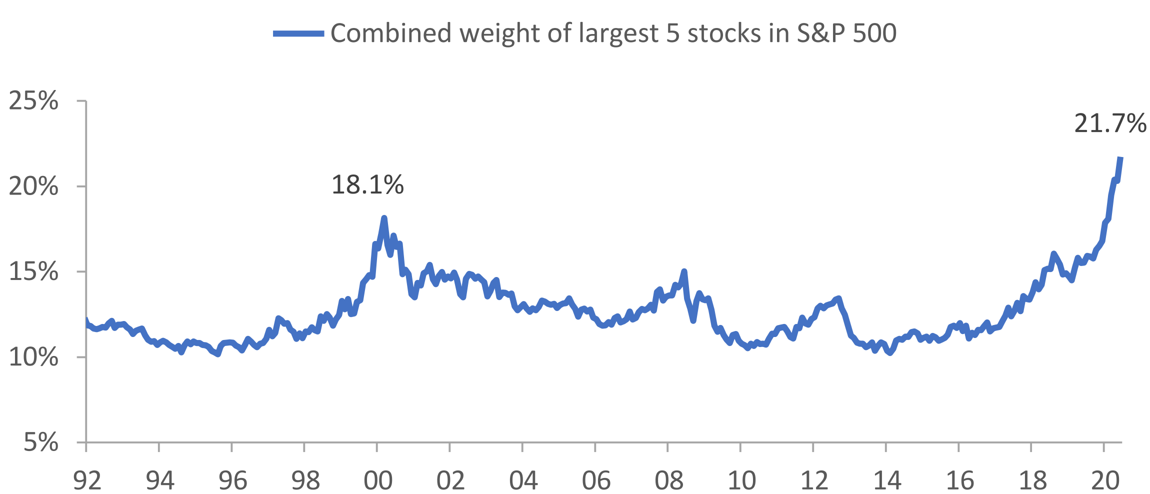
By now, we all know that wearing masks and practicing social distancing is the responsible way to go about our daily business. Financial markets are taking a different stance during the pandemic. A “safety in numbers”, herd mentality has driven everyone into the same securities and investors are currently buying Amazon stock with the same intensity that they bought Clorox wipes from the Amazon website in April.

The result is that index concentration has risen to extreme levels with the largest five stocks in the S&P 500 now comprising 21.7% of the index (Figure 1). This concentration is even higher than it was at the height of the Dot Com bubble.

Concentration problems are compounded because these five companies are technology-related meaning that their share prices could be affected were a shock to occur in a technology-related business risk. For example, supply disruption in Asia or more restrictive data privacy regulations in the US.

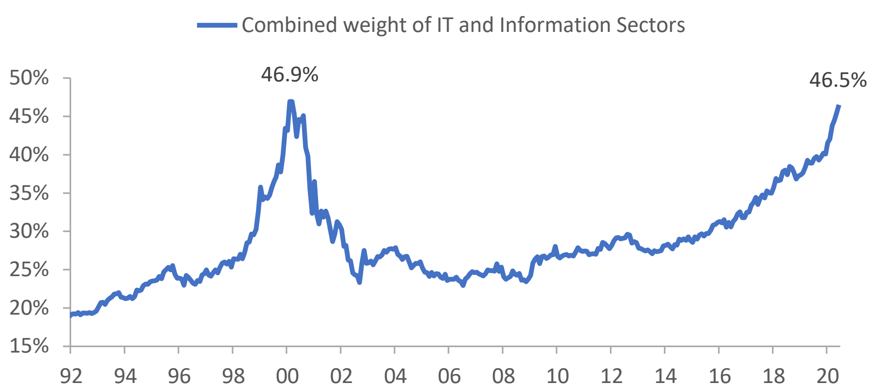
Figure 1. Weight of top 5 positions in the S&P 500



Total weight of largest 5 companies in the S&P 500, 12.31.1991-6.30.2020. Weights labeled on 3.31.2000 and 6.30.2020.
Source: S&P Dow Jones Indices, Syntax.

IT and Information stocks currently comprise 46.5% of the S&P 500 (Figure 2), close to their index weight in March 2000 (46.9%). The poor performance from technology stocks after the DotCom bubble burst, combined with the oversized weight of the two sectors caused the aggregate S&P 500 index to fall (-3.2% annually for the next 5 years). If all sectors were given an equal weight in March 2000, the S&P 500 would have had a positive return over the same period (+0.7% annualized). That is, the impact of the tech shock should have been contained in much the same way that the spread of the virus should be contained by socially distancing groups of people.

Figure 2. Weight of IT and Information sectors in the S&P 500



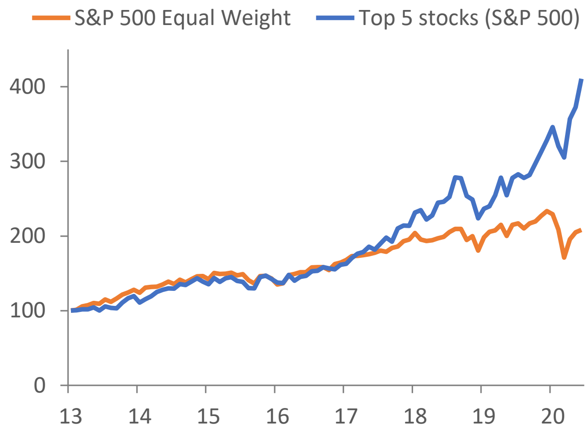
Aggregate weight of tech companies in the S&P 500 is at DotCom levels

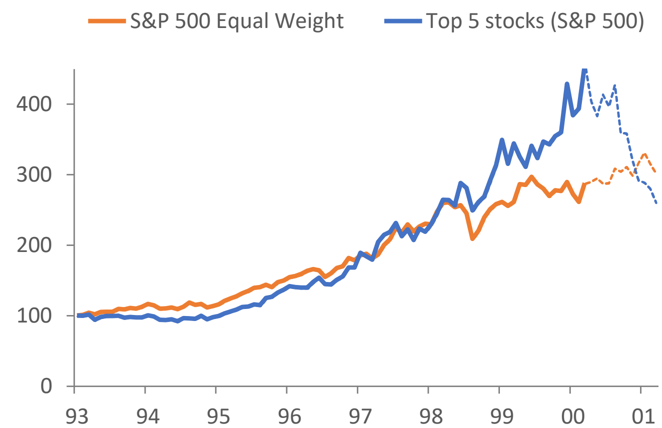
Combined weight of the IT and Information sectors in the S&P 500, 12.31.1991 to 6.30.2020. Weights labeled on 3.31.2000 and 6.30.2019. Source: Syntax, S&P Dow Jones Indices

We believe that the recent strong performance of the largest companies has given investors in these stocks a false sense of security. The big five companies are up 25% for the first half of 2020, which is particularly strong performance given that the average stock is down 10.8% over this period. The strong performance follows significant outperformance in 2018 and 2019 (Figure 3) but is unusual given that the largest five companies have underperformed the equally weighted S&P 500 significantly (by 2.5% per annum since 1992).

Of course, concentrated portfolios are easy to live with when they are outperforming, as has been the case for the S&P 500 (versus alternatively weighted indices, such as equal weight). However, we caution that the strong momentum and outperformance of the largest companies is similar to that seen during the DotCom bubble. During that episode, problems began to occur when the market woke up to the realization that valuations were factoring in unrealistic growth assumptions. When companies failed to meet their earnings expectations, a crowded exit caused prices to dramatically correct (Figure 4).

Figures 3 & 4. Performance of top 5 companies versus the S&P 500 Equal Weight index.





Performance of the S&P 500 Equal Weighted index versus the largest 5 stocks in the S&P 500 from 12.31.2012 to 6.30.2020 and 12.31.1992 to 3.31.2001 (equally weighted, rebalanced monthly). Dashed lines indicate performance of the S&P 500 Equal Weight and of the largest 5 stocks in the S&P 500 following the market peak in March 2000. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Source: Syntax, Factset, S&P Dow Jones Indices

Though the earnings of large cap technology stocks have been largely resilient to the pandemic, there are signs that prices have detached from fundamentals. Microsoft delivered stronger than expected second quarter revenues and earnings. However, its share price declined on the day of the announcement. suggesting some nerves around the 35x earnings multiple that the stock commands. Concerns around Q2 results season are further amplified due to the increased antitrust focus that the largest tech stocks are currently facing.

The Syntax Stratified LargeCap index avoids taking crowded positions in stocks or industries by directly diversifying business risk. This portfolio distancing approach reduces the impact that economic shocks have on the index as a whole.

By investing widely across all business opportunities, the Stratified approach avoids taking expensive momentum positions and a disciplined quarterly rebalancing schedule helps retain the strategy's value stance. The valuation differential to cap weighted products is at a ten-year discount, with the Stratified LargeCap trading at 2.5x book value and 19.4x forward earnings, versus 3.4x book and 24.9x forward earnings for the S&P 500.

Just like everyone knows that we need to wear masks to stay safe, everyone knows that diversification and valuation are important considerations when constructing investment portfolios. However, the most widely followed benchmarks, like the S&P 500 or Russell 1000, are currently violating these principles. For me, the thought of not wearing a mask in public is more risk than I am comfortable with, especially given the small price to pay for the insurance. By herding into the same securities, investors are taking more risk than they realize. History has shown that the largest companies in the index usually underperform the broad index, especially in periods when valuations become stretched. A more diversified approach such as Stratified Weight distances investors from these risks.

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