A $13 Trillion Problem

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Investing is a completely different activity from trading and playing the market. Investors think in terms of years and decades, whereas traders attempting to game price moves think in terms of days, weeks, and months.

Barron's interviewed one of the top-performing equity managers of the last thirty years on December 21, 2023. Barron's wrote, "Fidelity mutual fund manager Joel Tillinghast is hanging up his spurs at the end of 2023 after a multidecade career steering the Fidelity Low-Priced Stock fund." During the 30-year period from when Mr. Tillerhast took over this fund through the end of 2019, he produced one of the best equity mutual fund records among his peers. Barron's

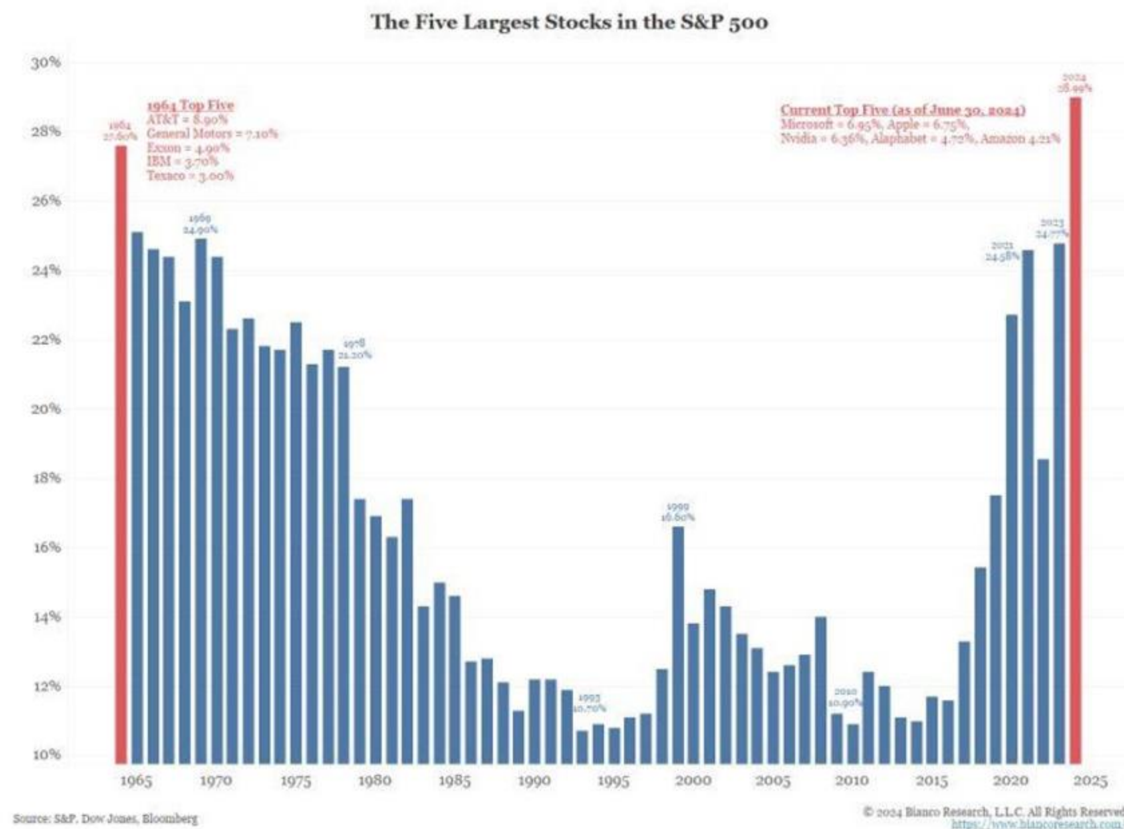
described his performance as follows: “Tillinghast, 65, began managing the now-$26.2 billion fund in 1989, with a strategy focused on small- and mid-cap stocks that trade at a discount to their intrinsic value. Over the years, the strategy broadened to include larger companies and those with more growth potential—always trading at a discount to their potential. The fund has returned an average of 12.6% since inception, according to FactSet, versus annual returns of 10.4% and 9.2% from the S&P 500 and Russell 2000 indexes, respectively, over the same 34-year period.” However, despite being one of the top-performing equity managers over the last 30 years, his fund underperformed the S&P 500 over the last six of seven years.

There are many ways to attempt to use public capital markets to grow one’s money. There are investors like Joel Tillerhast, and then there are traders who, in one fashion or another, attempt to “play the markets.” Over the years, I have discussed fundamental investing versus trading and playing the market. One very common factor used by those who are playing the markets is momentum. One of the prevalent factors used by fundamentally focused investors is contrarianism. When the markets become driven predominately by momentum, active managers are challenged if they maintain their discipline and resist following the herd. Joel Tillerhast did not lose his edge and intelligence over the last seven years as his recent results would seem to indicate. During the previous 17 years, from 2000 to 2017, he outperformed the S&P 500 over 70% of the time.

Unfortunately, equity markets over the last ten years have become highly mechanical due to the increasing prevalence of automatic passive investing practiced by many individual investors through their retirement plans. Compounding this issue are the very large quantitatively driven institutional investors who use passive ETFs and the largest most liquid stocks to execute their trading strategies. This growing mechanical nature of markets magnifies momentum tendencies and price-agnostic buying. This serves to funnel an increasing percentage of new investment dollars into the largest components of market-cap-weighted indexes, increasing the price momentum of those largest constituents and making those same stocks the preferred investments of quantitative strategies. Momentum becomes self-fulfilling.

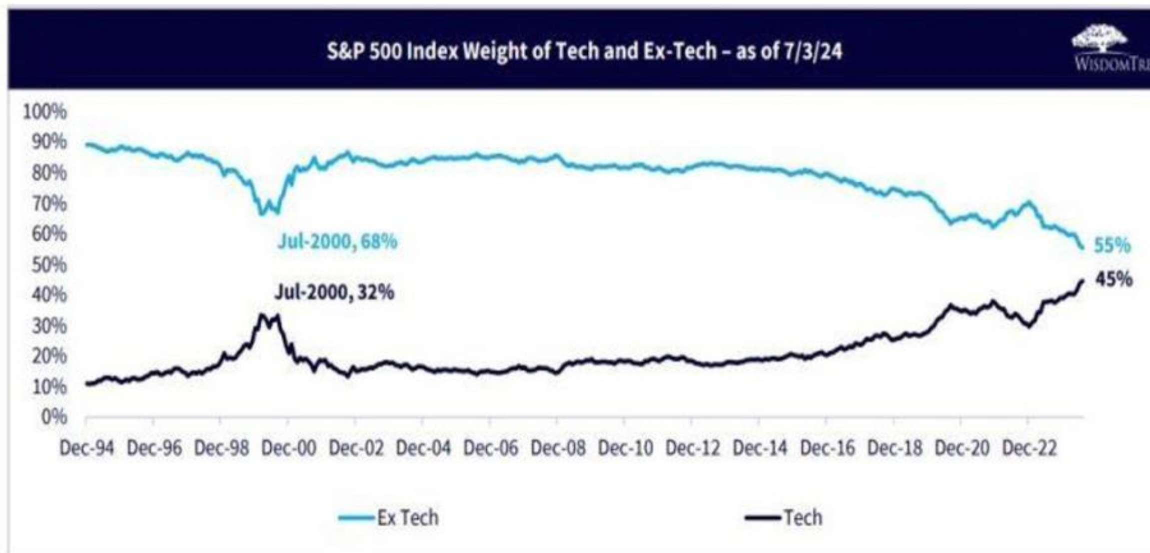
See below the narrative from Syz Group from its July 13th weekly market commentary coupled with an illustration that Bianco Research created:

S&P500 concentration at the highest level in at least 60 years: 5 largest stocks within S&P 500 = 28.99%. As mentioned by Jim Bianco: The risk of the current S&P500 concentration is that one day the opposite happens: five stocks could kill the index funds while everything else outperforms... "Restated, one buys an index fund to get diversification. But with record concentration, they are not getting it".



The idea that owning an index instead of owning shares in companies within the index is a low-risk strategy for equity investors is a concept that has been mainstream for a long time. For a long time, that idea of owning "the market" for diversification reasons and to lower individual stock, sector concentration, and industry-specific risks held true. With investing, too much of a good thing leads to imbalances and unintended risks. We can see the results of too much indexing and quantitatively driven momentum/trend-following strategies concerning individual stock concentrations within an index. Below, Syz Group created another illustration that shows how concentrated the S&P 500 has gotten from a sector standpoint:

Almost half of the S&P500 is now essentially tech...



Source: WisdomTree, FactSet, S&P. You cannot invest directly in an index. Historical forward P/E measured since 12/31/1994. Expanded Tech includes the Information Technology sector, Interactive Home Entertainment subindustry, Interactive Media & Services subindustry, Amazon, E-Bay, Etsy, and Netflix. Ex-Tech excludes the expanded tech companies.

I started in the investment management business in 1997 and worked as a technology analyst for what is today known as the Conestoga Funds company. Over the next three years, I witnessed the narrowness and concentration of the markets grow, with the Technology sector topping out, as shown above, over 20% before its spectacular fall that began in 2000.

Today, the S&P 500, on a market cap-weighted basis, is nearly 50% comprised of what most people would consider technology stocks. Of course, it is understandable that over the last 25 years, as our economy has become increasingly technology-focused, that weighting would grow. But from a diversification standpoint, having a benchmark equity index that is supposed to provide investors with inherent diversification be so concentrated within five companies that now comprise nearly 30% of the index, the idea of being diversified through an index has become a mirage.

Automatic pilot investing, as I like to call index investing, is alluring to many because it does not require a lot of thought. In recent memory, it has worked out very well for most who have resisted trying to time the markets. He correctly surmised that many investors could benefit from being able to buy the market through a low-cost index and capture the average of the gains and losses of active investors who are trading the underlying index constituent companies. From our perspective, the critical BUT is that index investing originated in the mid-1970s by the late John Bogle of Vanguard fame has grown so large that it no longer simply tracks a market driven by active manager, indexing has changed the behavior of the indexes.

Bogle’s theory proved correct, and for many decades that followed, investors who chose to passively use index investment products saved on investment management fees and achieved very favorable investment outcomes if they stuck with their strategy over the long

run. However, these indices, particularly the ones like the S&P 500, which are weighted based on the market capitalization of each underlying company, are not independent variables. This means that the index investing itself began as a way for some investors to "tag along" with the average of active investors, as it has grown so large that many believe this has distorted the indices' composition. The index no longer appears to reflect the average returns of active stock pickers. Instead, the index's composition is as much, if not more, driven by passive money flows and quantitative trading. Recent studies have estimated that 70-80 percent of daily stock trading volumes are derived from index passive money flows and long and short trading strategies. The proverbial tail (passive investing) is now waging the proverbial dog (active investing).

Over seven years ago, on June 17, 2017, JP Morgan's Marco Kolanovic made a provocative statement that was the basis of a CNBC article titled, Just 10% of Trading is Regular Stock Picking. The author, Evelyn Cheng, wrote, "Quantitative investing based on computer formulas and trading by machines directly are leaving the traditional stock picker in the dust and now dominating the equity markets, according to a new report from JPMorgan. Marko Kolanovic, global head of quantitative and derivatives research at JPMorgan, said in a Tuesday note to clients, "While fundamental narratives explaining the price action abound, the majority of equity investors today don't buy or sell stocks based on stock-specific fundamentals," Kolanovic estimates "fundamental discretionary traders" account for only about 10 percent of trading volume in stocks. Passive and quantitative investing accounts for about 60 percent, more than double the share a decade ago."

Throughout the history of the United States, we have vigorously argued that capitalism is the most efficient way to organize an economy in the United States. The hallmarks of capitalism are capital allocation driven to maximize return on investment and the resulting creative destruction accompanying such a capital allocation strategy. Our capital markets, otherwise known as our public and private fixed-income and equity markets, are the transmission mechanism for capital allocation. As active equity managers, we are a microcosm of free market capitalism in that we research available investments to identify and invest in those companies that we believe provide the best long-term total returns relative to the price we choose to pay in the present. Equity markets work best when all investors make such discerning judgments and vote with their capital. It can be argued that equity markets, and by extension, capitalism, have become distorted and corrupted when investors stop making discerning decisions with their capital and instead blindly allocate to an index without any consideration of economic value. With capitalism, capital is presumed to be allocated based on the investor's assessment of future returns on investment, but what we have seen in the equity markets of late is less capitalism and more non-discriminating herd behavior.

Market concentration and narrowness in what companies are garnering the lion's share of new money flows are suddenly getting much attention. We say it's about time! FT (Financial Times) published an article on January 18, 2024, titled Passive eclipses active in US fund market as assets swell to $13.3tn. In this article, the author, Will Schmitt, wrote: "At the end of December, passive US mutual funds and ETFs held about $13.3tn in assets while active ETFs and mutual funds had just over $13.2tn, according to data released by Morningstar." This comparison likely understates the dollars managed using a passive approach because many large ETFs and mutual funds that are classified as actively managed are actually considered "closet index funds." A fund's active management can be measured by its "active share." Martijn Cremer wrote a

seminal paper in 2016 titled Indexing and active fund management: International evidence on the concept of active share. In that paper, he estimated that approximately 20% of funds and ETFs categorized as active have an active share low enough to be considered closet index funds. So, using 20%, which could be higher today, the amount of passively managed money is likely closer, when you include closet index managers, to $16tn.

The age of fundamentally blind and mechanic investing has led us to an economy where the prominent market leaders have gotten so big that their only disruption risk comes from their peers, not small entrepreneurial companies. Disruption from upstart entrepreneurs is the "secret sauce" of U.S. capitalism, but today's multi-trillion information technology companies are largely inoculated from disruption because they are so large. In the event a small entrepreneurial company threatens disruption, these mega-large multi-trillion-dollar companies will either buy the smaller company or find a way to overwhelm the competitive threat using their almost unlimited amount of financial capital that they have at their disposal thanks to the mechanical money flow which elevate their share prices and market value. The result is what we are seeing today with very activist Federal Government regulators who find it necessary to step in and put in place regulatory speed bumps to attempt to curtail the never-before-seen market power and dominance that these technology oligopolies have amassed with the passive assistance of non-discerning money flows from index investing.

We are proudly active investors and will continue to perpetuate the positive attributes of capitalism. We have seen other episodes of narrow and concentrated markets and what happens when minor distortions grow into destabilizing distortions. We have seen signs that equity markets are getting to extreme concentration levels. Instead of celebrating new highs in the size-weighted indices, we are on high alert for a broadening of the markets that will incrementally force capital flows away from the largest of the large companies and into the areas of the market that contain attractively priced quality innovative and growing companies that have been overlooked for a long time.

Fortunately, we have attracted many clients who, like us, understand how capitalism is supposed to work and trust in discerning capital allocation to build and manage investment strategies and portfolios. Passive investing is alluring, but we subscribe to the axiom that "there is no free lunch." The last time investors became complacent and stellar market returns masked many imbalances, as we have seen over the last 5-7 years, was the late 1990s. The bill came due in 2000, and for the following seven years, investors experienced a much broader stock market, with small and mid-cap stocks outperforming the stellar outperformers of the 1997-2000 period.

Words of wisdom:

If you want to have a better performance than the crowd, you must do things differently than the crowd. Sir John Templeton

The intelligent investor is likely to need considerable willpower to keep from following the crowd. Benjamin Graham

The stock market is filled with individuals who know the price of everything, but the value of nothing. Phillip Fisher

Disclosure:

Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.

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Exchange-traded funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus provides a balanced analysis of the investment risks and benefits. Read it carefully before you invest.

- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.
- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.
- The Dow Jones Industrial Average (DJIA), also known as the Dow 30, is a stock market index that tracks 30 large, publicly owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.
- The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, with a weighted average market capitalization of approximately $4.3 billion, median capitalization of $1.2 billion and market capitalization of the largest company of $18.7 billion.
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