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Market Update – *Benchmarking the Benchmark*

by David A. Jaffe, M.D.

The common statement “everything’s relative” begs the question, relative to what? In the investing world, the work of a manager must be viewed in some meaningful context. Reporting a 10% return in a given year, for example, sounds great. What if the “market” was up 5%. That return looks even better. But what if the market was up 20% for the same period?

Investment managers often focus on a segment of the financial world, for example small companies, or international investments, and present their returns in the context of their niche. For a majority of those who employ a broad range of U.S. based companies, as we do at PASI, the published S&P 500 Index is widely viewed as a suitable benchmark, measuring the returns of the 500 largest companies in the U.S, weighted by company market capitalization.

As Nathan Polackwich will discuss in the article that follows, financial market conditions in 2023 have created an anomalous situation in which the commonly quoted S&P 500 fails as a benchmark if the goal is to portray the health of the U.S. economy by measuring the health of the 500 largest U.S. businesses.

Putting relativity aside for a moment, we can all celebrate the first six months of 2023, rebounding smartly from the declines of 2022 and defying most predictions. While a recession this year or next is not off the table, the economy has held up well in the face of the Federal Reserve’s interest rate hikes, and employment remains surprisingly strong.

Buoyed by technology stock gains, the *market cap weighted* S&P 500 stands up 16.89% year-to-date through 6/30/2023. Offering a reference point for the economy and broad stock market, the

equal weighted S&P 500 finished the first half with a gain of 7.03%. During this period, the PASI composite stock portfolio gained 9.89% (all measures include reinvested dividends).[1]

Simply stated, our long-term goal for management of client money has always been to produce competitive returns within a framework constructed to limit downside risk. Matching the narrowly concentrated S&P 500 returns of 2023 would require that we eschew our long-held risk management discipline. That discipline is a crucial element of professional money management, something that we value, and we believe our clients value as well.

The Magnificent Seven and Chesterton's Fence

by Nathan Polackwich, CFA

Just a handful of large cap technology stocks that have been dubbed "The Magnificent Seven" – Apple, Microsoft, Amazon, Alphabet (Google), Tesla, Nvidia, and Meta (Facebook) – have increased, on average, 60%, while the other 493 stocks in the S&P 500 have collectively gained just 4.5% (all figures are year-to-date through 6/30/2023 and include reinvested dividends). While it's normal for a handful of stocks to significantly outperform the stock market, it's decidedly abnormal for the best seven stocks to be among the eight biggest companies in the U.S. and the nine largest in the entire world.

The massive outperformance of these mega cap technology stocks, which now comprises fully 27% of the value of the S&P 500, has had an outsized influence on 2023 stock returns. Specifically, <u>of the stock market's 16.9% return through the first half of 2023, the Magnificent Seven is responsible for an incredible 11.3 percentage points</u>.

The good news for the PASI stock portfolio is that we own the first four. Our positions in these stocks, however, with the exception of Google (which is 4% of the PASI stock portfolio and also 4% of the S&P 500), are relatively smaller than their weightings in the overall market.

The natural questions in a situation like this are 1) Why don't you increase your weightings towards the stocks you own, and 2) Why not own Tesla, Nvidia, and Meta? To answer these questions I present the metaphor of Chesterton's Fence.

G.K. Chesterton (1874-1936) was an English writer best known for his fictional detective character, Father Brown, who appeared in a series of mystery novels. In addition to writing fiction, Chesterton was also a philosopher, and one of his most famous ideas was a concept that became known as "Chesterton's Fence." Chesterton advised that if you come across a fence and don't know why it's there you can assume it once had (and may still have) some practical purpose. Thus, before tearing it down, it's wise to find out why the fence was first built.

Chesterton's Fence is a metaphor that argues for caution regarding the dismantling of longstanding traditions, rules, or practices that may seem arbitrary or unnecessary at first glance.

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[1] **Please see disclosures on page 8 of this newsletter** in compliance with the requirements of SEC Marketing Rule with amendment 206(4)-1, effective 11/4/2022 for discussion of all portfolio and market performance reporting.

The metaphor urges people to consider the wisdom of the past and to approach change with humility and a willingness to learn from history.

When it comes to the construction of the PASI portfolio, over our 46 years we've developed several metaphorical fences of our own that past experience has taught us are in our clients' best long-term interests. Some of these fences are particularly relevant given the Magnificent Seven's historic performance this year.

Fence #1 – Never allow a stock position to become too large relative to the overall portfolio. We've set a limit on allocating no more than 5% of stock dollars to an individual company. In practice, we usually restrict our exposure to 4%, while our average position is 3% (what you'd expect in a 30 stock portfolio). We made this limit to capture the benefits of diversification, which the data suggests can be largely achieved by holding 20-40 stocks.[2] Diversification significantly lowers your downside risk without sacrificing long term returns (short-term returns will vary, as the first half of 2023 shows). As an extreme example, holding just two stocks might work out exceptionally well but also exposes an investor to the unacceptable risk of losing everything.

Fence #2 – Price Matters. Your long-term return on a stock depends on two variables – whether the company's profits and dividends grow as expected and how much you paid for an ownership stake in the business. If you pay too much for even the fastest growing company, your return will be disappointing. Conversely, buying a slower growth company at a large discount can produce exceptional returns. In short, price matters.

For instance, at the peak of the Internet Bubble in early 2000 the stock of Sun Microsystems hit a market valuation of 10 times revenue (sales). Two years later after the stock had collapsed (falling from $64 to $3), the CEO, Scott McNealy, said in an interview,

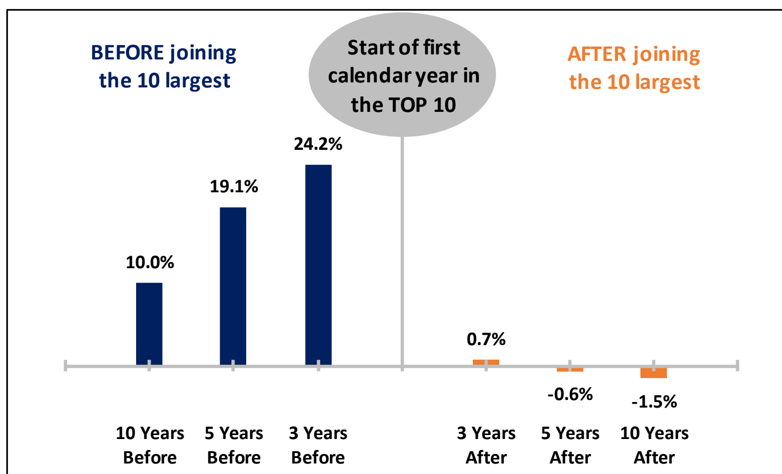
> "At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"

Nvidia, the best performer of the Magnificent Seven stocks this year, currently has a market value of $1.05 trillion, while 2023 revenue is expected to be just $43 billion. That puts Nvidia's Price to Revenue multiple at a whopping 24 times. And Scott McNealy thought Sun Microsystem's stock was expensive!

[2] They must be either randomly selected or diversified by sector and industry, which is how PASI manages the portfolio.

Tesla, it should be noted, has a still outrageous but relatively more pedestrian Price to Revenue multiple of around 8 ($800 billion market value with $100 billion in revenue). The problem is that the car industry is notoriously capital intensive and Tesla's profit margin is just 10%. So Tesla this year is expected to produce about $10 billion in profits. That's great! But paying $800 billion for $10 billion in profits doesn't look particularly appealing to us. If the anticipated growth embodied in that price doesn't materialize, the journey to a more reasonable valuation is likely to be unpleasant. Toyota, for instance, is valued at only $225 billion while generating $260 billion in revenue (Price to Revenue multiple of just 0.86). To be sure, Tesla's a much faster growing and more innovative company. But for its valuation to remain this elevated it will have to sustain an exceptional growth rate for a very long time, something few companies have managed to achieve, particularly once they've already hit $100 billion in revenue.

Fence #3 – Size Matters. The Magnificent Seven are now among the nine biggest companies in the world. (Oil producer Saudi Aramco is third while Warren Buffett's Berkshire Hathaway is seventh.) History suggests that once a company reaches the top 10 in U.S. market value, its subsequent returns are likely to be closer to average.



Source: Dimensional Fund Advisors

It's simply much harder to grow at an above average rate once a company becomes a certain size. Think about Apple, arguably the best company in the world, which now has a $3 trillion market capitalization. By comparison, the entire U.S. economy – which encompasses everything from the highways we build to all our defense spending to home and commercial real estate construction to the food we buy to the electricity we consume to all our healthcare spending – only generates an annual gross domestic product of $23 trillion. Realistically, unless we discover life on other planets interested in buying an iPhone it's hard to imagine how Apple could grow significantly bigger than it already is.

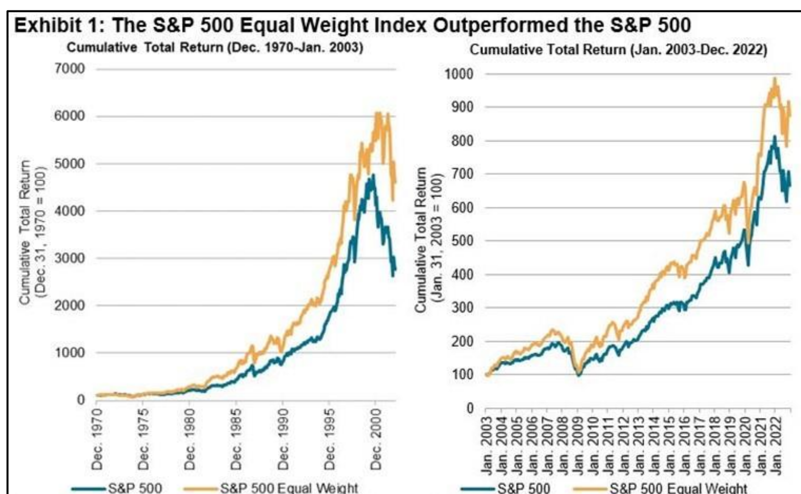
Of course, PASI owns the stocks of some of the world's largest companies that we feel still represent good value at low risk. But we enter these positions with the awareness that, because of their already massive size, they are somewhat less likely to produce above average returns over the long term.

Fence #4 – Beware the Growth Trap. The stock prices of Nvidia and Tesla highlight what the economist Jeremy Siegel has termed "the growth trap." Specifically, data going back to 1957 shows that stocks with the highest valuations relative to profits (Price to Earnings or P/E multiples) and the lowest dividend yields underperform the stock market over the long-term while low price to earnings/higher dividend yielding stocks tend to outperform. Similarly, the stocks of companies domiciled in the fastest growing countries also delivered sub-par long-term returns while those in more mature but slower growing economies tended to outperform. As Siegel wrote,

> "The growth trap seduces investors into overpaying for the very firms and industries that drive innovation and spearhead economic expansion. <u>This relentless pursuit of growth – through buying hot stocks, seeking exciting new technologies, or investing in the fastest growth countries – dooms investors to poor returns</u>."

One of my favorite anecdotes of Warren Buffett was in early 1998, when other investors were going crazy for Internet and technology stocks, he bucked the tide by acquiring Dairy Queen for $585 million. Today, Dairy Queen is estimated to earn nearly that much each year in *operating profits* alone.

One of the biggest ways PASI maintains the fences above – limiting stock position size, paying attention to price and market valuation, and being wary of the growth trap – is by allocating 3%, on average to our typical stock holding, and periodically trimming them so they don't grow into too large of a position. The S&P 500, in contrast, is market weighted, which simply means that the bigger a company **becomes the greater** its effect on the stock market's returns. Despite 2023's notable underperformance, historically, equal weight stock returns have been superior.



Source: S&P Dow Jones Indices LLC

Equal weight superiority has generally been driven by the modestly poorer returns of the largest stocks over time (and outperformance of smaller companies), an increased weighting in cheaper (value) stocks, and a rebalancing effect when outperforming stocks are trimmed and underperforming stocks are added in order to maintain equal weights. Rebalancing enhances returns because individual stocks prices tend to mean revert over time.

This year through 6/30/2023, thanks to the Magnificent Seven, the S&P 500 has surged 16.9% while the equal weight S&P 500 gained just 7%, a massive 9.9 percentage point difference. The last time a spread this large occurred was at the height of the Internet stock bubble in 1998 and 1999. Over the next ten years, the equal weight S&P 500 went on a tear, achieving 50 percentage points of outperformance.

While underperforming in the short term isn't fun, it's imperative to stay disciplined when investors become overly enamored with a few enormous, extremely expensive stocks. The fences we've constructed over the years to protect client assets are there precisely for times like this.

BNY Mellon E-Delivery – *Paper Free in 2023!*

by Jordan M. Bieber, CRPC®

As an industry leader in financial services, BNY Mellon invests heavily in technology. Quick access to important information is more crucial than ever given the speed with which business is conducted today. With this in mind, BNY Mellon has set its sights on increasing the adoption of paperless document delivery (E-Delivery).

Benefits of E-Delivery (and Online Access)

- ***Convenience:*** Quickly view, download, print, and email account communications from your computer or phone.

- ***Increased Security:*** Access account communication via password protected environment, eliminating paper delivery of sensitive financial information, and reducing the risk of identity theft.

- ***Centralized Record Keeping:*** Eliminate extra paper at home, and quickly search for statements and tax documents you need.

What to Expect Next

August – September 2023*:* Clients with an email address on file at BNY Mellon, who currently receive physical paper documents such as statements, confirms, notifications, or tax documents, will have their accounts "pend-enrolled" for E-Delivery. This DOES NOT automatically enroll you in E-Delivery. You will receive an automated email from BNY containing a link to BNY's investor portal, to log in and complete the enrollment.

Once enrolled, rather than receiving these documents through traditional mail, you will receive an email notification when new documents are available to view online.

October 2023*:* BNY September statements will include a message informing clients about the introduction of new fees associated with receiving physical paper documents.

Paper subscription fee***:** $2.00 per month, per account (assessed quarterly)
Paper tax document fee**:** $10.00 per year, per account (assessed annually)
**Inclusive of all paper documents: statements, confirms, notifications, and tax documents.*

January 2024*:* Applicable fees begin to accrue based on your E-Delivery status for each account. If you are fully enrolled in E-Delivery, there will be no applicable subscription fees.

March 2024*:* First paper subscription fee or paper tax document fees will be assessed.

We are here to help you seamlessly transition to paperless document delivery, providing guidance and ongoing support for any questions or concerns you may have. If you have not yet signed up for online access and/or E-delivery, and would like to do so, please contact our office.

Hurricane Season – *It's That Time of Year Again*

Officially ranging from June 1st to November 30th, Hurricane Season has once again arrived in Florida. Our hurricane procedures include preparation of our physical office to minimize the impact of water intrusion and moving our central computer to a secure location clear of the storm path. Most of our team will be able to plug in phones and laptops and be ready to serve your needs quickly, limited only by availability of electricity. David's Montana office serves as remote backup. BNY Mellon will be alerted to initiate contingency processing for client needs.

While PASI has settled on a staffing structure minimizing "work from home" time, we surely have the experience, as well as resources and technology, to serve client needs remotely if required.

You can read our Disaster Recovery Policy on our website www.pa-services.com. Please follow the "contact us" tab; you will find a link to the policy on the bottom left area of that page. In the event that primary communications are affected by a storm, we will post updates and any important information on our website. If you have any questions about our contingency planning, please don't hesitate to call.

Disclosure

Professional Advisory Services, Inc. may, from time to time, have a position in securities mentioned in this newsletter and may execute transactions that may no longer be consistent with this presentation's conclusions. Reference to investment performance of the PASI composite stock portfolio is made gross of expenses. For formal performance disclosure with net returns please contact our office.

The **PASI stock portfolio** includes the reinvestment of dividends; and is reduced by brokerage commissions but is gross of Professional Advisory Services, Inc. fee, which is described in Part II of form ADV, available upon request. Our fee is a maximum of 1% and decreases based on assets under management. As an example of fee impact, over a ten-year period, $100,000 invested in stocks growing at 8% per year would increase at the end of ten years to $205,419 net of 1% fee versus $220,804 gross return.

The **S&P 500 Index** is an unmanaged index of the common stock prices of approximately 500 widely held US stocks, which includes reinvestment of dividends but does not reflect brokerage commissions. This index is weighted by float-adjusted market capitalization of underlying constituents.

The **S&P 500 Equal Weight Index,** like the S&P 500 Index, is an unmanaged index of the common stock prices of approximately 500 widely held US stocks, which includes reinvestment of dividends but does not reflect brokerage commissions. Each company is equally weighted as of the respective rebalance reference date, rather than weighted by float-adjusted market capitalization.