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Building long-term relationships with long-term investors

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Dear Client,

> *Neil deGrasse Tyson has observed that "The universe is under no obligation to make sense to you." This also applies to the current economy*. – Vitaliy Katsenelson

Go back to January 1, 2023 and we will tell you the future. We've just finished the worst calendar year for the markets since 2008 and over the next six months we will experience the second, third, and fourth largest bank failures in US history and will narrowly avoid a collapse of our banking system. Politicians consumed with brinkmanship will wait until the very last minute to raise the debt ceiling, adding fear to already nervous investors. Inflation will persist although it will slowly abate while the Fed raises rates at three of its' four meetings in the first half of the year. The war in Ukraine will continue unabated while there will be an internal uprising of Russian mercenary forces against the Kremlin. The International Monetary Fund Chief, Kristalina Georgieva, will warn in January in an interview on *CBS Sunday* that "we expect one third of the world economy to be in recession [in 2023]" and that even for countries not in recession, "it would feel like recession for hundreds of millions of people." A month ago, at the end of November 2022, Bank of America analysts recommended selling US tech stocks in favor of Chinese stocks.

It's January 1st and if you'd like to get out of the markets, this is your opportunity. What's your call?

How have the markets performed since? The S&P 500 is up 16.89% this year! The MSCI World Index is up 15.09%! Not many had predicted these outcomes so, despite everything, the markets just chug along. The much-anticipated recession keeps getting kicked down the road and now the Fed's own economists are saying it's a coin toss on whether we will have one at all. That does not mean these predictions will not eventually come true, it just means the global economy and markets are resilient, incredibly complex and hard to predict. One wrong move and it could be costly.

What is driving this return? In a word, technology. Only a few months ago we wrote how tech stocks had been tumbling through 2022 but now they have come back with a vengeance. The tech heavy NASDAQ is up 32.32% this year, almost twice that of the S&P. We wonder if the analysts at Bank of America might like to reconsider. To be fair, the results are more complicated than the numbers but that's partly the point, predicting performance is not a science. Let's break it down with the S&P 500.

The S&P 500 Index is one of the most widely referenced indexes and is viewed as a barometer for the overall US economy but what is it? It is simply a list created by Standard & Poor's, a rating company, of the 500 largest US companies weighted by market capitalization. Market capitalization is the total value of a publicly traded company calculated by multiplying the number of shares by the price per share. "Weighting by market cap" means the larger the company the more of it is included in the index and therefore the largest company makes up the largest percentage. Currently this is Apple with a market cap around $2.9 trillion (yes, *trillion* with a "t") at 7.57% of the index. After Apple, the next six are all tech stocks, so the seven largest companies of the S&P 500 are currently tech stocks: Apple, Microsoft, Amazon, Nvidia, Tesla, Alphabet (formerly Google) and Meta Platforms (formerly Facebook).

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These stocks have been coined “The Magnificent Seven” as the latest moniker for the stocks du jour replacing the FAANG acronym we have written about before. Their combined market cap is larger than many countries and since the index is market cap weighted, these stocks have an outsized impact on performance. To give you a sense of scale, here are the weightings of the top 10 stocks in the index:

Rank	Company	Symbol	Mkt Cap Weight
1	Apple Inc	AAPL	7.57%
2	Microsoft Corp	MSFT	6.70%
3	Amazon.com Inc.	AMZN	3.08%
4	Nvidia Corp	NVDA	2.83%
5	Tesla Inc.	TSLA	1.97%
6	Alphabet Inc. Class A	GOOGL	1.88%
7	Meta Platforms Inc. Class A	META	1.77%
8	Berkshire Hathaway Inc. Class B	BRK.B	1.65%
9	Alphabet Inc. Class C	GOOG	1.62%
10	Unitedhealth Group Inc.	UNH	1.17%

Do the math and the top 10 account for 30% of the index and the Magnificent Seven in particular are 25%. Said another way, the Magnificent Seven are 1.4% of the companies in the S&P 500 yet they account for 25% of performance! Obviously, this means they will drive the overall index performance and for the first half of the year, they are up 86%. That’s some hardcore driving! Outside of these, the remaining 493 companies have had little growth this year. For an index viewed as a gauge for the US markets, it is very tilted toward just a handful of companies and at this time they are all in one sector.

What does all this mean for your portfolio? Before we answer that, we want to acknowledge the passing of Harry Markowitz. Unless you are an academic finance nerd like us, you probably never heard of him, but he is a very important person in your financial life. It was his pioneering research in the 1950s that lead to Modern Portfolio Theory (MPT) which basically states the performance of an individual stock is not as important as the performance of the overall portfolio. His work earned him a Nobel Prize and, when coupled with the strategies of Dimensional Fund Advisors (DFA), literally changed the landscape of investing. MPT and DFA are the backbone of how we manage portfolios. We pay our respects.

So back to the question, to us this reinforces the adage “stay in your [diversified] seat” as prescribed by MPT. It reiterates that when you dig below the surface, even just a little, nothing is as simple or straight forward as the headlines might suggest. No one knows where the next outsized performance is going to come from. So far this year it has been tech but last year energy was the best performing sector during what was otherwise an abysmal year. In 2021, it was all about GameStop and “meme stocks.” Next time it could be banking or healthcare or any of the economic sectors. Last year at this time we had to report that all the asset classes we use to build your portfolios were down year-to-date, a rare but not unprecedented occurrence (as we said at the time, just 8% of quarters from March 1979 through March 2022 had experienced negative returns for both US stocks and US bonds). This year we are happy to report the opposite: every asset class is up for the year. Not what you might have expected from the “predictive” information in our opening paragraph. Thanks to Harry Markowitz and MPT, we stayed in our seat.

Indeed, the markets are under no obligation to explain themselves.

John, Richard, Mary, and Ryan