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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

The Investment Big Picture

By Casey Clarke

Investing is hard. It involves emotion and relentlessly shifting narratives. We often sell winners too early and ride losers too long, even though doing the opposite can lead to winners turning into losses and recent losers bouncing back and recovering without us. The investment world is a giant paradox that puts many in a proverbial room of mirrors, awkwardly feeling their way around for a clear path forward. This is why many succumb to index investing, which as Steve's piece this month discusses, is a long-term approach without regard for price, value, or cycle consideration. In a way, it's the equivalent to throwing up one's hands and putting an end to the cognitive dissonance induced by sensationalized and often contradictory Wall Street blather. True, it's often a better approach than an ill-conceived, emotion-driven investment strategy, but that's not to say it's the best method for all situations and without real risks. We would argue that mechanistically buying a stock index when those stocks are obscenely priced, and in a bubble, puts an investor in one of the strongest positions for sudden, heavy, and lasting losses as is possible in investing. It's worth noting that bubbles typically reflect a deficit in critical thinking and an abundance of performance chasing. Throwing money into one is an exercise in extrapolation and hope. We would also argue that right now is one of the easiest environments in which to outperform those bubble-heavy stock indexes over time given the presumption that those risks and losses will inevitably play out.

Big picture action step number one: Avoid those over-hyped, bubble investments that can and will likely destroy you in time. Big picture action step number two: Instead, invest in things that are reasonably priced and would be the likely recipients of flows when the aforementioned bubble assets burst, but whose performance is not necessarily dependent on that happening.

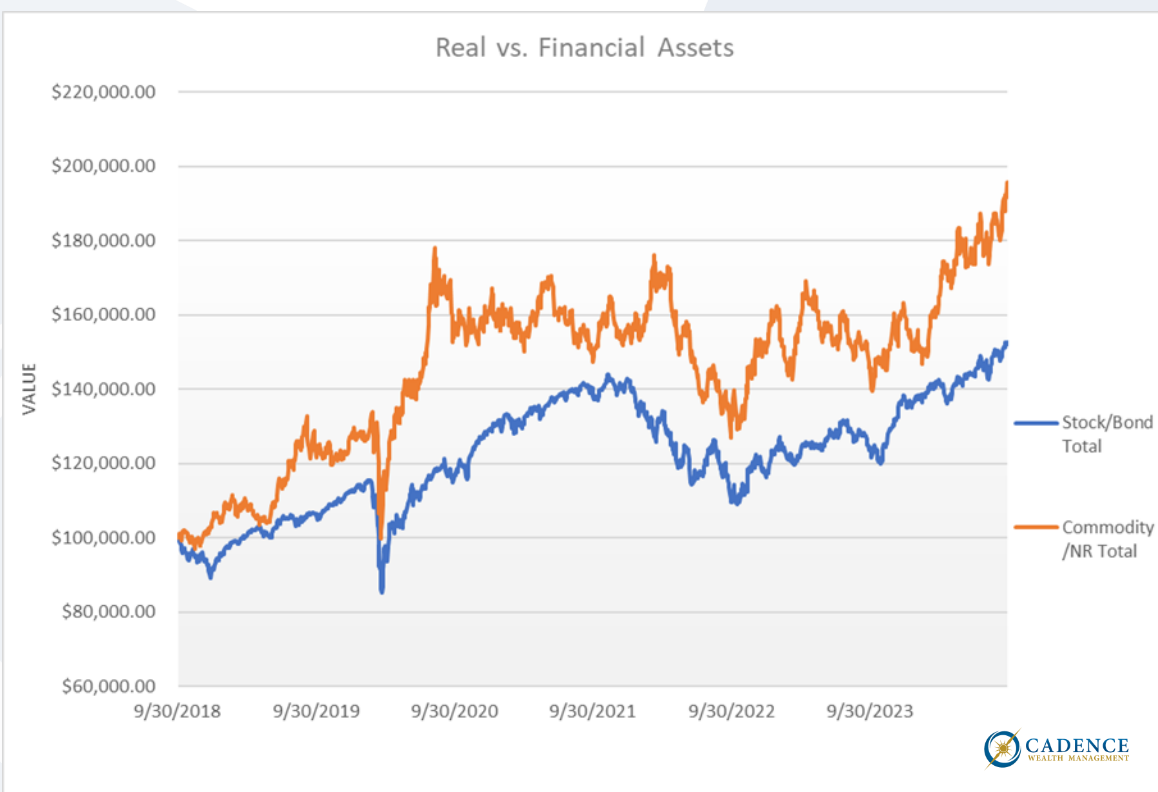
Long-term Cycles and Valuation

Market cycles tend to be self-limiting. Take gasoline, for example. Prices have always fluctuated back and forth with supply and demand rather than moving endlessly in one direction (inflation aside). This is because when the price gets too high, it incentivizes new production of product to sell into the market and disincentivizes additional demand. Eventually, after a lag, supply and demand adjustments enter the market and begin exerting the opposite pressure on prices, in this case lower. This is the nature of commodity prices, but many market cycles work the same way. Popular demand pushes prices higher, valuations rise, people talk, returns are great, generating more demand, which perpetuates the cycle. The same is true for things that are falling in price. The price movement itself can override any other fundamental consideration for the investment. This can go on for a while, but always eventually changes. When the relationship between one thing and another gets extreme enough, the likelihood that market participants will notice that discrepancy increases. It just takes a catalyst, or a few of them, to arrest inertia and shift mindsets sufficiently to act on that observation. In the end, investors are people, and people like to feel validated before changing their minds. It's a slow shift. We are generally indecisive and lumbering. This is why trends tend to run longer than we think they should, and also take longer to get started. Momentum takes time to both arrest and build.

Our clients are well aware that one of the long-term cycle relationships that's at extreme levels at the moment is that of financial assets (stocks and bonds, but mostly stocks) and real assets (commodities and natural resources). We won't reiterate the extent of the stock market bubble again here, but suffice it to say that it's the biggest in U.S. market history. Steve's index piece highlights that point sufficiently. By contrast, commodity and natural resource sectors are historically cheap – in essence, an anti-bubble situation, and U.S. government bonds after the last three years of carnage are also historically cheap relative to stocks. If there's one thing that seems to hold up over many decades of market history, it's the shift in preference over time between financial assets and real assets. The chart below dating back to the 1970's highlights this. When the S&P 500 (red line) is doing well, gold and silver (gold and blue lines) and other commodities generally, aren't. The opposite is also true. What this suggests is that when one positive cycle ends and subsequently performs poorly for a long period of time, the other can actually take over and deliver positive performance. This makes intuitive sense for a couple reasons. First, when times are good and people feel comfortable investing in the abstract nature of stories, narratives, and paper assets, they take for granted and see less value in tangible things that we depend on daily. When life gets more difficult, the preference shifts to real assets. Second, from a pure investment standpoint, when bubbles finally pop, money hunts for fairly-priced assets which tend to be the ones that were most neglected in the prior cycle. In short, we see that shift from stocks and financial assets in general into natural resource/real assets taking place now.

These long-term cycle shifts are never obvious while they're playing out. They happen over months and years in fits and starts, and keep investors doubting at every point along the way. Without a bigger picture view of where we are in the grand scheme of things, it would be nearly impossible to stay the course and resist the urge to seek the comfort of more consensus markets. That big picture keeps one grounded. If reasonably priced investments late in their bear cycle or early in their bull cycle drop in value, they will likely bounce back before long. On the other hand, if expensive and hyped investments drop in value late in their bull cycle or early in their bear cycle, they could drop much further and stay down for a very long time. This awareness gives the investor emotional staying power when things get difficult.

If I asked 100 investors what has performed better over the last six years, a balanced stock/bond portfolio or a diversified natural resource portfolio with some government bond exposure, I would guess that at least 80 would answer that the stock and bond portfolio would have performed better. Again, these big picture cycle transitions can be stealthy. Those 80 investors would be wrong. The chart below shows a hypothetical natural resource portfolio with exposure to gold, silver, miners, energy, and treasury bonds fairly significantly outperforming a stock and bond portfolio with exposure to the S&P 500, Nasdaq, foreign stocks, small cap stock, and corporate bonds. A little over 11% annualized for the former versus a touch over 7% annualized for the latter. We often get questions from clients around how long it takes for investors to catch onto this type of thing. Our answer is, it takes a while. Large investors typically start to move in first, which is what we're seeing now. This tends to arrest existing inertia and get things moving in the other direction. These large investors generally drive the early years of new cycles, but retail investors tend to get in very late. It typically has to be so obvious that the old investment category they got conditioned over years to love is no longer keeping up with some new, popular investment asset class, before retail investors jump onto a new cycle en masse. That being human nature, and the historical precedent, we are likely very early on in this shift from tech stocks to other less expensive categories such as natural resources (and treasury bonds over a shorter timeframe).



The chart on the prior page will look very familiar to our clients, and many of them will have memory of some of the ups and downs along the way. They are not easy, and in the moment, they can induce doubt, but looking back over a reasonable length of time clarifies the picture. Those preparing for major changes in financial markets in the right way have done just fine, even without those changes having fully materialized. Let's keep this simple; if our return over time is based on the price we pay now, we should, in general, stay away from the expensive, buy the relatively cheap, and adapt our thinking as cycles and prices change. That strategy given where we are in the investment cycle by the way, also puts us in asset classes that tend to be "safe-haven" investments that usually hold up well in chaotic environments. This is comforting given the nature of the upcoming election. In sum: we're at one of those points in history that comes around every 30 years or so where investors can get really hurt if they're just going through the motions and buying "the market". There is always an alternative. The trick is discovering it and having the patience to stick with it through the messy, not-so-obvious transition from one asset category to the other. For those who do and can, it's typically well worth the effort.

Market Indexes: What They Are, What They Aren't, and When to Avoid

By Steve DeBoth

What Is a Market Index?

A market index is a theoretical portfolio that represents a sector of the financial markets, with its value calculated based on the prices of its underlying assets. Different weighting methods—such as market cap-weighting and price-weighting—are used to adjust the individual influence of components within the index. The financial market sector represented by the index can be large, like the S&P 500's 80% representation of the US stock market, or the Bloomberg U.S. Aggregate Bond Index's 52% representation of the US bond market. Other indexes may focus on specific or narrow characteristics of the financial market, such as the S&P 500 Consumer Staples index, or geographic segments, like the FTSE 100 for U.K. stocks.

Indexes provide investors a concise overview of market sectors and their movements, eliminating the need to analyze every single asset within a sector. While investors cannot invest directly in an index, these indexes serve as crucial benchmarks and are widely used to develop index funds, making them integral to the investment management industry.

What a Market Index Isn't.

Diversified. Plain and simple. Market indexes are not diversified, as they represent a specific sector of the financial market as opposed to many different sectors. That being said, the 500 companies in the S&P 500 index do provide some amount of diversification within the large cap US market, but the vast majority of stocks in the index would lose value in an environment particularly difficult on large US stocks. When buying an index fund, then, know that you are not getting any diversification beyond that particular market sector or segment, and that to properly diversify you would need to hold multiple index funds, or especially investments that until now have been less in favor.

Speaking of index funds. . .

Index Funds

Index funds allow investors to gain access to market sectors without purchasing each individual asset, which can be cost-prohibitive. Why buy and manage a large collection of home builders stocks when you can instead buy an index fund tracking the home builders index? Index funds typically employ a replication strategy for its corresponding index, holding all the different constituents of that index. For example, the SPDR® Dow Jones Industrial Average exchange-traded fund owns the same 30 stocks in the same percentages as the Dow Jones Industrial Average Index. Although some management and trading costs are reflected in the fund's expense ratio, these costs are generally lower than those of actively managed funds, giving many index funds a cost advantage. Other advantages that index funds have over actively managed funds include that they can be more tax-favorable while also being simple to understand.

Index funds do have downsides, however. Some are how they are perceived and then therefore used, and some are how they can grow riskier at the worst times. Many people perceive index funds as being more diversified than they really are, as previously mentioned, which can expose them to more risk than may be advised. The perception that an index is diversified leads to this error, however the indexes themselves can become riskier over time.

The S&P 500 index is comprised of 500 stocks whose representation in the index is determined by the overall value of the company, so the bigger the company, the more its stock price moves affect the index. Apple is currently the largest company in the world on a market cap basis, and it represents a little over 7% of the S&P 500 index. Walgreens, on the other hand, is currently the 500th largest company in the index and represents a little under 0.01% of the index. For Apple to move the S&P 500 index by 1%, its share price needs to increase by 14%. For Walgreens to move the S&P by 1%, its share price needs to increase by a whopping 9,900%.

This outsized representation by a few companies is a blessing and a curse, depending on what the overall market is favoring. Right now, the seven largest companies in the S&P 500 represent nearly 32% of the value of the index:

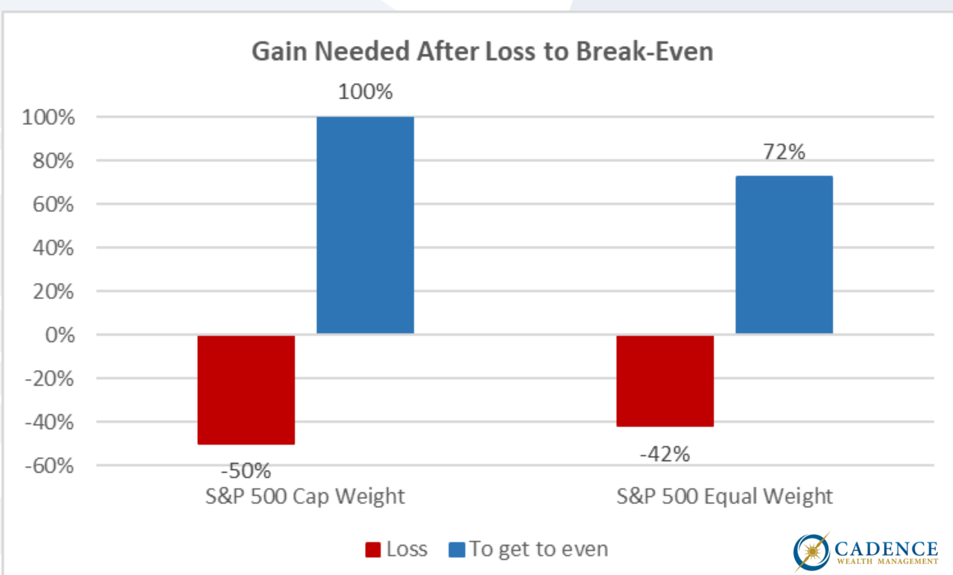
Company	Symbol	Weight
Apple Inc.	AAPL	7.12%
Microsoft Corp	MSFT	6.64%
Nvidia Corp	NVDA	6.28%
Amazon.com Inc	AMZN	3.72%
Alphabet Inc.	GOOGL	3.58%
Meta Platforms, Inc. Class A	META	2.57%
Berkshire Hathaway Class B	BRK.B	1.71%
Total Weight in Index		**31.62%**

By representing nearly 32% of the index, these stocks also get 32% of all the money invested in index funds. As people save into their workplace retirement plans every month, and more people now use index funds than actively managed funds, all the stocks in the index are getting purchased with every $1 that goes into an index fund. When that $1 goes into an index fund, $0.07 of every dollar is used to purchase Apple, and nearly as much goes into

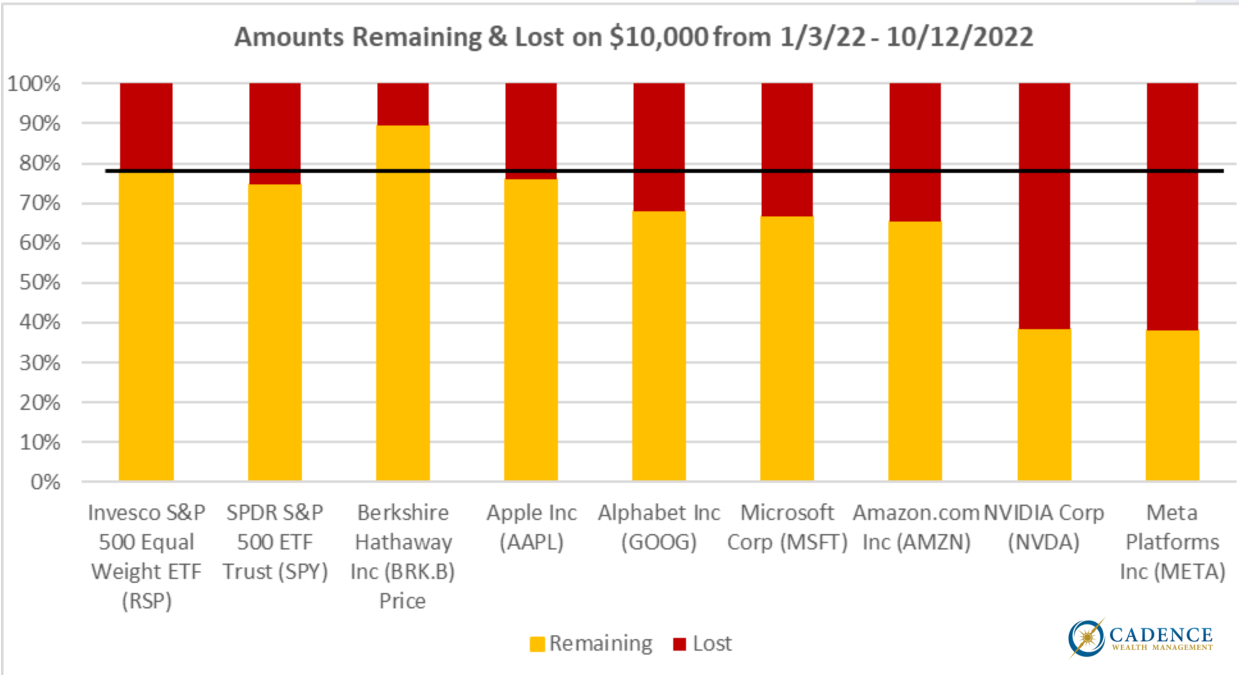
Microsoft, and all the way down the line, until $0.32 of every $1 goes to these seven. Walgreens, on the other hand, gets around $0.0001 of every $1. This mechanism props Apples' stock price up regardless of whether or not it's a good time to buy Apple; it's getting bought regardless.

The top 3 S&P 500 index exchange-traded funds took in over $14 Billion on their own last week. Considering all the other S&P 500 index funds, and all the other company retirement plan options that include funds that own these 7 stocks, the billions and billions and billions of dollars flowing into these funds being used to buy these stocks is absolutely mind blowing. If last weeks' S&P 500-related index fund flows were $40 Billion, let's say, then nearly $3 Billion of that was used to buy Apple stock alone. On an annualized basis, that's hundreds of billions of dollars that are flowing into Apple stock purchases, and Microsoft purchases, and on and on. With a river of money flowing into these stocks every week, there's no wonder they represent as much of the index as they do. And because they are so much of the index, more and more of their shares get bought, which makes them more and more of the index, which gets more and more of their shares bought, and so on. It's a self-reinforcing cycle where the largest stocks have tailwinds pushing them onward. When you own these stocks, whether in index fund form or mutual fund form, or just individually, you do get to benefit from that river of money propping the stock prices up.

But, what happens when 7% of every dollar removed from an S&P 500 index fund gets taken from Apple stock? This is how an index itself can become riskier over time. The same forces that prop prices up when money is flowing in will also drive their prices down faster when money flows out. We have already seen the effects of this recently. From when the stock market peaked on January 3, 2022 until it troughed on October 12, 2022, the S&P 500 index was down a little over -25%. The equally-weighted S&P 500 index, on the other hand, where each of the 500 companies in the index represent the same percentage of the index as each other, was down a little over -21%. That 4% difference was caused, in part, by the top seven stocks being down more than the average. That 4% difference may seem small, but consider if that ratio were to hold true for a market loss twice as large. In that event, the equally-weighted index would be down -42% and the market cap-weighted index would be down -50%. To get back to break-even after that, the market cap-weighted S&P 500 index would have to grow 28% more than the equally-weighted index:



Which brings us to today. Most of the top seven stocks today were also in the top seven in early 2022, but not all of them. Consider the current top seven S&P 500 stocks' performances during that last large downturn compared to both the market cap-weighted index as well as the equally-weighted index:



The black line is what remains of $10,000 invested on January 3, 2022 in the Invesco S&P 500 Equal Weight ETF as of October 12, 2022. Berkshire Hathaway was by far the best performer between the indexes and other individual stocks. However, even with Berkshire's relatively meager -10.5% loss, the average loss among these seven stocks was still nearly -37%. That is while the indexes were losing -21% to -25%. Imagine the potential size of these individual stocks' losses were the indexes down -50% or more. When nearly 32% of every dollar coming out of the S&P 500 index funds is coming out of these seven stocks, and when the loss on the index is down much more than we saw last time, the possibility these seven stocks will compound the losses is quite high. Meta is up nearly 350% since the market bottomed out two years ago, and Nvidia is up, wait for it, just under 1,000%. These two stocks right now are within sniffing distance of 10% of the entire value of the index. How much can they fall in a major market sell-off, and in turn, how much will their losses drag down the index, motivating even more selling?

The same way the massive amounts of money flowing into these positions help prop them up, the massive amounts of money flowing out of these positions in the future will compound their losses, and drag the index down with them. If all this sounds a bit familiar, it should, as I covered some of this in the January Cadence Clips. What has changed since then? The top seven stocks 9 months ago represented 27% of the index; now, it's nearly 32%. The more concentrated the index gets, the worse the future losses may be.

Should You Invest in Indexes at All Then?

Yes. Indexes do have a place in an investment portfolio. We use them in our clients' portfolios to get relatively cheap exposure to sectors of the financial market. However, we do not use them to mitigate risk inside the portfolios. For loss minimization, we use a combination of a lowered exposure to risky assets, as well as a careful selection of the assets themselves. We look to round out our portfolios with out of favor market sectors with attractive valuations and metrics, as well as alternatives to stocks and bonds that have proven repeatedly to minimize losses at times when both stocks and bonds are selling off.

You will never beat an index by owning the corresponding index fund. In a severe market downturn, we absolutely intend to beat stock market indexes' potentially -50%+ returns. When a bull market has just started, and the largest positions in the indexes are gathering the largest share of fund flows, this helps cause that compounding, upward spiraling set of returns, and is an attractive feature of owning market cap-weighted index funds. On the flip side, it is difficult to imagine another 1,000% return from Nvidia unless it sells off quite a bit from where it is today. When that sell-off happens, index funds are not the best place to hide. Hopefully, the people you care about are not blindly over-relying on index funds that have continued to get more and more top heavy, and that have already proven their top-heavy nature compounds their losses in market sell-offs.