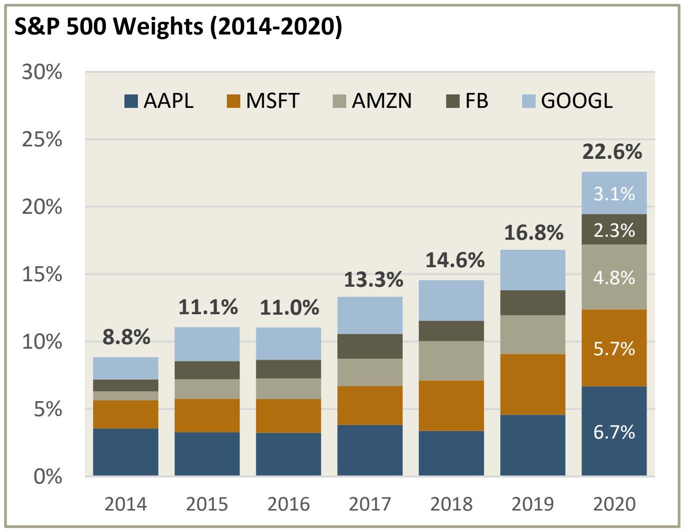
"A wise investor knows that the stock market is really a market of stocks."

- Sir John Templeton

Over the past five years, the S&P 500 Index (or "stock market") has become increasingly dominated by a handful of mega-cap technology companies. This new composition (and concentration) of the stock market has important implications for both active and passive investors, which we explore in this quarter's *Investment Perspectives*.

Consolidation at the Top

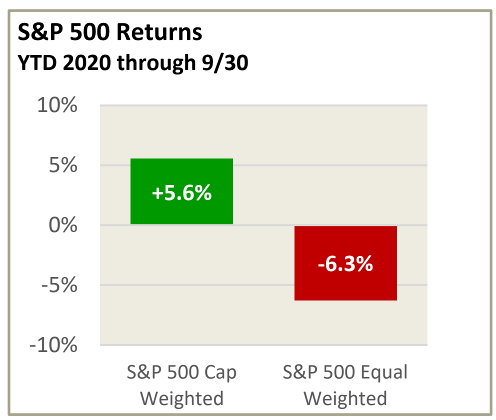
At the end of the third quarter of 2020, the five largest publicly-traded companies – Apple, Microsoft, Amazon, Alphabet, and Facebook – comprised nearly 23% of the S&P 500 and an astounding 40% of the smaller, tech-heavy NASDAQ Composite. Six years ago, these same five companies accounted for less than 9% of the S&P. Since the S&P is weighted by market capitalization, these tech giants have been propelled to represent an ever-larger percentage of the index as their sheer size and share price performance has far outpaced that of the broader market. Apple now has a market value over $2 trillion, after becoming the first company to top the $1 trillion mark in 2018. Microsoft and Amazon are not far behind at $1.5 trillion each, while Alphabet hovers just above $1 trillion.



Today's current concentration of the top five largest companies exceeds the 18% level reached in the 'dot-com' era in 2000 when Microsoft, Cisco, GE, Intel, and Exxon held the top positions by market capitalization. At present, the stock market is more concentrated than ever before.

Performance Impact

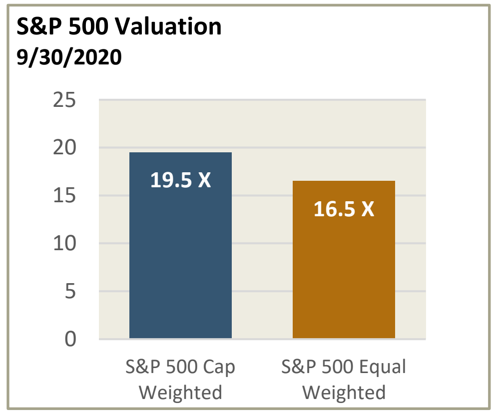
As a result of their significantly increased weightings in the S&P 500, these five tech companies now have an outsized influence over the performance of the index overall. Consider that the S&P 500 was up roughly 6% through the third quarter of this year, yet an equal-weighted version of this same index, which accounts for each stock's contribution equally, is down 6%. In fact, of the 505 companies in the S&P 500[1], 179 or 35% outperformed the market's 5.6% return, while 326 or 65% underperformed the market. Most of this massive difference in performance can be explained by the strong stock performance of the tech giants, whose resilient business models, superior growth prospects, and strong balance sheets have been greatly rewarded by investors during the COVID-19 pandemic.



As surprising as the positive performance of the stock market is this year, it can largely be attributed to a small group of companies. The tendency of the cap-weighted index to outperform the equal-weighted version over time makes some intuitive sense. Over the last 30 years, the performance gap between the S&P 500 and the equal-weighted index is 100bps: 10.6% vs. 9.6%. However, this year's discrepancy is particularly noteworthy. One could make the case that the equal-weighted index's lagging performance might serve as a more accurate representation of the economic fallout from COVID-19. As a result, the S&P 500, as a proxy for the stock market, may no longer accurately reflect the overall health of the economy.

[1] The S&P 500 Index tracks the stocks of the 500 largest U.S. companies, due to corporate spin-offs, different share classes, and merger and acquisition activity, the number can be greater than 500.

Skewed Valuation



Increased market concentration has also greatly influenced how investors perceive the general valuation of the stock market. As of the third quarter, the S&P 500 was trading at 19.5x its earnings per share (EPS) forecast for the next twelve months (NTM). Such a valuation is above the market's long-term average (of 16.5x), and therefore could be considered "expensive" relative to its own history. However, the equal-weighted index, which weighs each company's valuation evenly, is valued at only 16.5x, in-line with the long-term average despite record low interest rates bolstering asset valuations. This suggests the valuation of most market constituents may not be unreasonable relative to history. Once again, the difference can largely be explained by these mega-cap tech companies, which have an average valuation of 39x NTM EPS. In our view, these large tech companies are superior businesses to the average S&P constituent based on growth prospects, profitability, and risk profile, and thus should command a premium valuation. Nonetheless, their contribution to the overall market valuation creates a conspicuous distortion.

This discrepancy also means that investors must now be mindful when comparing an individual company's valuation to that of the overall market. While a stock might appear cheap relative to the market, this comparison could be misleading because of the dominance of the mega-cap tech stocks and the premiums they command.

Has Passive Become More Active?

Increased market concentration also presents new challenges for investors choosing a passive approach to investing. Previously, investors bought the S&P 500 with the confidence that they were not making individual stock bets but rather owning a broad basket of the 500 largest companies, diversified across sectors. However, given that the S&P is increasingly weighted towards these large tech companies and that their stock performance will drive more of the index's performance, investors may, unknowingly, be taking on more individual stock selection risk than they intended. In essence, passive investing has become more active because of increased exposure to a few of the most highly valued corporations.

The Importance of Active Management

Aureus has always taken an active approach to investment management, applying fundamental research and analysis to identify the most attractive opportunities on a risk-adjusted basis. In addition to active stock selection, we also carefully consider the position sizes of each stock and sector in the portfolio, adjusting accordingly as prices and information change. Given the number of challenges brought upon by the market's increased concentration, we believe an active approach to investing is now more relevant than ever.