LYELL WEALTH MANAGEMENT

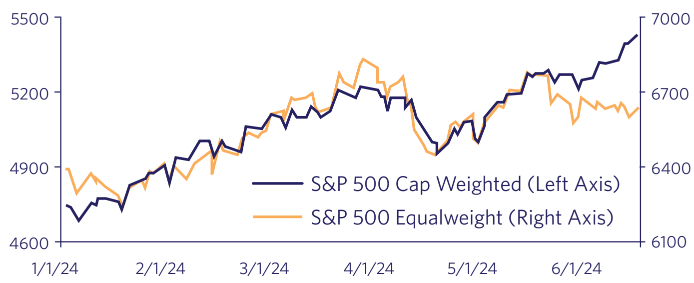
JUNE 21, 2024

Top Heavy

Lyell Wealth Management tracks its clients' U.S. stock performance relative to the S&P 500 Index ("S&P"). The S&P is, however, weighted by market capitalization. A market-capitalized index means the most valuable companies have a disproportionate impact on the return calculation and may not necessarily reflect overall stock market conditions. This year, very strong performance by some of the largest companies has masked weakness within much of the market. For example, the S&P index is up 4.3% in Q2, but the average S&P stock is down 2.0%. The past quarter's stock market advance disappears entirely if one weighs each S&P company equally, rather than by market-capitalization (Chart 1).

CHART 1

S&P 500 Market Cap vs Equal Weight Index: Last Six Months

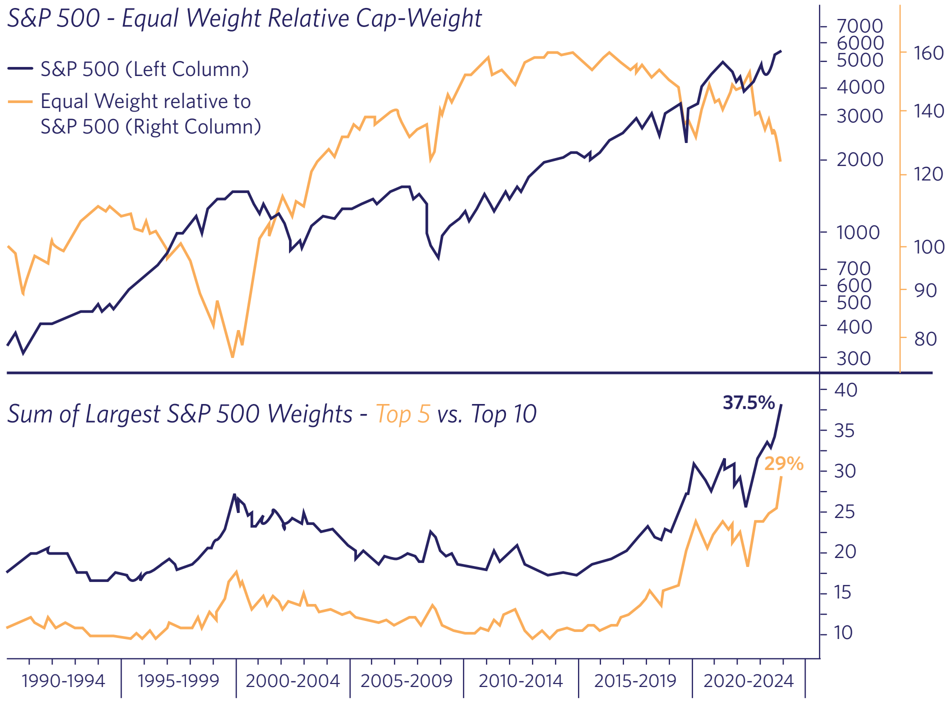


Source: Bespoke Investment Group

Although the 2024 year-to-date divergence has been extreme, leadership from the largest stocks has been a trend for the past decade as the S&P 500 has outperformed the equal-weighted index by a huge margin. This is also illustrated by the Top 5 and Top 10 most valuable companies representing an increasing percentage of the index (Chart 2).

CHART 2

S&P 500 - Equal Weight Relative Cap-Weight



Source: Strategas Securities

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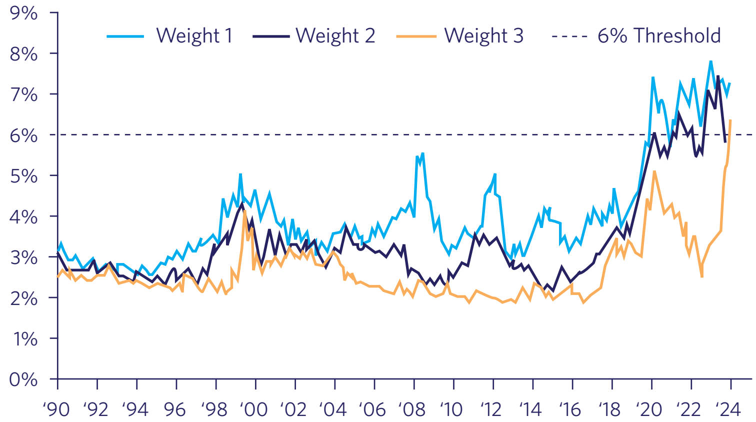
Since the late 1990s the largest stock in the S&P typically represented 3%-4% of the index. Except for Exxon in 2008, no stock represented over 5% until Apple did so in 2020. Since then, Apple has maintained over a 6% weighting and has been joined in the past year by Microsoft and Nvidia (Chart 3).

Apple, Microsoft, and Nvidia are each valued at over $3 trillion. Each company is individually worth more than the entire U.K. stock market, which is the biggest in Europe. Each also exceeds the sum total of the 2,000 companies represented in the Russell Small-Cap index (Chart 4).

The Top 10 stocks have delivered 76.5% of the S&P return year-to-date. One high-performing stock, Nvidia, has contributed over 30% of the S&P's return during 2024 (Chart 5).

CHART 3

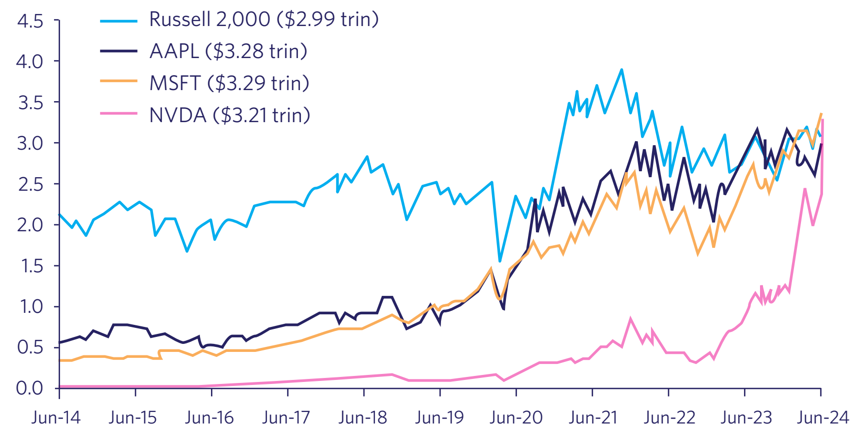
3 Largest S&P 500 Weights



Source: Strategas Securities, Bloomberg

CHART 4

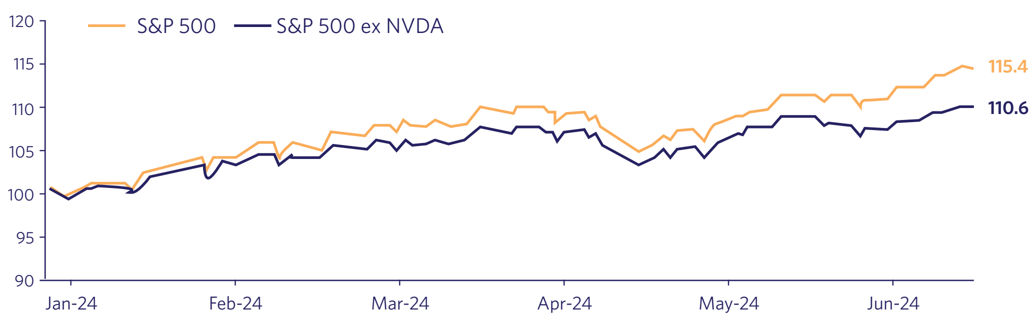
Market Caps ($, Trillions) of Russell 2,000, AAPL, MSFT, and NVDA: Last 10 Years



Source: Bespoke Investment Group

CHART 5

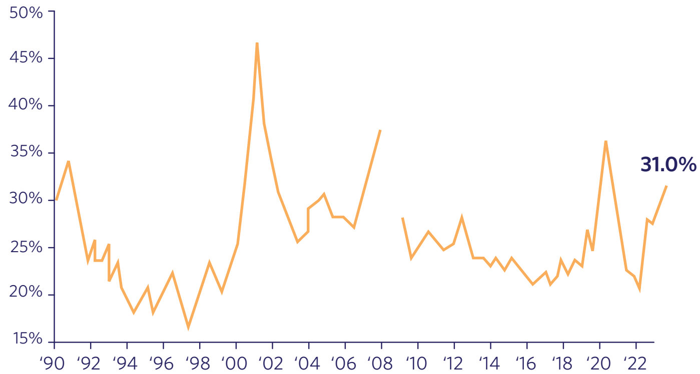
S&P 500 vs S&P 500 Ex. NVDA Performance YTD (Based on Change in Market Cap)



Source: Strategas Securities

CHART 6

Top 10 Net Income Contribution as a Percent of S&P 500 Net Income



Source: Strategas Securities

This degree of market concentration makes it challenging for active investors to keep up with the S&P index. Even if the leading stocks are in a portfolio, they are not likely to be so heavily weighted. It is unclear whether investors should be concerned with having a small number of companies represent such a substantial part of the market index. From a valuation perspective, the Top 10 stocks currently account for approximately 31% of the S&P Net Income versus holding a 37.5% market weighting (Chart 6).

The Top 10 stocks are currently Nvidia, Microsoft, Apple, Amazon, Meta, Alphabet, Broadcom, Berkshire Hathaway, Eli Lilly and JP Morgan. Table 1 provides a snapshot of some key metrics for these leaders. Markets are forward-looking and stronger profitable growth will be valued more than slower growth, so it isn't surprising that Meta and Nvidia receive higher valuations than JP Morgan or Berkshire Hathaway. As such, the relationship between the current Net Income and Market Weighting assigned to the Top 10 isn't alarmingly wide and valuation doesn't appear extreme for this cohort.

TABLE 1

Market Concentration May Not Yet Be Anything to Fear

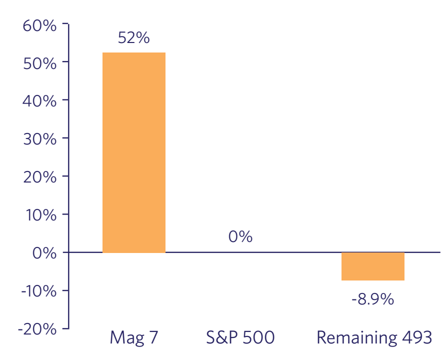
	Top Stock	Market Cap ($Tn)	Cumulative Market Cap Weight	Cumulative Net Income Weight	Profit Margin LTM	Earnings Growth LTM
1	MSFT	3.3	7%	5%	36%	25%
2	NVDA	3.1	14%.	7%.	53%.	791%.
3	AAPL	3.1	21%	13%	26%	9%
4	AMZN	1.7	25%	15%	6%	769%
5	META	1.1	27%	18%	32%	121%
6	GOOG	1.9	31%	23%	26%	45%
7	AVGO	0.7	33%	23%	24%	-27%
8	BRK.B	0.7	34%	27%	20%	877%
9	LLY	0.7	36%	28%	17%	8%
10	JPM	0.6	37%	31%	20%	22%

Source: Strategas Securities

Over the past decade, various acronyms have been assigned to a small group of highly valued growth companies exhibiting market leadership. In 2013, Facebook, Amazon, Netflix, and Google were dubbed the "FANG" stocks and Apple was later added to make them the "FAANG" stocks. Due to corporate name and stock leadership changes, FAANG was replaced by the "MAMAA" moniker representing Meta, Amazon, Microsoft, Alphabet and Apple. The most recent effort to group Big Tech stock market leadership has been under the title "Magnificent Seven" bestowed on Apple, Microsoft, Alphabet, Meta, Amazon, Nvidia, and Tesla. The Magnificent Seven are all currently among the Top 10 largest S&P stocks with the exception of Tesla. Indicative of why they are referred to as "Magnificent": while 2024's Q1 Net Income Growth for the S&P was flat, the Magnificent Seven delivered a 52% year-on-year increase. The other 493 stocks decreased by 8.9% (Chart 7).

CHART 7

S&P 500 1Q'24 Net Income Growth (Y/Y Pct. Chg.)

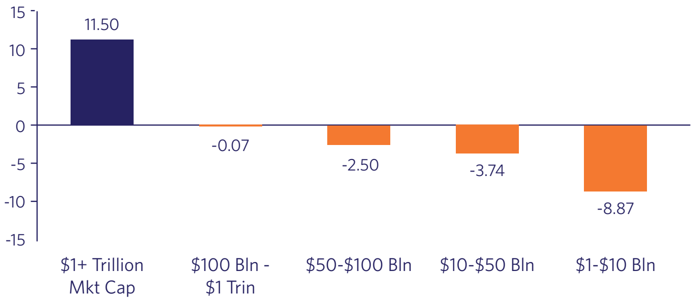


Source: Strategas Securities

The dominant investment theme over the past eighteen months has been Artificial Intelligence ("AI"), and companies deemed leaders or beneficiaries have generally had strong stock performance. However, size has mattered in 2024 even within the AI universe. The strong performance in Q2 and year-to-date has been concentrated in the AI companies with a greater than $1 trillion market-capitalization (Charts 8, 9, and 10).

CHART 8

AI Stocks: Q2 2024 Average Total Return (%) by Market Cap Range*



*Included in at least one of eight key AI-related ETFs. (183 stocks total)

Source: Bespoke Investment Group

CHART 9

AI Stocks: Avg. % from 52-Week High

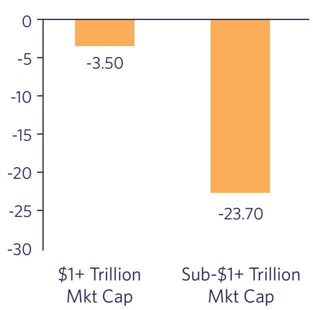
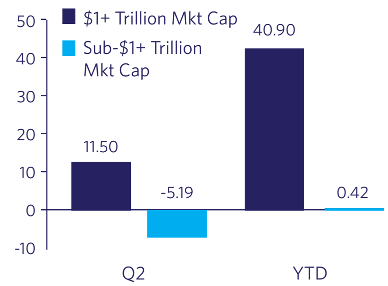


CHART 10

AI Stocks: Q2 and YTD Avg. Total Return (%)



Source: Bespoke Investment Group

In addition to size, the market in 2024 has been rewarding AI "infrastructure," such as semiconductor, cloud computing, and data center companies, versus "implementation" businesses which will presumably incorporate AI products and services for their end-users. The infrastructure companies are delivering explosive financial results now as well as tangible near-term growth. We seem to be in the "prove it" stage for the implementers as the market challenges them to incorporate AI in a cost-effective manner. In addition, new entrants may be able to leverage AI to encroach on incumbent industry leaders which may partly explain the current overhang on many software and services companies (Chart 11).

CHART 11

Ratio of Bespoke AI Infrastructure vs. Implementation Baskets

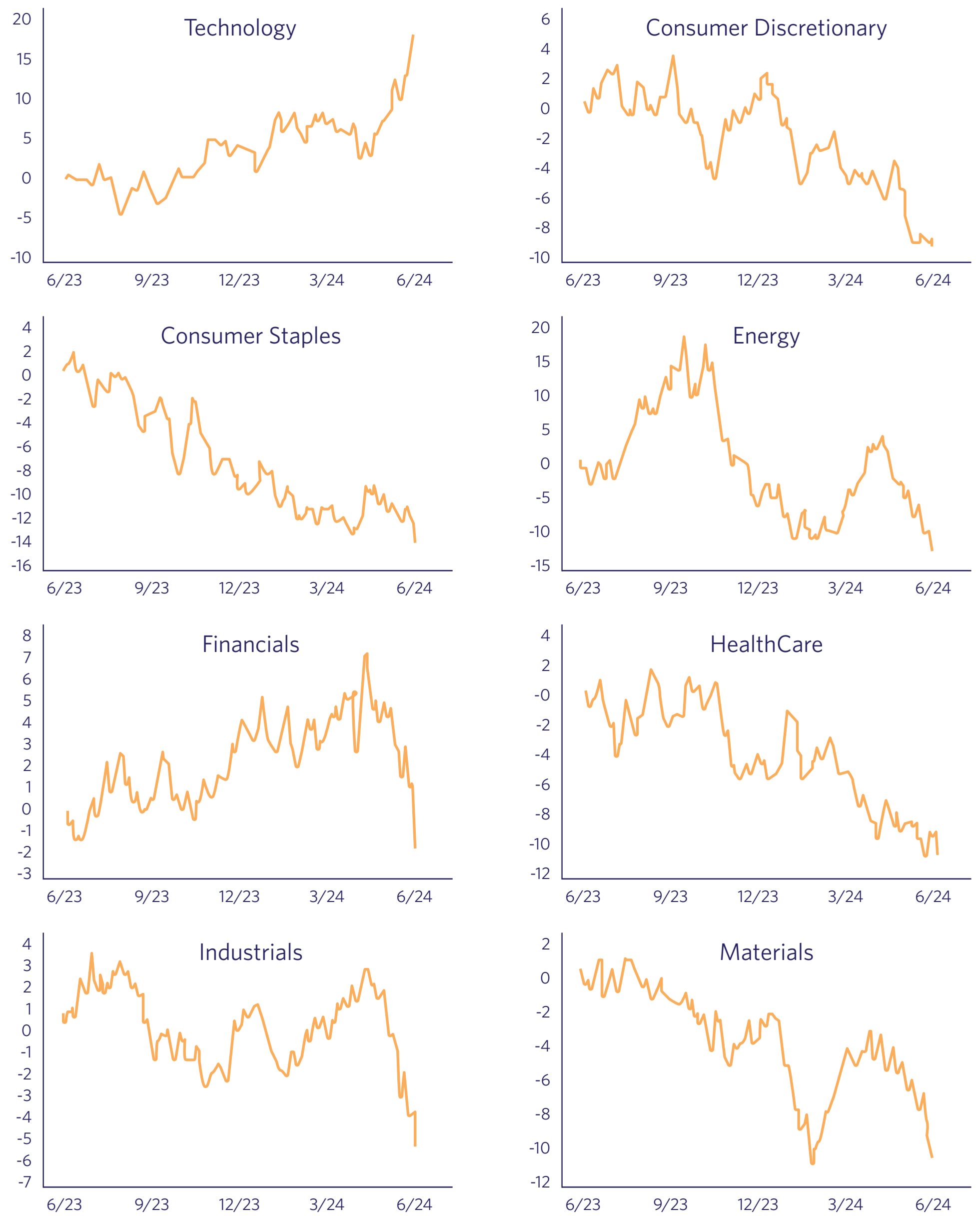
Source: Bespoke Investment Group

Although Lyell Wealth Management does not see valuation as unmoored at the top of the market, what we have been describing in the preceding paragraphs is narrowing market breadth. A stock market ideally sees widespread participation from many stocks and industry sectors in an advance. From a market technical perspective, we find ourselves in a rare occurrence in which the S&P index is "overbought" (which means it is extended above its moving average trading level) while the majority of New York Stock Exchange listed stocks are "oversold" (extended below their average trading level). As the Technology sector has outperformed the S&P, virtually every other sector has relatively underperformed (Chart 12).

The current disparity can be viewed either optimistically or negatively. Narrow breadth can foreshadow a "they shoot the leaders last" scenario whereby the widespread weakness telegraphs an end to a market rally. Certainly, from a timing perspective we seem overdue for a pullback. Alternatively, it can also provide substantial future market upside as the recent underperformers strengthen, carrying the index higher without the leaders needing to do anything. Although we are very interested in the resolution, we are most focused on the merits of each company in our client portfolios rather than the next market move.

CHART 12

Relative Strength vs. S&P 500 - Past Year



Source: Bespoke Investment Group

The increasingly digital economy has radically altered our society, and the degree to which commerce runs on or through the most valuable companies' platforms or infrastructure is unprecedented. Microsoft, Amazon and Google provide the cloud computing infrastructure on top of which almost every business or internet service operates. Apple has ~1.5 billion active iPhone users worldwide with 34 million registered developers and almost 2 million apps. Millions of customers advertise or sell on Facebook properties to 3 billion monthly active users. There are 139 million social media creators with a minimum of 1,000 followers in a creator economy estimated to be worth $156 billion. Google processes over 1.2 trillion searches per year and YouTube has more than 2.5 billion monthly active users. Amazon has over 200 million Prime members, and it handles over 37% of all US ecommerce with an expanding market share. And now Nvidia finds itself in the middle of a generational computing shift for which it spent 25 years uniquely positioning itself.

In addition to the massive customer and infrastructure scale of these behemoth companies, they enjoy unusually attractive business models for the most part. With the exception of Amazon's ecommerce business, they sport high gross margins. In many cases, they enjoy recurring revenues through subscriptions. These businesses are essential to other companies' operations and, in some cases, existence. For example, there are millions of businesses reliant on the Apple Appstore, Google Search, Amazon, and Facebook properties for customer acquisition. As we live in an increasingly digital environment, these companies are masters at managing and using data. This capability with data presumably positions them well to benefit in an increasingly AI world. Lastly, their massive cash balances and cash flows allow them to capitalize on AI opportunities. Reflective of this financial might, the Magnificent Seven now account for 20% of the overall S&P capital investment versus only 6% in 2015.

Given their huge size, these companies attract regulatory and political scrutiny, and large-scale M&A will be difficult. Their market power and growing share of the overall economy deservedly require that their practices be closely reviewed. However, it would be inaccurate to say that they don't operate in a competitive environment. In fact, in many segments they experience brutal competition although it is often with one or more of the other leaders. It has been Lyell Wealth Management's philosophy to not overreact to the risks to any one of these top companies by exiting client positions. This patience has been rewarded thus far, as past threats that seemed significant at various times have receded and leadership has been reestablished in many instances.

We are aware, however, that today's market leaders cannot lead forever. Nvidia's market capitalization has grown from $400 billion to over $3 trillion in less than two years. Much of Lyell Wealth Management's investment focus is on assessing whether a sea-change is underway for one or more of the leaders. While that day is not yet here, it will most assuredly come.

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