"Don't..."

By: Stephen Weitzel, CFP

I'm a big believer that it is easiest to learn lessons from other people's mistakes, but that we as human beings somehow need to experience the pain of that error on our own before we really internalize and believe what we could have learned simply by listening. For many of us who have raised children, coached a sports team, or trained someone new at work we know it all too well. You try to impart what should be done and the manner in which it should be done. Often, the prescribed method for achieving the desired result is rooted not only in what accomplishes the goal, but also in what reduces mistakes that could impair or inhibit the objective.

We were all in that learning position once, too! And while it would have been easier to follow the protocol, somewhere along the way, we probably ventured into the "Don't!" category once or twice, and we likely learned in due time why we were encouraged NOT to do "THAT!"

As investors, the dos and don'ts of successful investing are fairly basic and well known:

1. Buy low. Sell high.
2. (Do) be diversified. Don't put all your eggs in one basket.
3. Don't be emotional.

I bring this up now because I believe that the current market environment is both fraught with risk and poised for opportunity. Allow me to explain.

Fraught With Risk

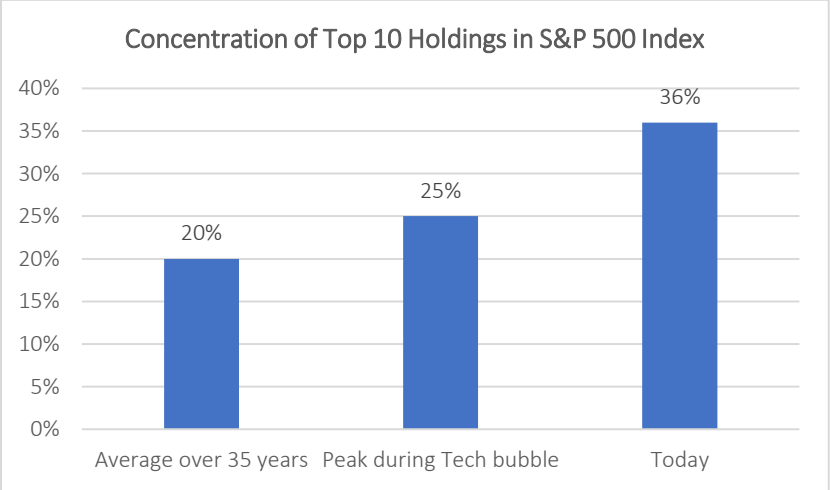
At the time of this writing, we are experiencing one of the most extreme periods in history for large cap stocks in the United States as it relates to valuation and concentration. This is most identifiable in the technology heavy Nasdaq and S&P 500. While the Nasdaq 100 has largely always been considered an investment in technology, the S&P 500 has been considered a diversified index of large US corporations. Unfortunately, many unsuspecting investors still believe both of those statements to be true.

Name	Ticker	Nasdaq 100 Weight	S&P 500 Weight
NVIDIA CORP	NVDA	8.69%	7.25%
MICROSOFT CORP	MSFT	8.50%	7.18%
APPLE INC	AAPL	8.48%	6.73%
AMAZON.COM INC	AMZN	5.53%	3.62%
META PLATFORMS INC CLASS A	META	4.87%	2.38%
ALPHABET INC CL A	GOOGL	4.48%	2.23%
ALPHABET INC CL C	GOOG	2.64%	1.88%
BROADCOM INC	AVGO	2.56%	1.72%
TOTAL		**45.75%**	**33.00%**

For illustrative purposes only, not a recommendation to purchase individual securities.

When you look under the hood, it's not hard to see why these two indexes are so highly correlated now. Their top holdings are identical, only varying slightly in the level of exposure to each position. This level of concentration, or lack of diversification, has been a tailwind for these indexes for the last decade as these companies have performed strongly. Many investors have cheerfully tagged along, turning a blind eye to the diversification eroding away beneath the surface. Eventually, it becomes not only a headwind, but problems typically described as "the perils of indexing." The concept being that following a long period of strong performance, indexes (and ultimately investors) are saddled with excessive exposures to areas within the market trading at lofty valuations that are susceptible to significant decline. They may be left underexposed and underinvested to areas that have underperformed.

As an example, prior to the Great Financial Crisis, the financial sector accounted for approximately 20%[1] of the S&P 500 total market capitalization weighting, which was its highest level in decades. That translated to 20 cents of every dollar invested in the S&P 500 index buying shares of financial services companies. The sector would go on to decline by 82% before bottoming in March 2009[2]. Alternatively, following the decline of the sector during the Savings and Loan Crisis in the early 1990's, financials accounted for only around 5%[3] of the S&P 500 Index. From that point, the financial services sector would go on to be one of the best performing sectors in the market over the next 15 years. But only 5 cents of every dollar being invested in the S&P 500 at that time was going into the sector. Many at the time, given the obvious problems, deemed the space "un-investable." Sound familiar? Commodities in 2020? As my friend, Larry McDonald, New York Times Best-Selling author says, "At the point of maximum loss, you can't get away…and at the point of maximum profit, you can't get in!"



These are the perils of indexing, and they are on our doorstep again. Recent research highlighted by Goldman Sachs shows that the top 10 stocks account currently for 36%[4] of the S&P 500 index. Too many eggs are crammed into one basket, and yet many investors seem undeterred. Caveat emptor. Buyer beware!

Poised For Opportunity

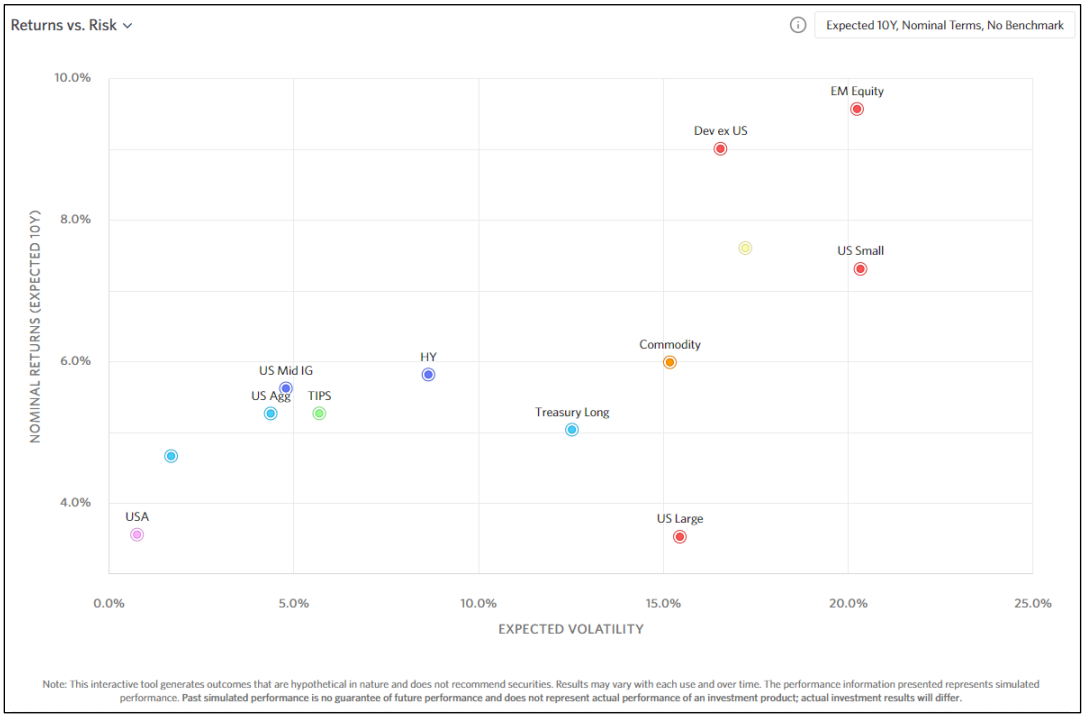
There is no free lunch, they say. However, in investing, there is! It's called diversification. Or at least Harry Markowitz, the father of modern investing, viewed it that way. Markowitz's development of modern portfolio theory (MPT)[5] demonstrated that by creating a portfolio of different asset classes (stocks, bonds, etc.), investors could reduce risk and increase their returns…OVER TIME! Not every time. Not every single year. But over time. Across bull markets and bear markets, diversification and asset allocation would provide a positive benefit to investors. A free lunch, so to speak.

Thus far, the 2020's have been a volatile decade for investors. The COVID crash. The stimulus induced recovery. An historic bond market sell-off. The longest, most durable bear market we've experienced since the financial crisis. Yet, **the biggest bear market that concerns me today is the bear market in investors who think they need to be diversified**. Too many investors today are not only benchmarking themselves to the S&P 500, but they're also asking their advisors why they should maintain exposure to anything other than the S&P 500. They are willing to abandon the basic tenants of diversification in favor of overexposing their portfolio to a small group of large cap US stocks, likely because they currently view it as a low-risk proposition. It is anything but.

However, many of the investment categories that have disappointed investors over the last several years may very well turn out to be the areas that provide them with better returns going forward.



In the chart above from our friends at Research Affiliates, we see the annualized returns and risk/volatility over the last 3 years (2021-2024) for many of the investment categories that make up a diversified portfolio. Notice how few areas have managed positive returns during that period. US Large Cap stocks stick out notably here. Bonds? An abject disaster by any recent historical standard. Many investors seem resigned to accept that this last 3 year period will continue into the foreseeable future, as if there is no other viable outcome. But what if it doesn't unfold that way?



PLEASE SEE IMPORTANT DISCLOSURES IN THE RA CAPITAL MARKETS EXPECTATIONS METHODOLOGY[6]

Investments that are concentrated in a specific sector or industry increase their vulnerability to any single economic, political or regulatory development. This may result in greater price volatility.

Sources: MSCI Inc. These forecast expected returns are calculated by Research Affiliates using data provided by MSCI Inc. No funds or securities relating to these forecast expected returns are sponsored, endorsed or promoted by MSCI Inc., and MSCI bears no liability with respect to any such funds or securities.

Here is the same chart, but this one is forward looking. These are the capital market assumptions for these same categories looking out over the next 10 years. Suspiciously, what falls to the bottom of the page? US Large Cap stocks? Could that really be? What moves to the top? Emerging Market stocks. Developed International stocks. Real estate investment trusts. US Small Cap stocks. All of those categories have been secular underperformers relative to the S&P 500 for the last 15 years. In some instances, by some investors, they've been abandoned. We at Reveille will not abandon them. We will embrace them.

Even bonds are expected to provide better returns than Large Cap US stocks over the next decade! Following losses of about 3.5% per year over the last 3 years, bonds are expected to produce returns near 5.5% annually over the next 10 years. Talk about a change of pace!

At Reveille, our Rules Based Investment Discipline, as always, will guide us as to when we need to be invested and when we need to be in cash. We will continue to practice the core tenants of successful long-term investing: asset allocation and diversification. We do so because it's prudent. We may even have some battle scars from where we have learned that lesson the hard way over the course of our careers. And also because of the free lunch.

References

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Disclosures

The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market.

The NASDAQ-100 (^NDX) is a stock market index made up of 103 equity securities issued by 100 of the largest non-financial companies listed on the NASDAQ. It is a modified capitalization-weighted index. ... It is based on exchange, and it is not an index of U.S.-based companies.

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Inclusion of these indexes is for illustrative purposes only.

Indices are not available for direct investment. Any investor who attempts to mimic the performance of an index would incur fees and expenses which would reduce returns.

This is not a recommendation to purchase or sell the stocks of the companies pictured/mentioned.

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Peachtree City – 525 Westpark Dr., Suite 100, Peachtree City, GA 30269 | 678.489.7314
Ocala – 2201 SE 30th Ave., Suite 201, Ocala, FL 34471 | 352.671.5310
The Villages – 4048 Wedgewood Lane, The Villages, FL 32162 | 352.750.6050

www.reveillewealth.com | info@reveillewealth.com

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