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IS PAST PROLOGUE?

We all were sea-swallow'd, though some cast again,
And by that destiny to perform an act,
Whereof what's past is prologue, what to come,
In yours and my discharge.
– William Shakespeare, The Tempest

So the last shall be first, and the first last:
for many be called, but few chosen.
– Book of Matthew, 20:16

It is rare that one can encapsulate financial markets with one salient fact. But today is that singular moment. The 10 largest stocks in the S&P 500 command roughly 35% of the market capitalization and 22% of the aggregate earnings. Single stocks regularly trade on premiums to the market of 60%. It's completely rational to expect any single stock to grow its earnings in excess of the market by 60% over some horizon. It is a different thing entirely to expect a group of stocks representing more than a third of the market to do so. And yet that is exactly what is implied by the current gap. Plainly that group of stocks must at some point in the future garner 35% of the market's earnings. How long that period is depends on when that group is expected to lose its supernormal earnings power. If you imagine that they maintain their edge over the next 10 years, then they only need to exceed the market's earnings growth by an average of 6% compounded annually. If their super power only lasts five years, then

the hurdle is twice as high. Among fundamental analysts, this trick is known as "beating the fade." In other words, growing earnings more than the market for longer than the assumed duration of growth advantage. And, for the last 10 years, the mega cap tech stocks have largely achieved that feat. But in doing so, they have only extended the expectations of superior performance into the future. Just prior to Covid-19 the Magnificent Seven stocks traded on a forward price-to-earnings multiple of 27.6x. Today it's 30.3x. Like a sprinter on a treadmill, the market takes each exceptional performance as proof that the athlete can do only better if it only adjusts the speed upwards a notch. I am worried some of our athletes are going to blow out a hamstring.

One of the core tenets of our investment philosophy is that markets are inherently learning engines that are trying to guess the future state of a chaotic system. In other words, the market is not a clockwork that produces a known output for a given initial state. It is like a weather model, but one where the collective forecasts shape the outputs. To understand what's going on, we need hard data like earnings and starting valuations but also a way to capture how the observers are adapting to the data. One way to capture this is to imagine a simulation of the stock market. We start with representative agents. The most important group are the asset owners (pensions, endowments, insurance companies and retail investors). These agents provide capital to professional asset managers who invest on their behalf. Now we must assume some characteristic behaviors. Let us assume some agents will be trend followers. They will buy winners and sell losers. And some fraction will be contrarians, acting in the reverse. Now assume that both groups are equally divided, and the system's path will depend on the fraction of total capital possessed by either group.

When I began my career in finance in the mid-1990s, it seemed like these groups were roughly in balance. There were giant contrarian pools of capital like Sanford Bernstein, Brandes, Templeton and Longleaf and giant gunslingers like AIM and Janus. And a great middle ground that comprised a mix — Fidelity, Capital Group, T. Rowe Price et al. And the return-generating process depended on the predominance of companies reversing trends (Apple, IBM, Continental) versus companies extending their lead (Amazon, Adobe, Google). That process was relatively balanced from the late 1990s till the GFC. And so the two groups waxed and waned, but there was enough balance in impulses to ensure a roughly equal amount of capital resided in either group.

Starting in 2013 a small group of technology franchises that had domain superiority benefited from a phase shift to 5G and mobile-first services, cloud software, big data and cybersecurity, among others. This fundamentally altered the landscape. The winners benefited from technical monopolies, increasing returns to scale and network effects — that extended their dominance beyond horizons that, in prior eras, might have attracted competition. The winners simply kept winning. Now consider what happens in our simulation. The "trend follower" agents start gathering a disproportionate share of assets. But there's one important feature of the simulation I left out that now becomes relevant. Over time, each agent gets to alter their nature. Imagine a soccer game where the losing side has the option of trading out their jersey for the winning team. Pretty soon, you have 22 players shooting on an empty goal. You can imagine where the final score ends up.

We have lived through a dramatic period in markets in which the first have regularly ended up first. Over the trailing 10 years, the U.S. equity market has returned a compounded annual return of 13% versus 5% for the rest of the world. The technology-heavy Nasdaq 100 index has beaten the S&P 500 by 5% annualized over the same period.

While acknowledging that the past may be prologue, we have positioned portfolios slightly against the perpetuation of the prior trends. We have expressed this contrarian tact in three ways. We are overweight a selection of high growth names outside of the Magnificent Seven that embed similar growth themes at better valuation relative to their growth rates. We call this strategy Systematic Alpha because it captures a broad swath of names held by hedge funds with superior track records of stock selection. Secondly, we have overweighted Europe relative to the U.S. European stocks are trading on a multiple of earnings that is two standard deviations cheap relative to their historical discount to the U.S. Third, we are overweight a basket of defensive growth names in the U.S. that trade on a cheaper price earnings ratio relative to its growth rate than the mega cap tech names.

When Jesus and his disciples leave Jericho to go up to Jerusalem, he describes the Kingdom of Heaven with a complex parable that he closes with the promise that "the last shall be first." Thankfully, our investment thesis is not predicated on the End of Days. We will be amply rewarded if the arc of the universe bends closer to a more equitable repartition of rewards.

—T. Brad Conger, CFA, Chief Investment Officer