It doesn't make sense for value investors to bar investments simply because (a) they involve high-tech companies that are widely considered to have unusually bright futures, (b) their futures are distant and hard to quantify, and (c) their potential causes their securities to be assigned valuations that are high relative to the historic averages. The goal at the end of the day should be to figure out what all kinds of things are worth and buy them when they're available for a lot less.

–Howard Marks

July 19, 2024

S&P 500 Rallies 15% in the First Half of 2024, Led by AI Heavyweights

The first half of 2024 brought a robust 15% surge in the S&P 500, fueled mostly by a handful of stocks that investors see as the prime beneficiaries of artificial intelligence (AI). Meanwhile, the broader market, as reflected by the S&P 500 Equal Weighted Index, posted a modest gain of 5%—the third-largest gap between the two indices since 1989. In fact, nearly 40% of the S&P 500 (roughly 200 stocks) actually declined in the first half of the year.

The Nasdaq Market Intelligence Desk neatly summed up the current state of affairs: "Q1 was a rising tide that lifted all boats, but Q2 revealed a tale of two tapes with poor market breadth and selective gains among large-cap growth stocks."

This technology-driven advance isn't a recent phenomenon. Over the past 3 years, the S&P 500 Equal Weighted Index has risen by a cumulative 8% even as the tech-heavy market-cap-weighted index has gained 27% (through June 30). Such subpar performance by the Equal Weighted Index is a far cry from its historical average gain of about 33% over all rolling 3-year periods since 1980.

Index concentration plays a big role in this divergence. As of June 30, the 25 largest components of the S&P 500 had a market cap equal to the rest of the index combined, with the top 10 stocks alone accounting for 37% of the S&P 500's total market cap—a level of concentration we haven't seen since the dotcom bubble. Jason Zweig of the *Wall Street Journal* notes that such high levels of concentration have historically been unsustainable, and although only time will tell whether history will once again repeat itself, we're betting it will.

The period leading up to the dotcom crash, when we saw similar divergences, suggests other parallels as well. Following the crash, for example, growth stocks lagged, and value stocks experienced a catch-up phase after prolonged underperformance.

The Magnificent Seven's Dominance

Seven tech titans, popularly called the "Magnificent Seven," were the stars of the show in 1H 2024, contributing ~61% of the S&P 500's gains. (Nvidia alone accounted for 31% of the index's rise.) In 2Q gains were even more concentrated, with Nvidia, Apple, and Microsoft alone accounting for over 90% of the S&P 500's price appreciation amid continued enthusiasm about AI. According to the *Wall Street Journal*, AI companies soared an average of 14.7%, while non-AI firms saw a 1.2% decline during 2Q. But Magnificent Seven stocks are far from cheap, trading at an average of 37x their forward earnings versus the S&P 500's 21x.

The Magnificent Seven have significantly influenced S&P 500 returns since 2021, contributing 33% in 2021, 56% in 2022, 63% in 2023, and 61% so far in 2024 (as of June 30). But their performance has varied widely. In 2021, the worst-performing member advanced by a modest 2%, while the best-performing stock surged by an impressive 125%. In 2022, they weren't so magnificent at all, with a performance range that spanned from -27% to -65%, and a median decline of 44%. Then in 2023, not a single Magnificent Seven constituent was left out of the rebound rally, as they posted a range of returns from +48% to +239%. And this year the volatile trend continues, with year-to-date performances varying from -20% to +149% through June 30.

Performance of "Magnificent 7" stocks in S&P 500

Returns	'21	'22	'23	YTD '24
Magnificent 7	**40%**	**-40%**	**76%**	**33%**
***Share of returns*	*33%*	*56%*	*63%*	*61%*
S&P 500 ex-Mag 7	**17%**	**-8%**	**8%**	**5%**
***Share of returns*	*67%*	*44%*	*37%*	*39%*

Source: JP Morgan Guide to the Markets.

Sector Performance

In 1H 2024, Technology led all market sectors with a +28.2% gain, closely followed by Communication Services at +26.7%. By contrast, Real Estate shares underperformed, losing 2.4%, and Materials saw a modest +4.1% gain. Interestingly, normally sleepy Utilities had a good showing, advancing +9.4% for the first half. But even this advance had an AI component, with investors wagering that the massive electricity demand needed for AI computing would be good for certain utilities.

Small Cap Underperformance

Small-cap stocks continued their underperformance, and as of June 30 they still sell ~17% below their all-time highs. Without the standout performance of Super Micro Computers, which gained 188%, the Russell 2000 would have posted a negative return for the first half of 2024, a lag largely explained by the small-cap universe's lack of AI exposure.

A Shift in Market Leadership or Another Head Fake?

The July 11 CPI report, which showed easing inflation, sparked optimism among investors for a September rate cut. On the day of the report's release, the Russell 2000 surged by 3.6%, benefiting from lower interest rate expectations—a logical advance since small-cap companies, being more reliant on floating rate debt, stand to benefit from a lower-interest-rate environment.

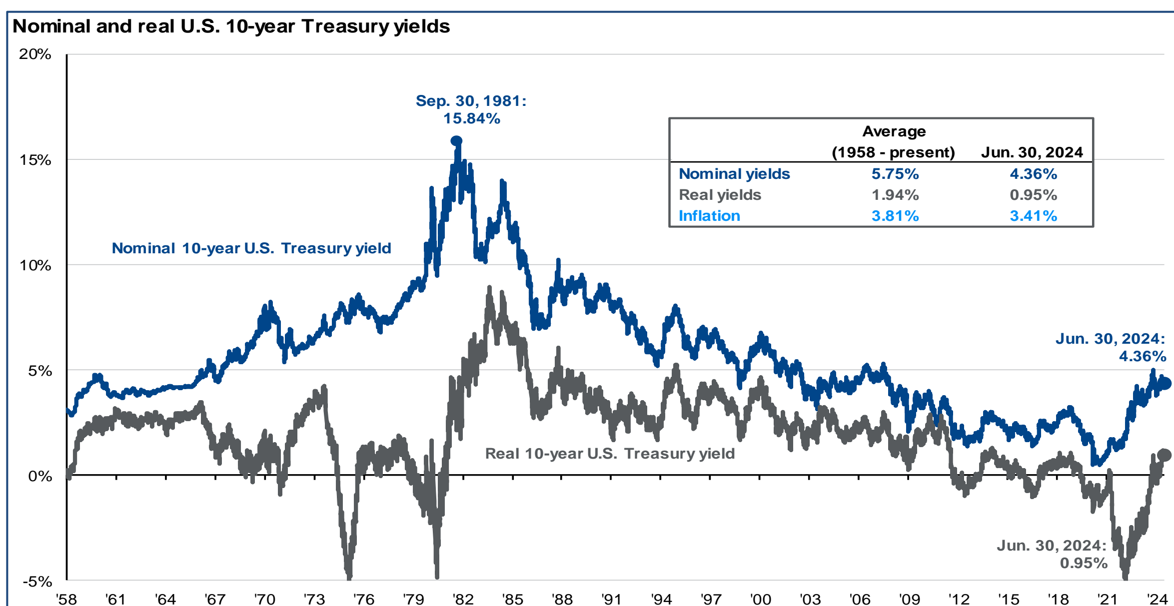
In contrast, the tech-heavy Magnificent Seven saw significant losses, collectively shedding $597 billion in market value in a single day. While the knee-jerk rotation out of some high-flying names and into these forgotten small-caps makes sense, the magnitude of the reaction is puzzling—after all, technology stocks should still be beneficiaries of lower interest rates. This divergence, though only recent, has continued. Could it signal the beginning of a broader rotation out of the Magnificent Seven and into smaller company stocks, or is it merely a temporary pause in large-cap dominance? Time will tell—*and it's worth remembering that there have been numerous false starts for small-cap stocks in recent memory.*

History does provide some hope for small-cap investors, however. During the 1994-1999 tech boom, the S&P 500 outpaced the Russell 2000 by 93%. After the bubble, small-caps significantly outperformed the S&P 500 by 114% through 2014, according to Spencer Jakab of the *Wall Street Journal* (although whether history will repeat remains to be seen). The current market environment, characterized by high valuations and concentrated gains in a few large-cap stocks, may provide an opportunity for small-caps to shine once more.

Market Valuations and the Fed

The S&P 500 index level (5,460 as of June 30, 2024) has advanced ~14% since January 3, 2022 (the previous market peak), when it stood at 4,797, but it currently trades at a similar 21.0x (fwd.) multiple of earnings. While that is an elevated multiple historically speaking (the 30-year average is 16.7x), back in March 2000 the S&P 500 traded for 25.2x (before losing 49% of its value over the following 2 calendar years). It is worth noting that the S&P 500 equal-weighted index currently sells for a more modest (but far from cheap) 16x (fwd.).

The Fed started 2Q 2024 signaling three rate cuts for the year but in the face of stubbornly high inflation is now predicting just one or two cuts, although recent inflation data have convinced the market that a September rate cut is almost an absolute certainty. We do note just how badly both the Federal Reserve (which started 2024 predicting three rate cuts) and the bond market (which began the year forecasting six to seven rate cuts) have failed at predicting both the direction and the magnitude of interest rates. In our opinion, investors are better off not trying to forecast when the Fed will cut rates (which even the Fed itself seems unable to do!) and instead concentrating on finding businesses that will perform well regardless of where interest rates stand.



Source: JP Morgan Guide to the Markets.

At the risk of echoing our last quarterly letter, whether the Fed reduces interest rates twice this year or only once, investors should view current interest rates in their proper historical perspective. At 4.36% and 0.95% (as of June 30, 2024), respectively, nominal and real yields are still low, historically speaking. The economy can function—and has repeatedly functioned—with rates at these levels or even higher. If today's figures seem high, they are high only relative to recent history.

<u>Presidential Election Year Dynamics</u>

Many investors are concerned about investing in a market that has seen one of the strongest first-half performances since the dotcom bubble. However, Bank of America research suggests that a large first-half advance has historically been bullish for stocks, noting that the S&P 500 has advanced 10%-20% in the first half of the year 26 times. In 88% of these instances, the index saw further gains in the 2H, with a median return of 10.1%. Even so, as we've already mentioned, we believe—and have believed for some time—that the best values are in the small-cap arena, not the S&P 500.

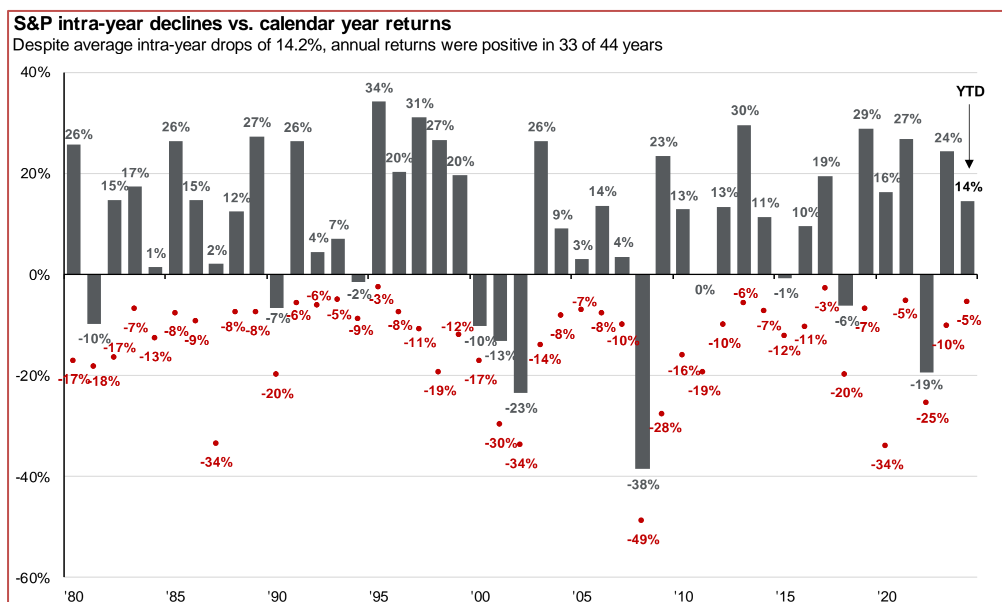
Another concern for investors is the upcoming presidential election. Historically, presidential election years have been positive for stocks, especially when a clear winner emerges before the election. However, as Jack Hough of *Barron's* points out, 46 presidents is a relatively small sample size, so statistics regarding presidential election years and stock market performance should be taken with a grain of salt.

According to Ed Clissold, chief strategist at Ned Davis Research, since 1950 the S&P 500 has risen from April 30 to October 31 during 77.8% of election years, with a 3.3% median advance from May to November. He cautions that years with a close presidential contest have seen the worst stock market performance, whereas landslides tend to produce the best.

We think that staying the course and not adjusting your portfolio based on which party holds the White House is the wisest strategy, and history bears us out. According to Charles Schwab, an investor who put $10,000 in the S&P 500 in 1961 and held only when Republicans were president would have made $102,293 by the end of last year, versus $500,476 for Democrats—but one who stayed in the index no matter which party held the White House would have made $5,119,510!

Investor Sentiment

2024 has been highly unusual in its lack of major market pullbacks. According to JP Morgan, since 1980 the average intra-year pullback has been 14.2%. The biggest S&P pullback thus far in 2024 has been a mere 5.5%, a figure that is particularly remarkable amid stubborn inflation, uncertainty surrounding interest rates, a wild presidential election contest, and significant geopolitical tensions.



Source: JP Morgan Guide to the Markets.

Financial advisor Edward Jones Investments notes that the intrayear pullback was smaller in only 4 years (1993, 1995, 2017, 2021) out of the past 4 decades. Moreover, the stock market has been relatively calm on a day-to-day basis, with only one daily 2% move in the S&P 500 thus far this year, versus an average of 21 occurrences per year since 2015. This extended period of minimal downturns has naturally fueled bullish sentiment among both professional and amateur investors alike.

According to the latest Investor's Intelligence survey, the number of bullish investors has increased to the highest level since 2021 (when the S&P 500 ended up *declining* by 18% the following year). What's more, bearish investors have declined to the lowest level since late March. As contrarians, we are somewhat concerned by this widespread bullishness.

Interestingly, despite the overall bullish sentiment, investors have not been voting with their wallets. According to the Investment Company Institute, investors withdrew a net $9.3 billion from U.S. stock funds in the quarter and invested $81.1 billion into bond funds.

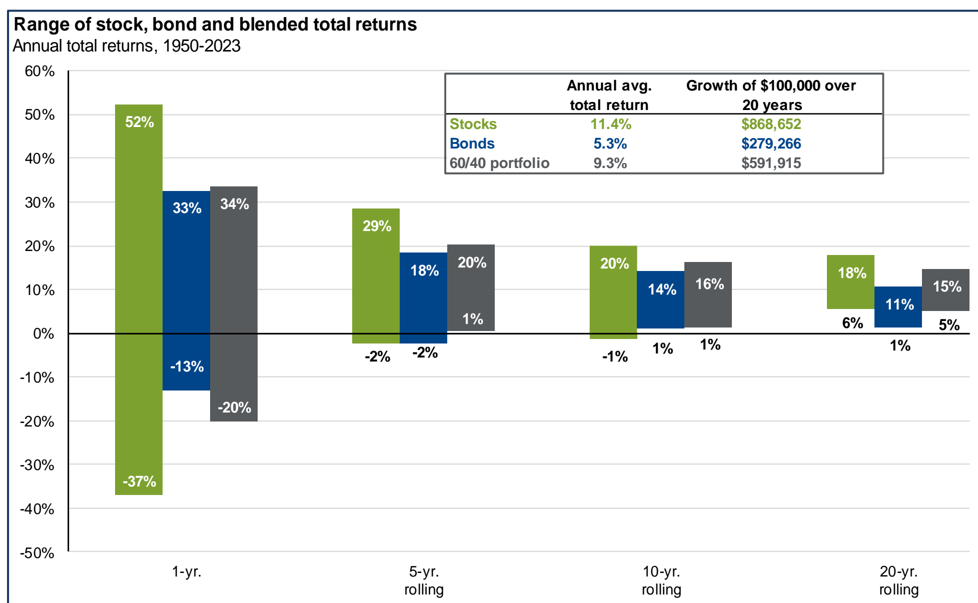
How Can I Invest in a Market That Is Selling at All-Time Highs?

As value investors with a contrarian streak, we like to invest when no one else wants to buy, so investing while the market is at or near all-time highs naturally feels uncomfortable to us. Historically, however, not investing simply because the market is at (or near) an all-time high has been a mistake. Trying to time the market is extremely difficult, and the pitfalls of doing so are well documented. Since 1950, the S&P 500 has closed at an all-time high in 6.6% of trading sessions, making today's situation less rare than it might seem. And historically there hasn't been a significant difference in future returns between investing on a random day versus investing on days when the S&P 500 was at an all-time high.

Most important, we invest in stocks, not markets. Although the major indices are arguably overextended at present, we are still finding stocks that we believe are intrinsically undervalued (particularly among small and mid-cap shares).

The Long-Term View

We've said it before and we'll say it again: individual investors stack the odds of investment success in their favor when they stay the course and take a long-term view. According to data from JP Morgan, there has never been a 20-year period when investors did not average a gain of at least 6% per year in the stock market. Past performance is certainly no guarantee of future returns, but history does show that the longer a time frame you give yourself, the better your chances become of earning a satisfactory return.



Source: JP Morgan Guide to the Markets.

As always, we're available to answer any questions you might have. In addition, please contact us if your financial circumstances have changed, so that we can adjust your portfolio(s) accordingly. You can reach us at jboyar@boyarvaluegroup.com or (212) 995-8300.

Best regards,

Mark A. Boyar

Jonathan I. Boyar

IMPORTANT DISCLAIMER

Past performance is no guarantee of future results. Investing in equities and fixed income involves risk, including the possible loss of principal. *The S&P 500 Index is included to allow you to compare your returns against an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks representing all major industries. The Russell 2000® Value Index measures the performance of the small-cap value segment of the U.S. equity universe. It includes those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values. The S&P 1500 Value Index measures value stocks using three factors—the ratios of book value, earnings, and sales to price—and the constituents are drawn from the S&P 500, S&P Midcap 400, and S&P SmallCap 600. The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ. The volatility of the above-referenced indices may materially differ from that of your account(s), and the holdings in your account(s) may differ significantly from the securities that constitute the above-referenced indices. Your results are reported gross of fees. The collection of fees produces a compounding effect on the total rate of return net of management fees. As an example, the effect of investment management fees on the total value of a client's portfolio assuming (a) quarterly fee assessment, (b) a $1,000,000 investment, (c) portfolio return of 8% a year, and (d) a 1.50% annual investment advisory fee would be $15,566 in the first year, with cumulative effects of $88,488 over 5 years and $209,051 over 10 years. This material is intended as a broad overview of Boyar Asset Management's philosophy and process and is subject to change without notice. Account holdings and characteristics may vary, since investment objectives, tax considerations, and other factors differ from account to account.*