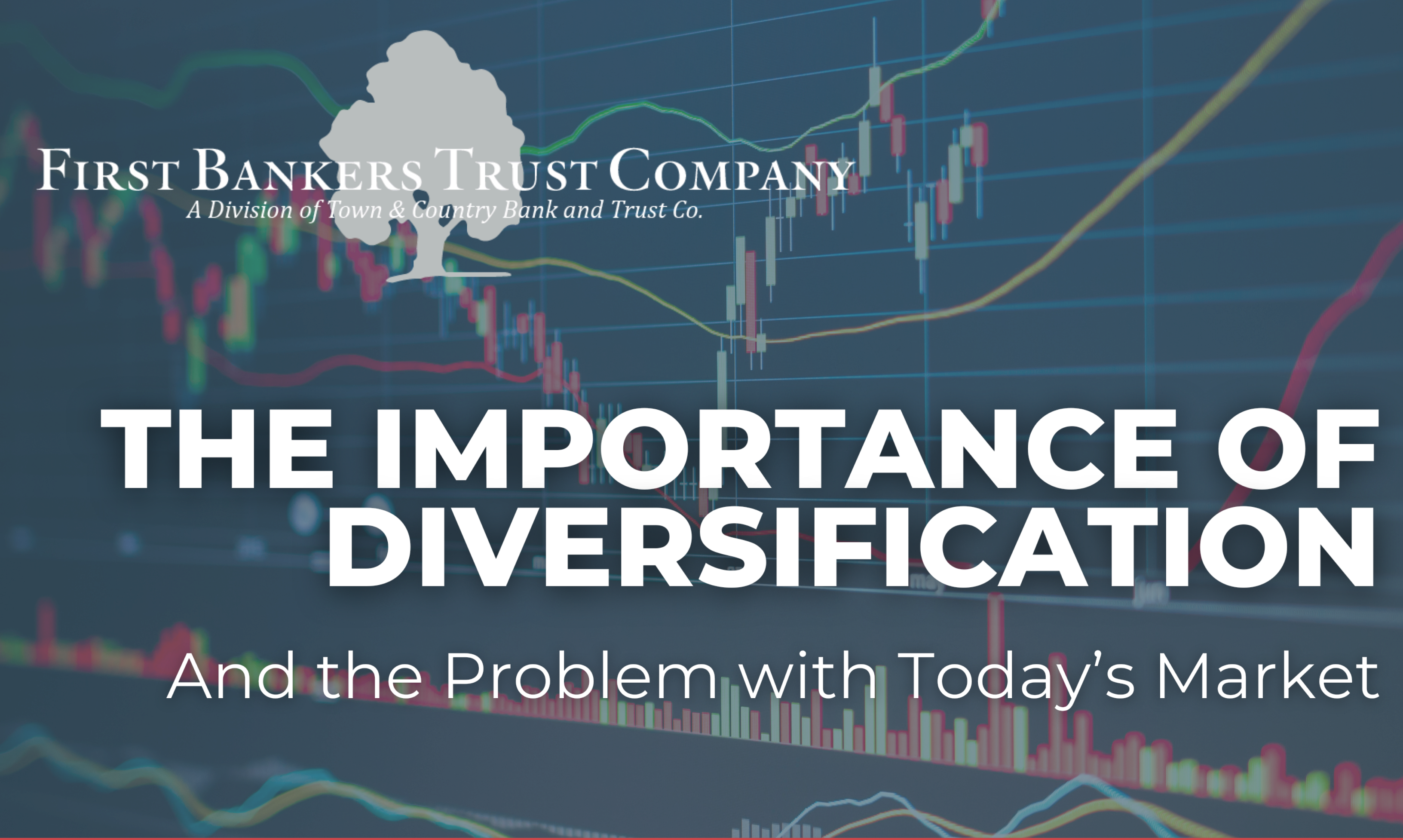


First Bankers Trust Company
A Division of Town & Country Bank and Trust Co.

THE IMPORTANCE OF DIVERSIFICATION

And the Problem with Today's Market

Written By:
Your First Bankers Trust Team

Investing can teach one numerous lessons: quantitative, qualitative, business, economics, and an abundance of psychology. Arguably the most important lesson of investing is that of simple diversification. The math behind diversification is simple: if you put all your eggs in one basket and that basket goes down 50%, you are in some serious pain. Even a basket of ten eggs with nine delivering a solid 10% return but one egg dropping by 50% lowers your return all the way to 4%.

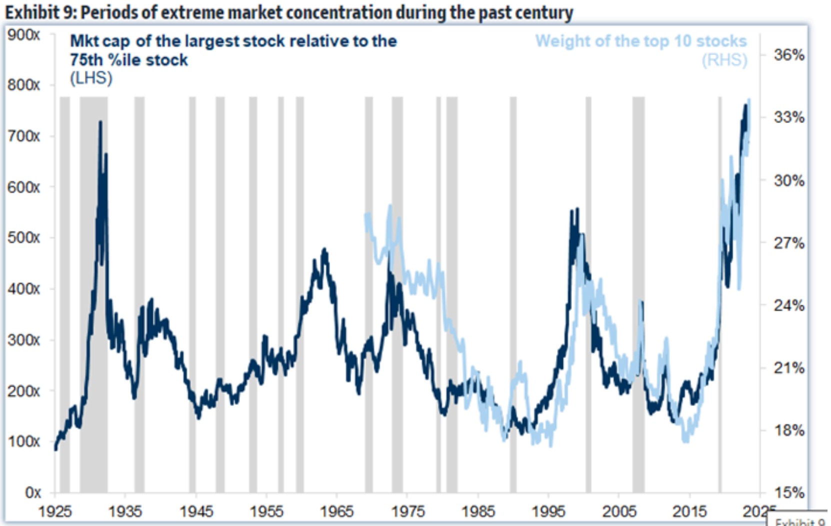
The intuition behind diversification is simple too: market participants are investing in the future, and nobody can predict the future with precision and often enough the market can't even predict the general direction. No matter how confident you are in your research and analysis, it is important to diversify because even if you are right, as John Maynard Keynes famously quipped, the market can stay irrational longer than you can stay solvent. In other words, the price can move against you and your correctly predicted fundamentals for longer than your desired holding period or forecast. Of course, the best argument for diversification is the classical "black swan" event, whether that be at a micro level – a rockstar CEO passing away suddenly – or the macro level – pandemics, anyone? Investing is much like baseball: a seemingly middling success rate still lands you in the Hall of Fame, so diversification is a powerful tool to allow portfolios to score runs even with some team members striking out.

When the Easy Button Fails

We finished last year highlighting the impact the "Magnificent 7" had on the S&P 500 Index. As a reminder, the Magnificent 7 is simply the seven largest stocks in the S&P 500 Index: Apple, Microsoft, Google, Amazon, Telsa, Meta (formerly Facebook), and Nvidia. The S&P 500 is a market-capitalization weighted index, so the largest companies can have an outsized impact on the index. This year started out with a strong, broad-based rally. Yes, the Magnificent 7 continued its incredible streak of outperformance, but most industries and stocks experienced a good first quarter. That changed dramatically in the second quarter, as the S&P 500 Equal Weight Index, in which the 500 constituents are weighted equally rather than by market capitalization, was down roughly 3% while the Magnificent 7 powered ahead another 17% and thus lifted the traditional S&P 500 Index to a ~4% return for the quarter.

This massive dispersion is drawing a lot of attention, and deservedly so. As the chart from Goldman Sachs showcases, we are in extremely rare territory. The top 10 stocks in the S&P 500 (broadening out ever so slightly from the Magnificent 7), now account for roughly 35% of the index. Our estimates put the Magnificent 7 currently at ~30% of the index. At just over 4% average position, it may not alarm on face value. However, both market history and a study of capitalism should serve as a warning sign.

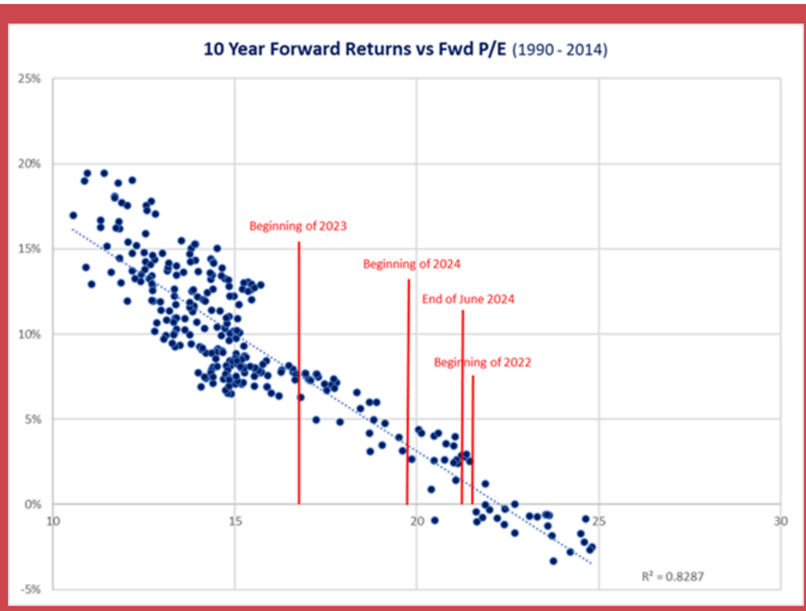
Exhibit 9: Periods of extreme market concentration during the past century



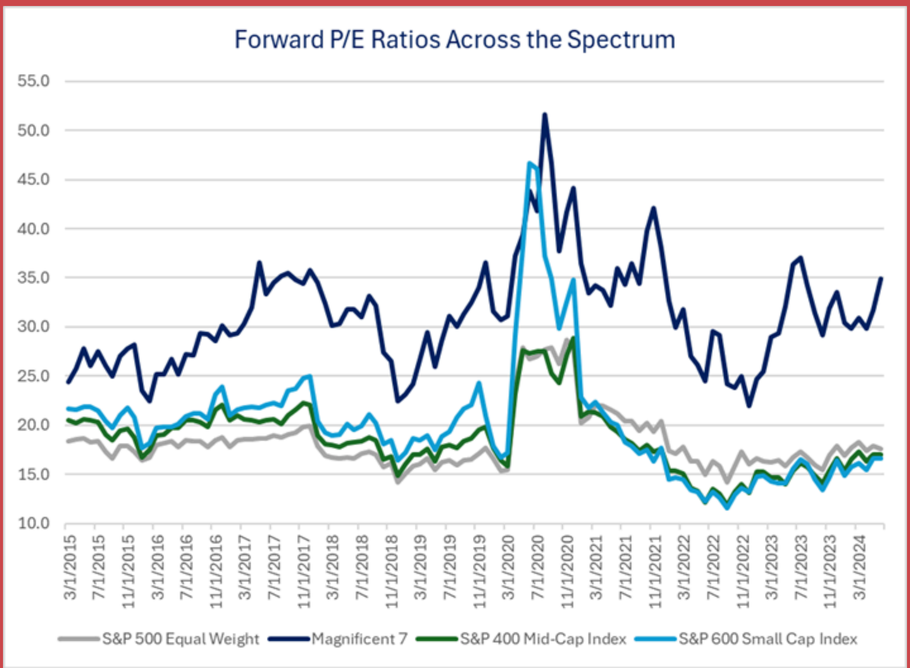
Universe consists of US stocks with price, shares, and revenue data listed on the NYSE, AMEX, or NASDAQ exchanges. Series prior to 1985 estimated based on data from the Kenneth French data library, sourced from CRSP, reflecting the market cap distribution of NYSE stocks

Source: Compustat, CRSP, Kenneth R. French, Bloomberg, Goldman Sachs Global Investment Research

These are a collection of fabulous businesses. Well, at least six of the seven, in our opinion. Their market power and contributions to the U.S. economy are incredible. But perhaps another warning sign besides a simple percentage of the index viewpoint is the price the market is willing to pay for the future earnings of these companies. The S&P 500 as a whole finished the second quarter at 21.2X the next twelve months of forecasted earnings. As the chart to the right shows, that lines up with very low expected returns over the next ten years.



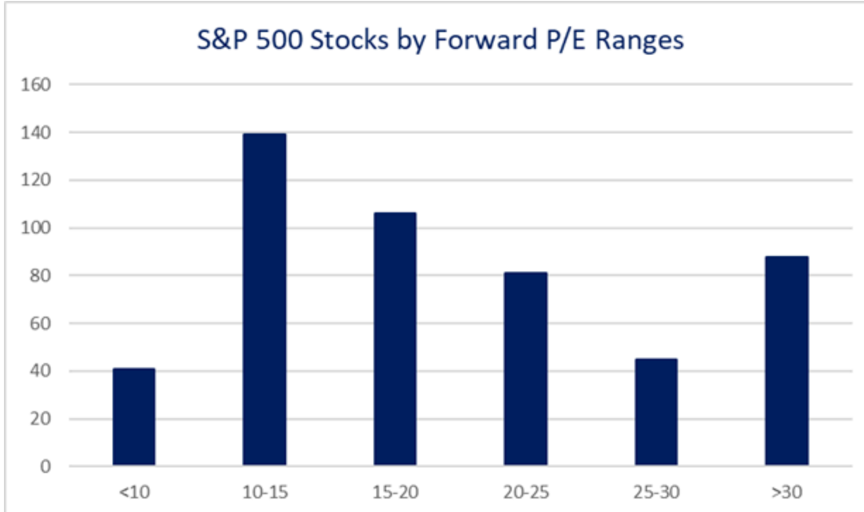
The market's habit of ranging from euphoria to despair makes it extremely unlikely that we get a smooth 2% annual return from here. Furthermore, the market also finds a way back to equilibrium to allow new entrants the opportunity to buy at reasonable prices and earn solid risk-adjusted returns. In fact, the patient new entrants can often prey on the despair that often follows euphoria. Even with the worst recession since the Great Depression interrupting the market, those that bought at reasonable valuations after the 2000 tech bubble popped were rewarded with almost a doubling of their money over the next ten years (when including dividends).



Let's dig a layer deeper into the market to see if we are approaching a full-blown replica of the 2000 tech bubble. The price the market is paying for a dollar of the next twelve month's of earnings for the Magnificent 7 drastically outstrips what it will pay for other index constituents. A valuation premium is always likely to exist for the biggest companies. They got to where they are through superior fundamentals and thus deserve a premium. But at what point is the market overpaying for them, both in relative terms and absolute terms?

In the near-term, these companies have faster expected revenue growth, higher margins, and several are virtual monopolies. The premium is deserved. We're not disputing that. In fact, we think it is likely several will overcome their massive valuations and deliver solid returns from here (market-beating returns to be determined!).

The reassuring information despite the lower implied returns for the easy button index solution is that multiples remain reasonable below the surface, although plenty of stocks outside the Magnificent 7 also trade at extremely high multiples of earnings. Again, some deserve premium valuations, but one has to question if they all do.



The Bull Case for the Continued Concentration

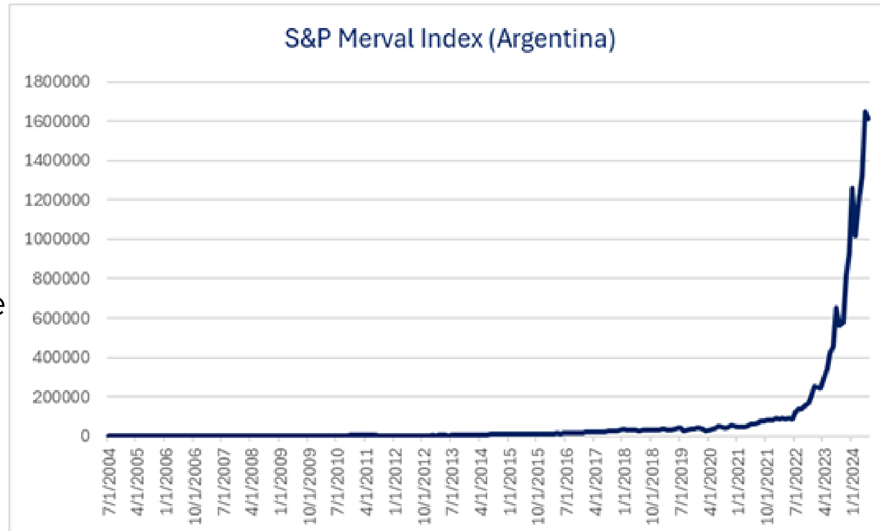
Our view on the Magnificent 7 coming into the year was that the "trade" was long in the tooth, and it was time for the group to see greater dispersion in returns: some due to deteriorating fundamentals, some due to excessive valuations, some due to a need to price risk for competition. The first quarter proved us correct. Several stocks not only broke their correlation from the group but, gasp, went down in the first few months. However, the second quarter made our call seem like a fleeting dream. The fact that this "trade" returned beckons us to revisit the topic, and of course, question where we may be wrong.

Most highly concentrated markets	
Index	Weighting of top 10 stocks
FTSE 100	46%
Nikkei 225	37.8%
S&P 500	35%
Euro STOXX	26.2%
MSCI Emerging Markets	22.8%
TOpix	19.3%
MSCI ACWI	18.3%

While the U.S. has rarely seen markets this top-heavy, many other countries have seen this level of concentration for a long time. We believe this is likely due to less dynamic economies with less competition and disruptive innovation. If Nvidia can really maintain its virtual monopoly on GPU's (the semiconductor segment it dominates) at 75%+ gross margins sold largely to other Magnificent 7 companies, shouldn't the market question the capabilities of those companies to innovate a way around the tens of billions being allocated? Jeff Bezos, the founder of Amazon, famously stated: "your margin is my opportunity". Perhaps Nvidia isn't the loser and a small Nvidia customer started in a garage creates the best consumer Artificial Intelligence (AI) platform. Should Google trade at these valuations when it is on the cusp of having its massive search moat disrupted?

We don't know what the outcome of the AI arms race will be. Nobody does. But the fact that the Magnificent 7 "trade" is back should alarm market participants. If the arms race keeps feeding the beast of capital expenditures and a creative disruption does not occur, it is fair to argue the whole group should lose some of its premium. In that situation, in which American companies do not generate strong returns on invested capital and innovation slows or ceases, perhaps a permanently concentrated stock market persists European style. But it is worth noting European stocks trade at much lower valuations than American counterparts due to less innovation and lower returns on invested capital.

As we noted, the Magnificent 7 are not the only stocks trading at incredibly high valuations. Some observers of our government's massive debt burden believe it will end in hyperinflation. Thus, stocks are the only way to preserve wealth and these cynics point to the performance of Argentina's stock market during hyperinflation. Others simply look at the sequence of events (a 1919 pandemic to start) and call for a roaring 20's stock market bubble. Some may even draw the parallels to the tech bubble in calling for higher stock prices for this group. Whatever the thesis, it is strange to witness the bull case for this basket of stocks to become, intentionally or unintentionally, increasingly cynical.



What Does this Mean for Portfolios?

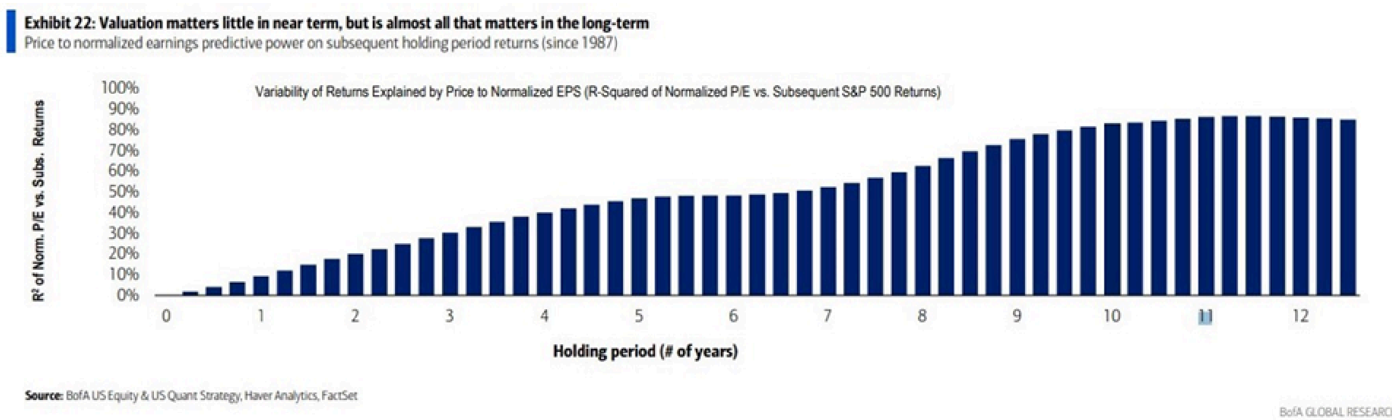
We are still believers in the incredible engine that is the American economy. While inflation risks still linger and have the potential for a flare up next year, we believe in a dynamic economy that will deliver supply to excess demand and thus cool inflation (if with a delay). We are still believers that valuations matter. We are still believers that innovation will continue and disrupt incumbents.

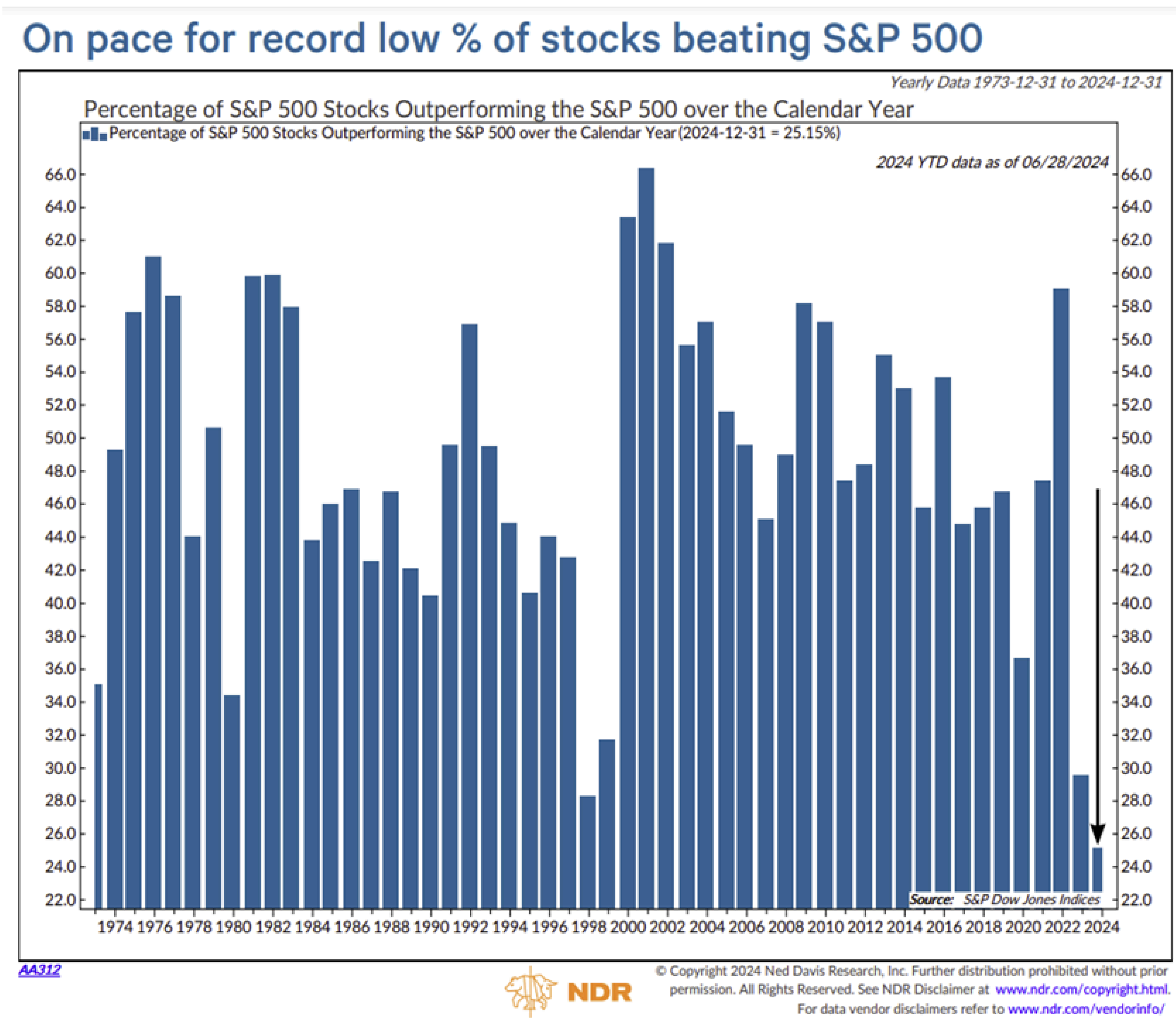
Finally, at the time of this writing, we are still believers that there are attractive segments of the stock market to make strong long-term returns. Valuations remain reasonable in many places, and we believe in a dynamic corporate America that extends beyond the Magnificent 7. We will remain disciplined in our strategy no matter what the AI arms race produces and look to continue helping clients navigate interesting times and reach their goals!

Sincerely,
Your First Bankers Trust Team

Chart Appendix

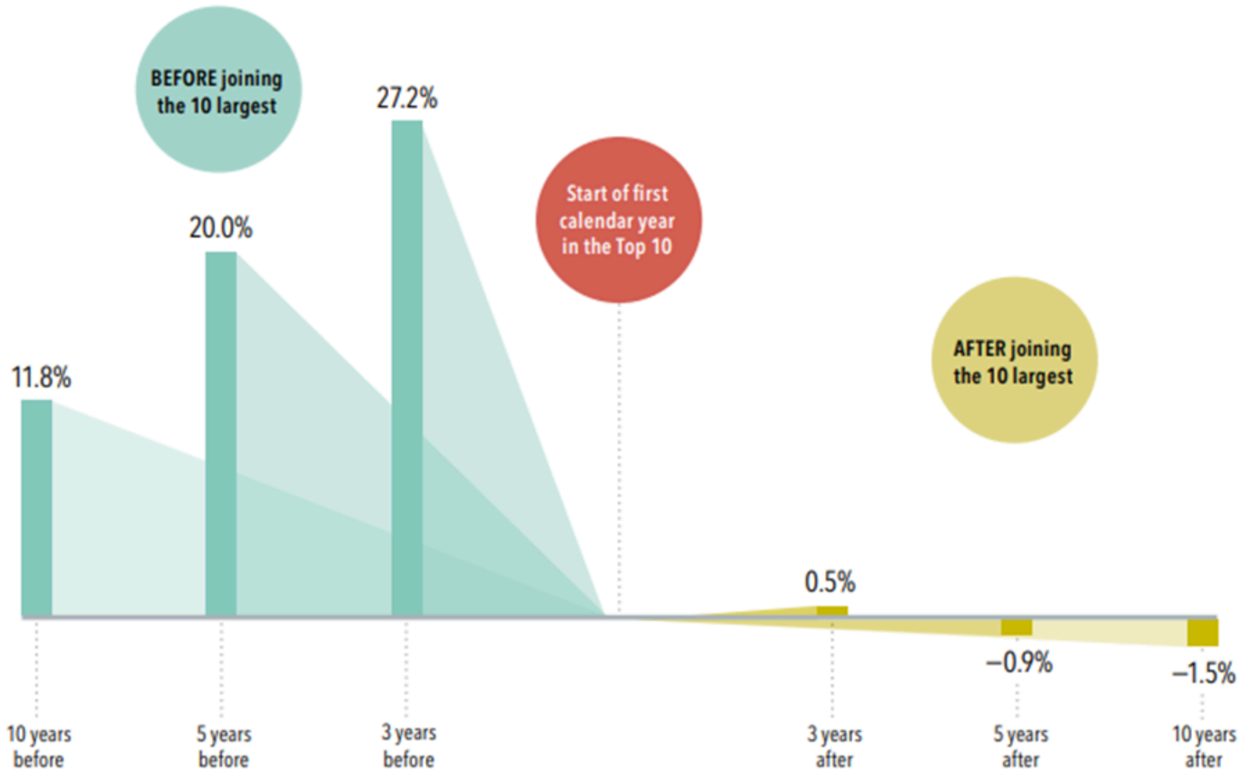
Sources: Bloomberg, First Bankers Trust Research, Bank of America Global Research, Ned Davis Research, A Wealth of Common Sense, Piper Sandler





AVERAGE ANNUALIZED OUTPERFORMANCE OF COMPANIES BEFORE AND AFTER THE FIRST YEAR THEY BECAME ONE OF THE 10 LARGEST IN THE US

Compared to Fama/French Total US Market Research Index, 1927–2023



The 2000 Momentum Trade Was Very Low Quality

Unlike Today, The 2000s Mo Bubble Was Fueled By Unprofitable/Long Duration Stocks

Index Wgt Of Lowest Decile Of Profitability Stocks

(French & Fama)