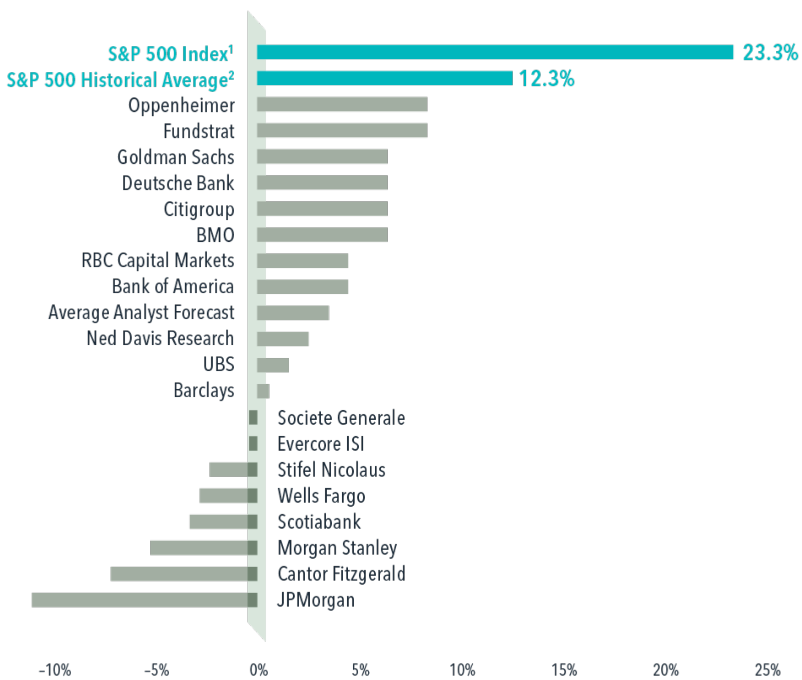
Analyst, Schmanalyst

The first quarter is a great time to reflect on the importance of tuning out those financial industry experts who make confident-sounding predictions about exactly what will happen in the coming year. All that's needed to remind us of their folly is an introspective examination of how those predictions panned out last year.

For reference, US large-cap stocks rose by 23.3% in 2024. This figure far exceeded the expectations of analysts polled at the beginning of the year, none of whom believed that the US large-cap market would grow by even its historical average rate of return. In fact, nearly half of the analysts predicted a negative year for the index. For their sake, we hope those industry-famous analysts didn't miss out on returns from US stocks during such a strong year.

The wide dispersion and wanton inaccuracy of predictions from the supposedly smartest and best-resourced analysts in the country highlight exactly why we at Rockwood do not make asset allocation decisions based on forecasts. Prognostication-based strategies have no place in a disciplined and evidence-based investment process. In order to earn the long-term average returns to which you are entitled, we know that you need to be "in your seat" when the market delivers bursts of exceptional returns.

Equity analyst predictions vs. actual US large-cap index calendar year return in 2024



Past performance is not a guarantee of future results.

The Surgeon General vs. the S&P 500

If the surgeon general were an investment expert, he or she would not waste any time slapping a warning label on today's S&P 500. Concentration in major equity market indices is at a 50-year high. The top five companies in the S&P 500 comprise approximately 30% of the index … yikes! This figure is more than double the 14% average since 1990. Further compounding the issue is that the five stocks — Apple, Nvidia, Microsoft, Amazon, and Google — are all technology stocks, meaning that they are highly correlated with one another.

Many investors choose an index fund like the S&P 500 in hopes of achieving diversified exposure to a particular segment of the market. However, it is certain that the majority of investors are unaware of the concentration risk that recently has been embedded in many major market indices.

If an investor owns the S&P 500 today, they are effectively asserting that "**I am choosing to put 30% of my money in five highly correlated technology stocks, and then I'll attempt to more responsibly invest the other 70% in the *S&P 495*.**" Of course, there is no such thing as the S&P 495 — we just made that up for effect. But we are sure you get the point we are making — owning the S&P 500 as an investment strategy is fraught with risk that many investors won't see coming.

Incidentally, we have no issue at all with the S&P 500 as used in its role as a commercial benchmark for market cap-weighted large-cap US stocks. It just shouldn't be mistaken for a prudent investment strategy. Commercial benchmark? Just fine. Preferred strategy for portfolio implementation? Not so much.

Impact on Portfolios

Such intense concentration in market indices can have equally hidden and profound effects on many unsuspecting investors' portfolios. The issue silently simmering is that a handful of mega-cap stocks drive the majority of returns for the indices. The issue is compounded by the notion that many of these stocks are in the information technology sector.

At the time of writing, technology stocks account for 33% of the S&P 500 Index and 60% of the Russell 1000 Growth Index. Therefore, an index like the S&P 500 now acts more like the information technology sector than it did a decade ago when the sector was less than 13% of the index, and certainly more than in 1990 when the sector had just a 6% weighting.

It isn't just sector concentration that may lead to changes in return characteristics but factor exposures as well. Many of the mega-cap stocks, such as Nvidia, Amazon, and Microsoft, are more growth oriented and can have negative

SURGEON GENERAL'S WARNING

The S&P 500 Is Significantly

correlations with interest rates. These factors are in stark contrast to other stocks such as ExxonMobil or General Motors (two companies that have been in the top five of the S&P 500 many times in the past), which have typically positive correlations with rates. This dynamic may be one of the drivers behind the increasing correlation of the S&P 500 and the US bond market in recent years — which, of course, can lead to increased portfolio volatility.

The silver lining for well-advised investors is that the faster pace of change these days and shorter competitive advantage periods may make room for new companies to ascend to the top of the charts. If change is accelerating, it may make new and smaller companies that are destined to become the leaders of tomorrow even more attractive. Of note, these small- and mid-cap companies are historically inexpensive on a price-to-earnings basis relative to large-cap stocks. Importantly, you already own them all and you don't need to pick the winners to participate in the ascendence of smaller stocks when it arrives.

The moral of the story is accepting index weighting as it happens to appear and mistaking it for a sound investment strategy is going to end poorly for many investors who simply don't understand what they own. We're sure the surgeon general would agree.

Source: Alger 2025, Standard & Poor's, Vanguard.

Perspective About Tariffs and Equity Markets

One of the focal points following the presidential election is the potential for an increase in tariffs applied to goods produced outside the US. Many investors have wondered what this could mean for markets both at home and abroad.

We don't have to look far for a meaningful data point. A recent period offering perspective on this issue is President Trump's first term in office. Beginning in 2017, the administration eyed China as a target, and by 2018, they began imposing tariffs across a range of products. The next couple of years saw back-and-forth trade discussions that eventually led to an agreement, though preexisting tariffs remained in place. Despite a wave of forecasts to the contrary, China posted higher cumulative returns than the US and the MSCI World ex USA Index over the four years of Trump's term.

The graphic below reminds us that markets are forward-looking, and it's likely that economic impact from initiatives such as tariffs already are reflected in current market prices. When these expected developments come to pass, the effect on markets may be quite uneventful.

Growth of $1 during President Trump's first term,
January 2017–December 2020

Past performance is not a guarantee of future results.

In USD. Data shown from January 1, 2017–December 31, 2020. Growth of wealth shows the growth of a hypothetical investment of $1. Data presented in the growth of wealth chart is hypothetical and assumes reinvestment of income and no transaction costs or taxes. The chart is for illustrative purposes only and is not indicative of any investment. Performance includes reinvestment of dividends and capital gains. MSCI China Index and MSCI World ex USA Index returns are net dividend. Tariff events data sourced from Reuters. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.