

## **Newsletter: July 2024**

Through the first six months of the year, the S&P 500, which is a market cap-weighted index, generated a total return of +15.3%. The S&P 500 Equal Weight index, which applies an equal weight to each S&P 500 constituent regardless of market cap, generated a total return of only +5.1%. The difference between the returns of the two indices through the first half of the calendar year is the largest such performance gap since returns data for the S&P 500 Equal Weight began in 1990 and reflects the extraordinary outperformance recently of large stocks over small.

The dispersion in stock returns based on market cap is even more pronounced when comparing the S&P 500 to the Russell 2000, which comprises small cap and midcap stocks and which has generated a year-to-date total return of only +1.7%. The difference between the returns of these two indices through the first half of the calendar year is the largest such performance gap since returns data for the Russell 2000 began in 1979.

Much of this dispersion in stock returns based on market cap can be attributed to a single stock: NVIDIA, which designs a computing technology known as graphics processing units (GPUs), currently has a \$3 trillion market cap and a nearly 7% weighting in the S&P 500. The stock generated a total return of nearly 150% during the first half of the year, accounting for roughly one-third of the S&P 500's year-to-date return.<sup>1</sup> Given that there are 499 other stocks in the index, this concentration of returns in a single stock is astounding and, as far as we can tell, unprecedented. There are half a dozen stocks in the S&P 500 with market caps in excess of \$1 trillion, and the performance of just those stocks—which include, in addition to NVIDIA, Alphabet (Google), Apple, Amazon, Meta (Facebook), and Microsoft—accounted for considerably more than half of the S&P 500's year-to-date total return. 74% of the stocks in the S&P 500 underperformed the index itself during the first half of the year.

We believe that this extraordinary concentration of returns, whereby a small number of individual stocks have made a disproportionate contribution to the returns of the overall index, probably reflects a few different factors. First, as we have discussed in prior letters, there continues to be a great deal of exuberance in the field of artificial intelligence (AI), which has led to substantial appreciation in the share prices of those companies perceived to be beneficiaries of AI, including the largest technology companies mentioned above. For many of these companies, however, the opportunity to generate substantial revenue from AI remains speculative and unfulfilled, while the investment in AI computing capacity is already consuming significant amounts of capital. As a provider of GPUs, NVIDIA earns revenue from AI-related investment by some of these other businesses, but the long-term earnings opportunity that AI potentially represents for these other companies remains difficult to quantify.

Second, as we discuss further below, the rate of growth in the broader economy has been uneven, which is reflected in the more pedestrian returns from a market index such as the Russell 2000, which represents a broad cross-section of US businesses. Many businesses have struggled to manage the effects of elevated and volatile inflation and of higher interest rates, from which the mega-cap technology companies have been comparatively insulated.

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<sup>1</sup> NVIDIA's weighting in the S&P 500 at the beginning of the year was approximately 3%.

Finally, the fact that the S&P 500 is a market cap-weighted index can lead to momentum-driven behavior: a company's share price increases; its weighting in the index therefore increases; of every new dollar invested into a corresponding index fund or exchange-traded fund, a greater portion is used to purchase more of the stock, which in turn leads to further increases in its market cap, etc. Momentum-driven behavior is also a more general phenomenon, whereby market participants buy a stock simply because its share price has been going up. Examples include the dot-com frenzy of the late 1990s and the resurgence of the so-called meme-stock craze more recently. We suspect that many recent buyers of NVIDIA have been similarly motivated. In the long run the valuation of any stock is anchored by the earnings power of the underlying business, but in the short run its share price can reflect any number of more fleeting phenomena, such as greed or the fear of missing out. In that sense, we can speak of both the wisdom and the madness of crowds.

With respect to the economy, there are two topical questions that we believe can be mutually illuminated via the connection between them. The first is why so many people seem to have negative perceptions of the economy during a period of continued economic growth, and the second is whether higher interest rates are in fact good or bad for the economy. Regarding the former, polls and surveys suggest that a significant number, even a majority, of people believe that the economy is in a recession, despite the fact that Gross Domestic Product (GDP), which measures overall economic output, continues to expand and the unemployment rate remains low. Regarding the latter, the conventional framework is that higher interest rates have a negative impact on economic growth, as debt-financed consumption and investment contract in response to more expensive financing costs. A more recent speculation, however, is that households with net financial assets and fixed-rate mortgages are generating greater net interest income in a higher-rate environment and therefore have more money to spend.

We believe that the distribution of household incomes is the key variable that begins to thread together the foregoing observations. Higher-income households tend to have net financial assets and little to no debt, other than perhaps a mortgage, which often has a fixed interest rate; thus, their net household incomes tend to increase in response to higher interest rates. Middle- and lower-income households, by contrast, are more likely to have non-mortgage debt—whether credit card, auto, and/or student loans—and that debt is more likely to have a variable interest rate or to have been taken on after interest rates had already begun to rise. There is also a stark difference across households in the ability to withstand the impact of higher prices. The Consumer Price Index is 12% higher than it was at the end of 2021 and 21% higher than it was at the end of 2019, so the cumulative impact of inflation in recent years has been quite significant, which has made it more difficult for many households to save part of their income or to avoid taking on additional debt. Finally, wealthy households own a disproportionate amount of stocks and have therefore captured a disproportionate share of the benefits of a rising equity market.

We find it plausible that the economic benefits of higher interest rates and of a rising equity market, which on balance are concentrated among a numerical minority of total households, are offsetting the economic costs of higher rates, which, along with inflation, are negatively affecting a numerical majority of households. This would seem to reconcile polling and survey data indicating widespread frustration with the economy, on the one hand, and positive GDP growth, on the other. It might suggest, for instance, why packaged foods and other consumer staples companies have been complaining about a “weak consumer,” while travel-related spending remains robust.

Thus, both the S&P 500 and the economy seem to be characterized by an overall strength that is unevenly distributed, with a relatively small number—of stocks and of households, respectively—making a disproportionate contribution to the aggregate result.

In our last letter, we discussed our investments in Zurn Elkay Water Solutions, Rush Enterprises, and Fortrea Holdings, all of which had market caps of \$5 billion or less when we initiated our investment. Each stock had a

rough second quarter and underperformed the S&P 500 year-to-date. Zurn's operational performance continues to impress us, and the company raised full-year guidance when it reported first quarter earnings in April. Its flattish share price performance thus far this year follows its +41% total return last year. We have been similarly satisfied with Rush's operational execution, particularly amid a still challenging freight market environment, and we expect earnings to ramp nicely off 2024's trough level over the next couple of years. Rush's underwhelming share price performance year-to-date follows last year's +47% total return.

Fortrea's performance has been more of a mixed bag. The share price had undergone a substantial rally between August of last year and April of this year, but reacted negatively to the company's first quarter earnings in May. The clinical trials that Fortrea runs on behalf of its pharmaceutical and biotechnology customers tend to last multiple years. When a customer initially awards a clinical trial to Fortrea, the latter books the value of the award into its backlog, which then declines over time as the trial progresses and the revenue is recognized. For any company for which backlog is part of running its business, the book-to-bill ratio is a measure of how much future business is being won compared to how much current business is being completed. Fortrea targets a 1.2x book-to-bill ratio on a trailing basis, and as of 3/31/24 its book-to-bill ratio since it became a public company in July of last year was 1.22x, slightly ahead of its target. In the first quarter, however, its quarterly book-to-bill was only 1.11x, to which the equity market reacted negatively.

Just two trials accounted for more than all of the gap between 1.11x and 1.2x: (i) a large pharmaceutical customer cancelled one of its own in-house trials, which freed up its own trial capacity, and as a result it brought in house the trial that had been awarded to Fortrea; and (ii) a small biotechnology customer delayed the award of one of its upcoming trials. The former situation does happen periodically, as large pharmaceutical companies both run their own trials and outsource to contract research organizations (CROs) such as Fortrea. The latter trial was in fact subsequently booked by Fortrea during the second quarter. The specific facts regarding these two trials suggest that the relative weaker book-to-bill ratio in the first quarter was not a sign of a more serious challenge facing the business but rather ordinary-course variation in bookings, which is bound to occur quarter to quarter, especially for a mid-sized business such as Fortrea where one or two trials can have a material impact. Our conviction in that view has been strengthened by additional research we have conducted in recent weeks, and, where appropriate, we have added to existing positions, as we believe that Fortrea's ability to win its fair share of a growing market, coupled with substantial margin-enhancement opportunities, will lead to attractive earnings growth in the years to come.

At Beck Mack + Oliver, we continue to analyze a variety of potential new investment ideas, attempting to ascertain, in the first place, whether the company in question is an excellent business that we would desire to own for a long period of time, and, in the second, what kind of valuation we would be comfortable paying for it. During 1990-2022, the S&P 500 and the S&P 500 Equal Weight generated annualized total returns of +9.7% and +9.6%, respectively. Since the end of 2022, however, their cumulative total returns have been +45.6% and +19.6%, respectively. We made some observations above that tried to shed light on this recent performance divergence based on market cap, and while we are not predicting a near-term reversion to the mean, we do intend to take advantage of any stock-specific opportunities, whether in the current environment or when prevailing conditions in the equity market begin to shift.

Partners of Beck Mack + Oliver