Beacon Trust

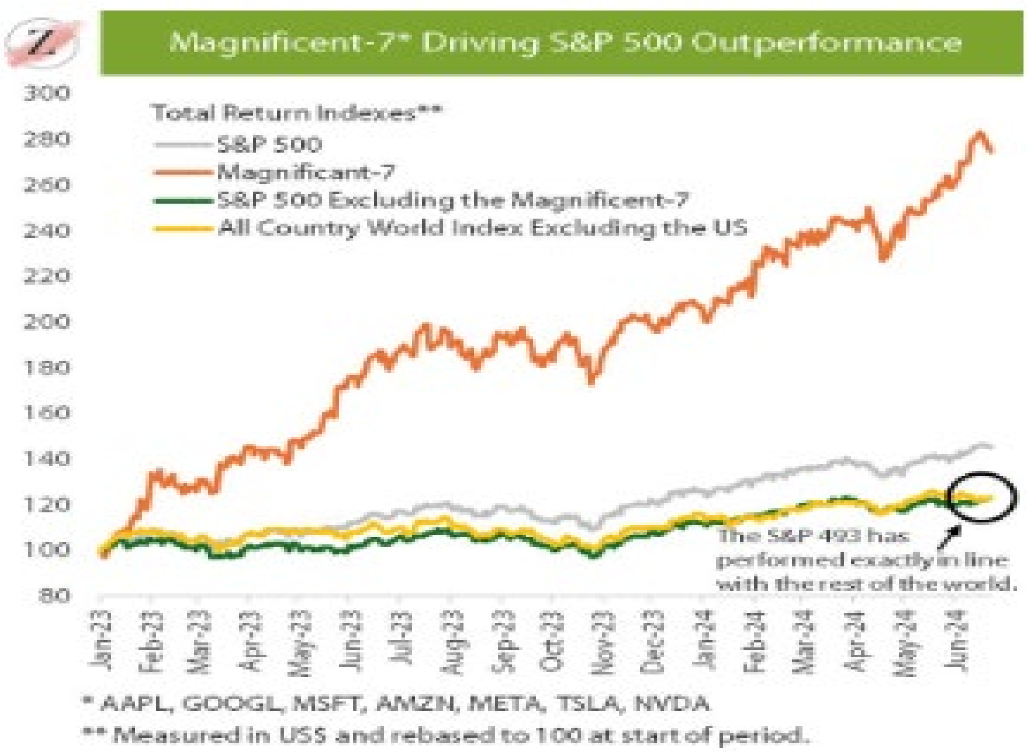
July 9, 2024

First Half S&P 500 Index Divergence

The divergence between the equal weight S&P 500 Index and the traditionally reported market-cap weighted S&P 500 Index (composite) often reveals critical insights into the underlying market dynamics (breadth) and investor behavior. These indices, while containing the same 500 constituent companies, differ significantly in their methodology, leading to different performance outcomes.

The S&P 500 Composite is market-cap weighted, meaning companies with larger market capitalizations have greater influence on the index's performance. As a result, the S&P 500 Composite tends to be dominated by large-cap stocks, particularly in those sectors like technology, where companies like Nvidia, Apple, Microsoft and Amazon have substantial weights. This concentration can lead to outsized impacts from a few strong performing or underperforming stocks.

In contrast, the S&P 500 Equal Weight assigns an equal weight to each of the 500 companies, regardless of their market capitalization. This approach reduces the influence of mega-cap companies and provides a more balanced representation of the overall market. As a result, the performance of the Equal Weight index can diverge significantly from the Composite, especially in periods of market volatility or sector rotation. This is no more apparent than this year.



Source: Zevin Asset Management

There are several factors that account for the noted divergence between these indices:

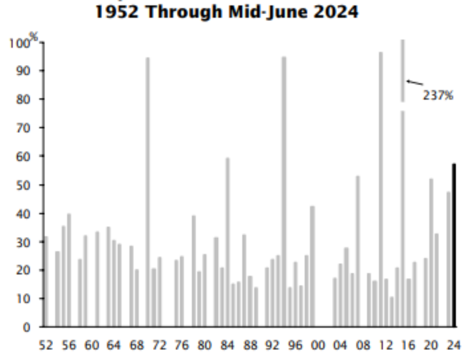
1) **Sector Performance:** When a specific sector, particularly technology, outperforms or underperforms the broader market, the S&P 500 Composite is more likely to reflect this due to its heavier weightings in such sectors. Alternatively, the S&P 500 Equal Weight, by spreading the exposure evenly, tends to mitigate those sectors overall impact.

2) **Market Leadership:** In bull markets led by a few large-cap stocks, the S&P Composite often outperforms the Equal Weight because gains of these market leaders significantly boost the composite index. Conversely, in markets where a more diverse set of companies that have smaller market capitalizations relative to a concentrated cohort of mega-cap stocks perform well, the S&P 500 Equal Weight tends to outperform, because it provides greater exposure to these companies.

3) **Valuation and Momentum:** Market-cap weighting often leads to higher exposure to stocks with strong momentum and higher valuations, which can be beneficial during periods of rapid growth but can result in outsized volatility, due to their weight in the benchmark, during market corrections. The equal weight methodology, meanwhile, inherently promotes rebalancing discipline that can mitigate market risk associated with overvalued stocks.

The S&P 500 has returned +15% this year, with the top-five-performing stocks accounting for a whopping 57% of the total (see Exhibit 1). Already 2024 ranks as the fifth most-concentrated year since 1952. The top-performing issue, Nvidia (6.6% of the index), represents almost 30% of the return, three times its contribution last year and the third-largest share on record (see Exhibit 2). It's the most impressive performance since 1927 when one considers the index's return was modest in the other two episodes. The question addressed in this piece is does any of this predict what's going to happen from here? Is the concentration of returns an obvious sign of excess, a non-event or soon to normalize?

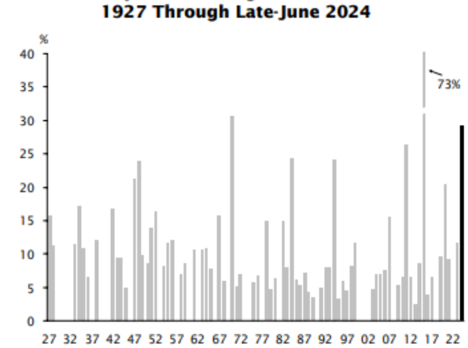
Exhibit 1: The S&P 500[1]
Share of Total Returns Attributable to the Top-Five Contributors Each Year[2]
1952 Through Mid-June 2024



Source: Empirical Research Partners Analysis.

[1]Based on top 500 stocks by capitalization from 1952 through 1977.
[2]Blank means returns were negative in that year. The top-five contributors in 2024-to-date have been Nvidia, Alphabet, Microsoft, Meta Platforms and Amazon.

Exhibit 2: The S&P 500[1]
Share of Total Returns Attributable to the Top Contributing Stock Each Year[2]
1927 Through Late-June 2024

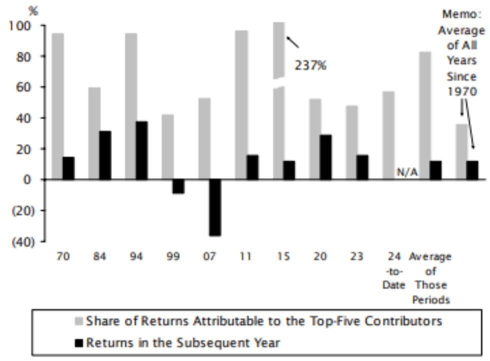


Source: Empirical Research Partners Analysis.

[1]Based on top 500 stocks by capitalization from 1952 through 1977 and large-cap stocks from 1927 through 1951.
[2]Blank means returns were negative in that year. The top contributor in 2024-to-date has been Nvidia.

In nine of the last 72 years, of which 56 had positive returns, more than 40% of the market's performance was attributable to the top-five performers (see exhibit 3), and specifically in the Technology & Communication Services (see exhibit 4). All of those occurred since 1970. In part of 1984 and in 1994 in its entirety, monetary policy was in a tightening phase. Generally, the performance leadership came from Big Tech or Big Oil, with AT&T being an important stock in the early years.

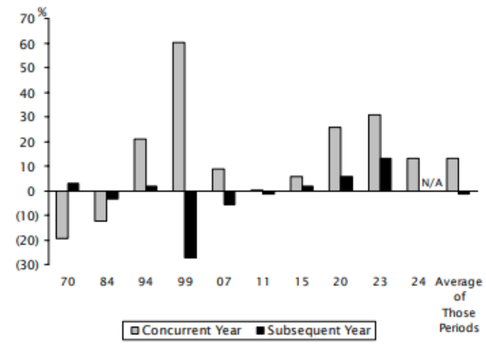
Exhibit 3: The S&P 500
Years When 40% or More of the Returns Were Attributable to the Top-Five Contributors[1] And Returns in the Subsequent Year
1952 Through Mid-June 2024



Source: Empirical Research Partners Analysis.

[1]Excludes years when the index return was negative. The top contributors in 2024-to-date have been Nvidia, Alphabet, Microsoft, Meta Platforms and Amazon.

Exhibit 4: Large-Cap Technology and Interactive Media Stocks
Relative Return in Years When 40%+ of the S&P 500's Returns Were Attributable to the Top-Five Contributors[1]
Monthly Data Compounded to Annual Periods
1952 Through Mid-June 2024

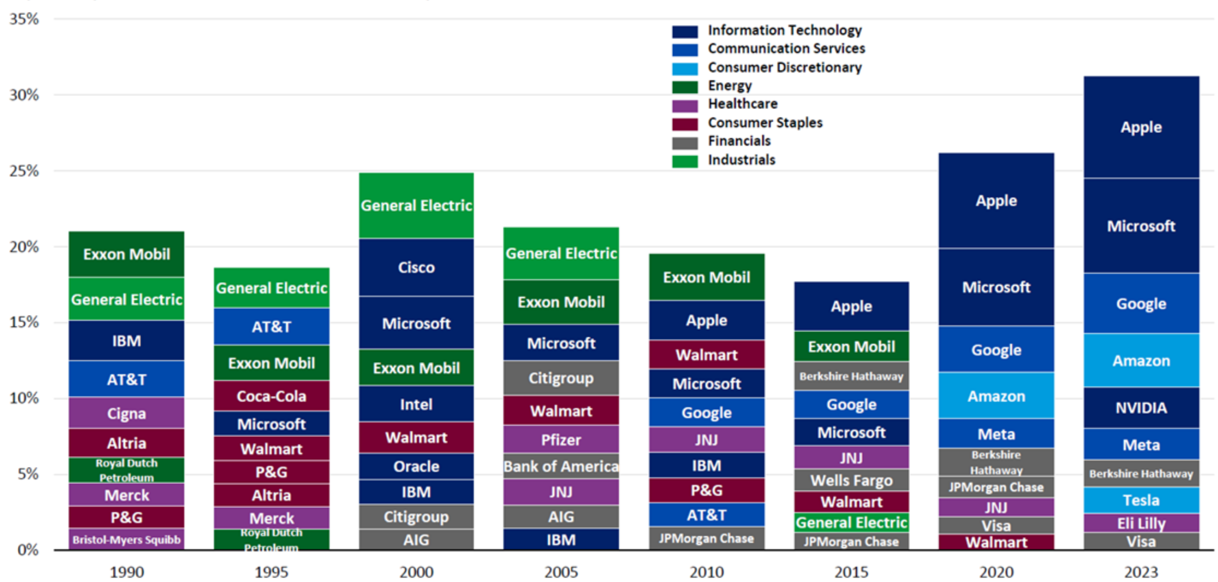


Source: Empirical Research Partners Analysis.

[1]Capitalization-weighted data.

The exhibit below is a wonderful illustration of the ever-changing dominance of various sectors and companies in the composite index.

Top 10 Companies as a Percent of Total S&P 500 Market Cap



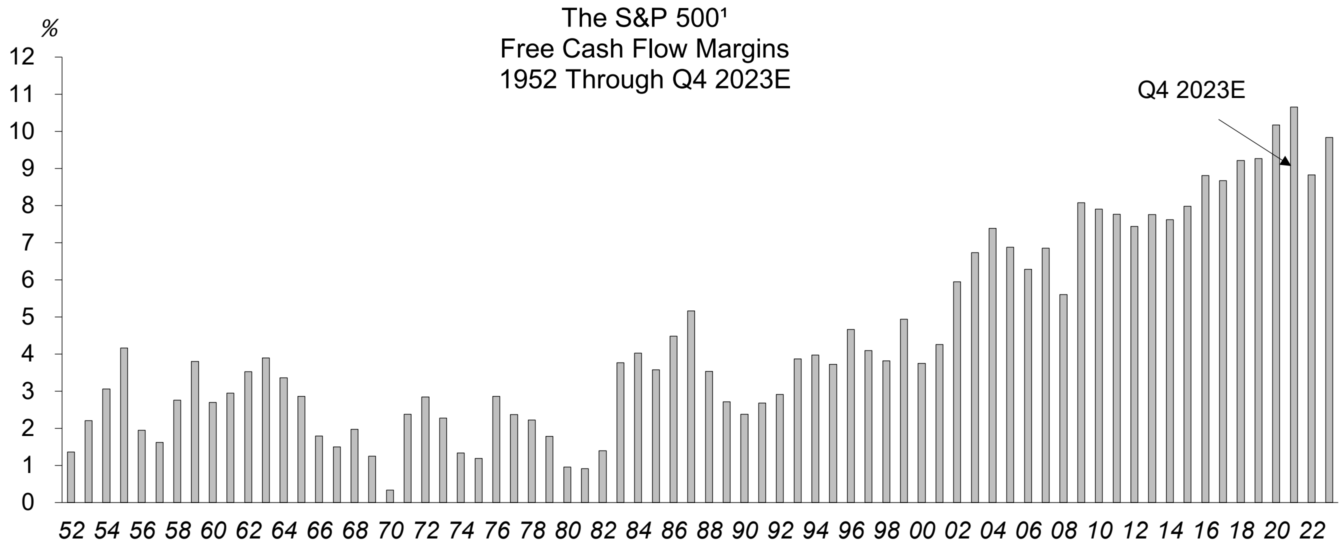
It's not at all unusual for performance divergence to exist between the S&P Composite and the S&P Equal Weight indices. In fact, historical data demonstrates periods of notable divergence. For instance, during the 2020-2021 market rally driven by a handful of mega-cap tech stocks, the Composite significantly outperformed the Equal Weight. Conversely, in subsequent periods where market breadth broadened and small caps participated, the equal weighted benchmark showed relative strength. This again occurred in late 2023 through early 2024. It should be noted, though, that with each of these periods there has been a return to normalcy. The key unknown factor though is when not if, the current divergence will persist for some time (see below).

Source: STRATEGAS

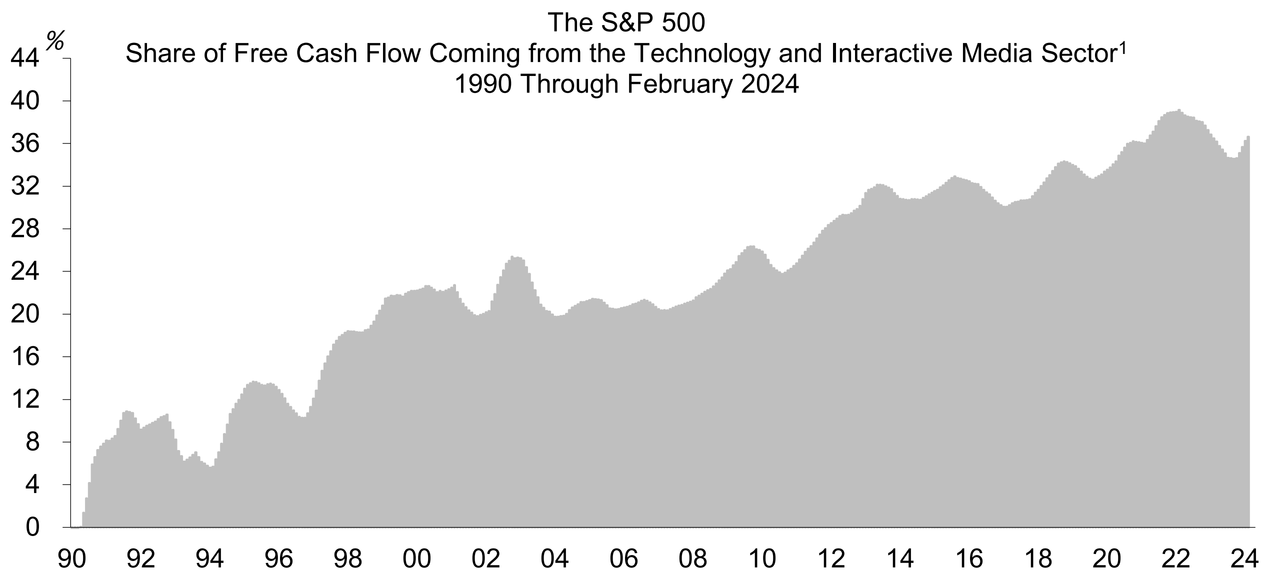
Valuation is another important element to the current market dynamic that needs to be considered. The Mag 8 (NVIDA, AAPL, GOOGL, MSFT, AMZN, META, TSLA, NFLX) are trading @30x earnings. The balance of the S&P 500 composite valuation is 18x, mid-caps at 15x and small- caps 14x. Couple the lower valuations in the broader market with high single digit earnings growth and one has a plethora of opportunities. Unfortunately, for the moment, investors are reluctant to reduce exposure to make room for them. Their reasoning? The need to be competitive with the benchmark without regard for the commensurate risk associated with the exposure. Unfortunately, that may be a short-term outlook that could have consequences.

At Beacon Trust, our foundation for stock selection is based on two primary tenets: Return on Invested Capital (ROIC) and Free Cash Flow Margins. Historically, these have been highly predictive of successful, long-term stock performance. Additionally, these screens provide our portfolio management team with a number of attractive investment opportunities across all sectors enhancing portfolio construction.

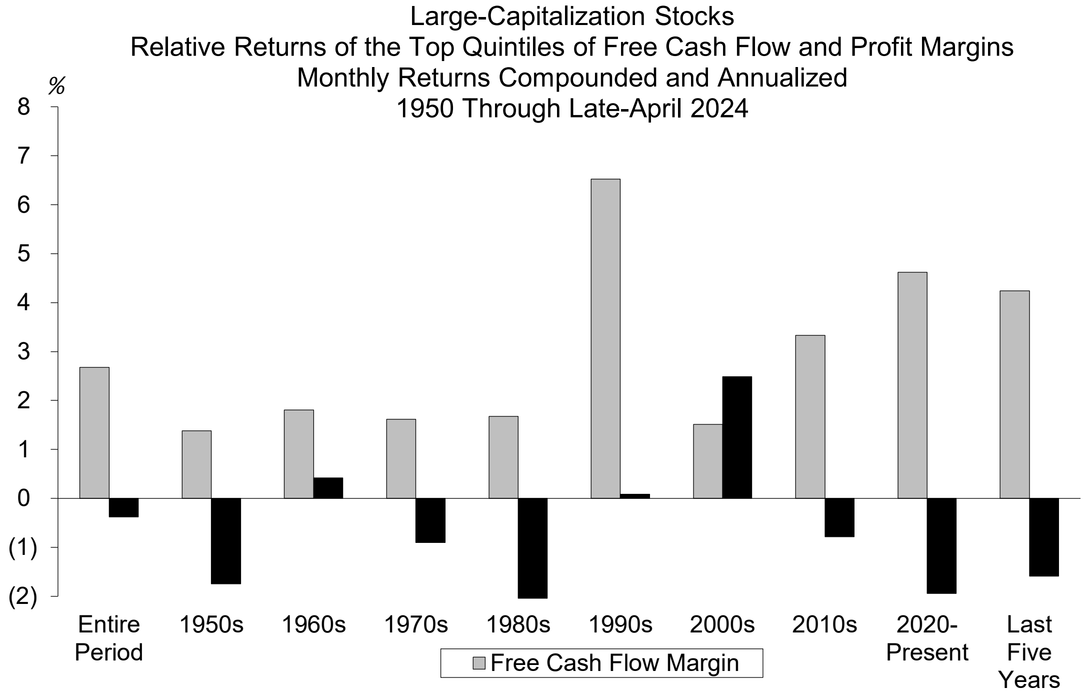
The charts below clearly illustrate the increase of FCF margins on the S&P 500 and, more importantly, the influence FCF has had on the technology and communication services and the subsequent returns. In turn, these charts also highlight the influence that technology and communication services sectors have had on the S&P 500 composite.



Source: Corporate Reports, Empirical Research Partners Analysis.
[1] Excluding financials and REITs; prior to 1976, the large-cap universe is used.



Source: Corporate Reports, Empirical Research Partners Analysis.
[1] Smoothed on a trailing six-month basis.



Source: Empirical Research Partners Analysis.

In conclusion, it is important to understand the construct of various indices used to measure returns and their influence on client portfolios. Typically, clients engage our services to grow their wealth over time with the understanding that periodic volatility will occur and, therefore, risk management is important. One of those tools is a strict adherence to limiting individual stock exposure; the policy being a maximum of 6%. As we stated earlier, it is also important to note that periods of significant concentration in market returns can persist for some time, however, do tend to eventually broaden out to other sectors/stocks with rate cuts potentially being a catalyst for a broadening out in the market. As we don't believe we can accurately predict the timing around this, we continue to focus on our long-term foundation for managing equity strategies at Beacon Trust, which is rooted in investing in high quality businesses for the long-term with the goal of providing competitive long-term returns while controlling risk.

Beacon Trust 163 Madison Avenue, Suite 600 | Morristown, NJ 07960 | 973.377.8090 | BeaconTrust.com