



Understanding the Source of Market Returns

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We are long-term, values-based, and socially responsible investors. We view consideration of sustainable factors as essential in forming portfolios of high-quality companies that are better positioned to reduce risk and identify opportunities. We believe that companies proactively managing business risks related to sustainable issues make better contributions to the global economy and are more resilient.

At Saturna, we believe in making your investment dollars work hard for you and that your interests always come first. Saturna strives to not only offer the best investment opportunities from mutual funds to IRAs, but to match those sound investments with superior customer service.



In this piece, Scott Klimo, Chief Investment Officer and Portfolio Manager, discusses the nature of market returns over the past decade, as well as what the future may hold. Some insights include:

- *A look at trends driving returns for top-performing stocks*
- *A comparative look at market concentration across multiple stock indexes*
- *How historical trends can inform our understanding of the effects of market concentration today*

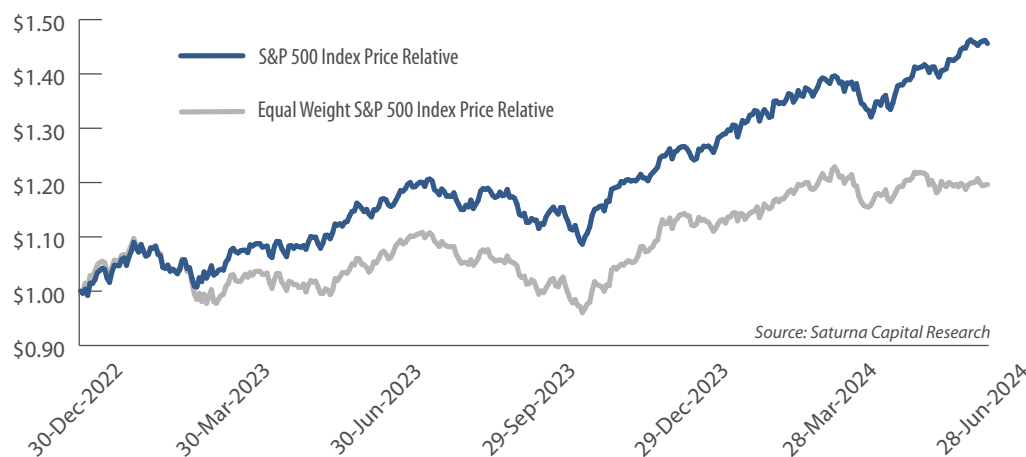
As hard as it may be to believe, the past decade has been a period of outstanding stock market returns in the United States. Despite everything that's transpired since 2014, the S&P 500 Index returned an annualized 12.85% as of June 30, 2024. An investor who put \$10,000 in the market on June 30, 2014, would now have about \$33,500.

The past five years have been even better, with the S&P 500 Index seeing an annualized return of 15.03%. At that rate, an investor more than doubles their money over five years.¹ While 15% is nice, it pales in comparison to the 24.56% rise in the S&P 500 Index for the year ended June 30, sparked by Nvidia's May 2023 results release. This alone led to a single-day 24.3% jump in the share price.

The announcement brought the words “artificial intelligence” (AI) to the attention of investors around the world and sparked a tech-driven market rally. Since that day, Nvidia stock appreciated a further 225.4% (as of June 30, 2024) as a rush to build AI models drove soaring capital expenditures and semiconductor purchases. Meanwhile, the promise of future AI applications boosted the fortunes of companies considered well-placed to exploit the new technology. In 2023, these companies — Apple, Microsoft, Nvidia, Alphabet, Meta, Tesla, and Amazon — earned the moniker the Magnificent Seven.

Apart from extending a long period of technology outperformance and exposing the market’s fondness for nicknames — remember the FAANGs² or the BRICS³ — one side effect of excitement around AI is greater market concentration due to the largest companies in terms of market capitalization appreciating the most. This has led to index performance misrepresenting the experience of most companies. Reviewing the performance gap between the standard-market-capitalization-weighted S&P 500 Index and the S&P 500 Equal Weight Index, which treats all companies equally regardless of size, illustrates the point.

S&P 500 Index Price Relative vs. Equal Weight S&P 500 Index Price Relative



Return figures support the trends shown in the graph. In 2023, the Magnificent Seven provided 60% of the S&P 500 Index return. Amazingly, the figure for the first half of 2024 is the same. The performance led to the largest stocks accounting for an ever-greater share of the index. At the end of 2023, the ten largest stocks accounted for 32.6% of the S&P 500 Index total market capitalization. By the end of the first half of 2024, that figure had risen to 37.4%.

Looking at the concentration in a global context provides insight. At the end of the first half of the year, the ten largest stocks in Japan accounted for only 22.4% of the TOPIX 500 Index. Similarly, in Europe, the top 10 stocks carried 20.9% of the weight of the STOXX Europe 600 Index. In contrast to the technology-dominated US top 10, the Japanese leaders include automotive, telecommunications, financial, media, staffing, and electronics companies. In Europe, global semiconductor lithography leader ASML appears but pharmaceutical, luxury, food, and cosmetic companies hold the other positions.

We are not arguing that European and Japanese markets are better or worse because of the greater diversification among the largest companies. On one hand, their failure to develop more significant technology leaders goes a long way toward explaining the outperformance of the US market since the global financial crisis of the late 2000s. On the other, as Nobel Prize winner and developer of modern portfolio theory Harry Markowitz said, "Diversification is the only free lunch in finance."

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We are arguing that risks may emerge with the greater concentration seen in the US.

From the perspective of an active manager, the risk of underperformance as the market rises due to the appreciation of a handful of the biggest stocks looms largest. Funds are required to act prudently, and one measure of prudence is the avoidance of concentration risk. The individual investor can address that issue through indexing. No matter how much a stock appreciates or how big it becomes, an investor will have full exposure through an index.

The problem arises when the market stops going up, as it did in 2022 when the S&P 500 Index fell 19.4%. It's not unreasonable to expect that those stocks that have appreciated by the greatest amount may be more vulnerable to declines when the market reverses. If those also happen to be the largest stocks, the index will sink just as aggressively as it rose. That's especially true when the situation exists, as it does today, that index returns have been driven more by an increase in valuation than an increase in earnings.

Returning to Nvidia, in 2023 it reported earnings of \$1.19. Current consensus expects a banner year, with earnings jumping 117% to \$2.58. The share price, however, has appreciated 159% this year at the time of writing.⁴ Perhaps Nvidia deserves the higher valuation, as 100% earnings growth and expectations for continued strong demand don't come around very often.

But what of other highfliers? As of August 21, stocks such as Eli Lilly, Broadcom, Trane Technologies, Oracle, Tyler Technologies, Colgate, Boston Scientific, and AbbVie all appreciated by at least 30%. Only in the case of Eli Lilly does the earnings growth match the share price appreciation. It's not unusual for share prices to outpace earnings when coming off a down year in the market but last year the S&P 500 Index gained 24.2%.

Before concluding, I have a confession to make. I noted how the performance of a handful of large stocks "has led to index performance misrepresenting the experience of most companies" as if it were something unusual. In fact, that's the standard state of affairs.

In a paper published in the CFA Institute's Financial Analysts Journal last year, the authors examined the returns for more than 64,000 global stocks from 1990–2020. From this, they concluded that wealth creation is highly concentrated. They explained:

The five firms (0.008% of the total) with the largest wealth creation during the January 1990 to December 2020 period (Apple, Microsoft, Amazon, Alphabet, and Tencent) accounted for 10.3% of global net wealth creation. The best-performing 159 firms (0.25% of total) accounted for half of global net wealth creation. The best-performing 1,526 firms (2.39% of total) can account for all net global wealth creation.⁵

Given the list of the top five firms, we see that, Nvidia aside, little has changed over the decades. An old market chestnut states, “Ride your winners and cut your losers” — a strategy supported by the information above. Somewhat perversely, behavioral finance tells us that investors feel the pain of a loss more significantly than the pleasure of an equivalent gain. This “loss aversion” leads investors to sell winners while holding on to losers, perceiving the loss as real only once it has been realized.

In any event, perhaps the increasing market concentration in the United States is to be expected given the country's global dominance in technology and technology's ever-expanding importance in the economy. If so, the Magnificent Seven and adjacent companies will continue to power market returns, although likely at the expense of higher volatility than we might otherwise experience.

Endnotes

- ¹ Here's a good place to introduce the Rule of 72. The amount of time required to double an investment can be roughly calculated by dividing 72 by the return. In this case, $72/15.03 = 4.89$, so just under five years.
- ² FAANG refers to the five most popular US tech companies: Meta (formerly Facebook), Amazon, Apple, Netflix, and Alphabet (formerly Google).
- ³ BRICS is an acronym used to refer to economic powers experiencing rapid growth. As of now, these are Brazil, Russia, India, China, and South Africa.
- ⁴ As of August 21, 2024.
- ⁵ Bessembinder, Hendrik, et al. Long-Term Shareholder Returns: Evidence from 64,000 Global Stocks. *Financial Analysts Journal*. March 7, 2023. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3710251

About the Author



Scott Klimo CFA®
Chief Investment Officer and Portfolio Manager

Scott Klimo, Chief Investment Officer, joined Saturna Capital in May 2012. He received his BA in Asian Studies from Hamilton College in Clinton, NY and also attended the Chinese University of Hong Kong and the Mandarin Training Center in Taipei, Taiwan. Scott has over 30 years experience in the financial industry with the first several years of his career spent living and working in a variety of Asian countries and the past 20 years working as a senior analyst, research director and portfolio manager covering global equities. Mr. Klimo is a Chartered Financial Analyst (CFA) charterholder and an avid cyclist. He is a supporter of various environmental organizations and served for several years on the Board of Directors of the Marin County Bicycle Coalition.

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1300 N. State Street
Bellingham, WA 98225-4730
www.saturna.com

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