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TRANSCRIPT: Q2 2024 Market Update

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Hi everyone. This is Steve Elwell, chief Investment Officer of Level Financial Advisors, and this is your second quarter 2024 market commentary recap. So the second quarter was a continuation of growth for the stock market, specifically in the US. The US stock market grew 3.22%. International stocks were slightly down, but emerging markets had a nice quarter, up 5.13%. Global real estate continued to struggle with high interest rates affecting the real estate market, and the bond market had a slight recovery, a barely positive quarter at 0.07% in the US and 0.11% globally. Interest rates continue to fluctuate as investors in the markets try to determine exactly what might happen specifically with the Federal Reserve later this year. Will they cut rates? Will they not cut rates? The inflation data continues to be a little muddled. There was a slight increase in the spring, but then a decrease following in May and June. And so ultimately interest rates appear to be potentially on the decline, if it's true that inflation continues to go down later in the year.

The Federal Reserve is, I think it's fair that they're trying to be patient and stick to their original plan, which is trying to wait for inflation to get down into the mid to lower 2% range. 2% is their stated target, but obviously a dramatic decline from where inflation was back in the summer of 2022 when we were facing 8%, 9% inflation. And clearly that needed to get under control because inflation is not only a problem financially, but becomes a bit of a psychological problem as people start to expect high inflation, they continue to pull demand forward by buying things now as opposed to waiting even a couple of weeks or months if they think the price is going to dramatically go up. So it's a two-prong aspect of trying to get it under control.

But we remain fairly optimistic that inflation will continue to subside and the Federal Reserve will eventually get to the point where they will cut interest rates. It remains to be seen if it'll be later in the fall here, or they won't start potentially until 2025. Foreign banks though, specifically the European Central Bank, are already not only strongly considering cuts, but certain areas have already started to cut interest rates. So some other developed nations and blocs of economies are ahead of the US in terms of starting to reduce interest rates. I'm sure anyone involved in real estate or the housing market or anyone with family members or who are shopping for houses themselves are certainly looking for interest rates to come down. Although the flip side of that is if interest rates start to come down, it's feasible that prices start to go back up to a faster extent than what they might already have done. So obviously there's a double-edged sword there if interest rates end up going down.

But back to the stock markets specifically here for the second quarter, and actually for even year-to-date and one-year, you can see here on this chart from Dimensional Fund Advisors on the returns for the second quarter and one-year. And clearly, across the board, US stocks, international stocks, emerging markets, all have had a good twelve-month period here. US stock market up 23%.

Well, one of the things we want to dive into on this particular quarterly commentary is the divergence of some of the largest stocks in the US and what's driving returns for the US stock market, specifically those seven companies that many investors have labeled the acronym of, or not an acronym, but the title of the Magnificent Seven, which is really essentially the seven largest when you're looking at Apple and you're looking at NVIDIA and Tesla and Microsoft and Facebook and Google and Amazon.

We're going to jump in here to... well, first let's start with the chart here on the S&P 500. So specifically what I want to show here is just how big the largest stocks in the S&P 500 have become and how that looks relative to historically what have the 10 largest stocks in the S&P 500 looked like weighting-wise? So this chart from JPMorgan is pretty helpful. If

you start at the top right, the weight of the top 10 stocks in the S&P 500 generally has hovered anywhere from 17% to as high as like 32% over the last 25 years, 30 years. But now specifically with NVIDIA really ripping higher over the last couple of years, the top 10 stocks in the S&P 500 represent 37% of the total market capitalization.

So essentially, when you think about the weighting as... When you talk about the S&P 500, every stock, each of the 500 stocks, they're not given equal weighting. They're weighted by size, how large. If you take the share price they trade at and you multiply it by all the outstanding shares, that gives you a valuation as to what that company's worth. And so Apple might be worth, if I'm going off the cuff here, 2 trillion, whereas the smallest company in the S&P 500, the smallest of the bunch might be worth 2 billion instead of 2 trillion. So obviously the weighting is very different. Apple gets a much higher weighting, and that smaller company gets a much smaller weighting.

So really what I'm trying to illustrate here and what this chart is showing is that when you look at the combined weighting of the top 10 stocks, it makes up 37% of the total weighting of the S&P 500, and that's obviously quite a bit. That's more than at any other period over the last essentially 30 years, even during the tech bubble. That doesn't necessarily mean that this is a bubble. I mean, there's no doubt NVIDIA and Apple and all these companies are making a lot of money, and obviously if profits get larger and larger and larger, then investors are willing to pay a higher price for those shares and the company's valuation gets larger and larger. Really, the question will be what ends up happening going forward? One of the interesting facts that we mentioned in the quarterly letter that came with your statements this quarter was that if you go back to the top 10 largest companies back in the tech bubble, the tech boom that happened in the late nineties and the bubble that burst ultimately in early 2009, of those 10 companies that were the largest at that time are no longer in the top 10 largest.

And that doesn't necessarily tell you that these companies are going to fall or do poorly or anything like that. I think the more likely scenario is everything else starts to catch up. When valuations go up dramatically, part of the reason for that is not only the additional information investors have received in terms of the companies are making more money and they're doing really well and they're growing, but also an expectation about how they will continue to grow or earn more money in the future. And that expectation is no guarantee. That's a prediction. So part of that is baked into the price, and the real question will be, will the NVIDIAs of the world be able to continue to grow at the pace that the market thinks it will grow at? And That doesn't mean NVIDIA does poorly. But obviously if the market thinks, oh, profits are going to continue to grow, for example, at 10% a year and they grow at 8%, the market will be disappointed. That doesn't mean NVIDIA didn't grow, it just means it didn't grow as fast as the market expected. If that were to happen, one would to expect that the returns of a company that has a scenario like that would not be as positive as they have been recently, and could even be negative if investors are really disappointed.

So this is not new. We've had other instances where the top 10 largest companies have really started to dominate the S&P 500. It just, in my mind as an investor, it leads me to believe that diversification is probably, it's always important, but it's extra important right now because you don't really want to have all your in one basket or even a couple of baskets when it comes to investments. You generally want to try and protect yourself by using diversification to the fullest extent of its value.

And when 37% of the S&P 500 consists of just 10 stocks, I would want to make sure I have exposure to other companies in case those 10 stocks disappoint. I want to be clear, this is not me or Level saying that we think any of those 10 stocks are going to do poorly going forward. We don't know any better than anyone else about what might happen with them. But I do know that if they do do poorly, then we'll be glad that we own a lot of other things because we don't want to have all of our exposure set just to those type of companies.

So I think that's very important. I think that's worth mentioning, and I thought this chart did a good job of showing just how that weighting of the 10 stocks has changed. And even if you look at this chart on the left, it even shows that at

current valuations, those 10 stocks are valued at about 148% of what their average value has been over the last essentially 30 years. And again, those valuations don't necessarily mean that they're overvalued. It means that the market's expectations for them to continue to deliver higher profits in the future, the expectations are pretty. All things equal, higher expectations generally leads to higher prices. Higher prices with those expectations, if there is disappointment, can lead to subpar returns in the future if companies are not actually able to deliver on that expectation.

So time will tell, it always does. Everybody wishes we had a crystal ball and could say, oh, what is the perfect time to buy this company or this asset class or sell that one? And unfortunately, that's not the reality of how the investment world work because nobody's been able to consistently time anything in the investment markets. But as a bit of a guide, it is helpful for us to just look at these prices and look at the valuations of different asset classes and say that based on historical evidence, we know that diversification is important, and we know when a certain asset class starts to become higher priced, higher valuations, that we also want to make sure we own other things in case that asset class isn't able to deliver on those expectations.

And even as we look at, I want to narrow in specifically on the "Magnificent Seven", again, Apple, Amazon, Google, Facebook, Microsoft, NVIDIA, and Tesla, NVIDIA really being the leader of the group here over the last 18 months, some really interesting information on the couple of charts listed on this slide. But specifically what I want to highlight is this year, actually we'll talk about all four of the last year, so essentially three and a half years, starting in 2021, the Magnificent Seven earned 40% while the S&P 500, the other 493 stocks inside of the S&P 500 earned 17%, no small amount, 17% is pretty good, but the Magnificent Seven really led the way that year.

2021, if you remember right, was a fantastic year for stocks. It really was the first inkling... I mean the second half of 2020 was pretty good post-COVID, but 2021 is really where investors started to feel a lot more confidence that the economic earthquake that was COVID was not only passed, but companies had adjusted and the economy was strongly recovering as things opened back up after that.

Of course, in 2022, we all remember that the stock market did quite poorly, and the Magnificent seven got hammered that year. They lost 40%. So essentially a large amount what they had earned the year prior, whereas the S&P 500 excluding the Magnificent Seven, had only gone down 8%. So obviously in that scenario, the diversification of owning all 500 stocks was very helpful. You did not decline as much as those seven stocks happened to in 2022.

Fast-forward to 2023, which was another good year for the investment markets. The magnificent seven strongly rebounded from that huge decline in 2022, earning 76% that year if you look at those seven stocks. The other 493 stocks remaining in the S&P 500 earned about 8%. So a big divergence there. And then that divergence has continued so far in 2024, again, mostly led by NVIDIA, which has really just ripped higher for a pretty dramatic increase over the last 18 months.

But if you look at 2024, it's a continuation of what had happened in 2023 where those seven stocks have earned 33%. The remaining 493 stocks have earned 5%. So even 5% being halfway through the year is on pace for a 10% year. Nobody would look at that and say that's a bad year. In fact, that would be slightly above average for the 120-year history compared to any other 12 month period for the S&P 500. But clearly the majority of the returns that have come from the S&P 500 this year has been a result of those seven stocks.

So we think that context is always important when you're talking about investing, because sometimes it can feel like, as you look at the investment markets and you say, "Oh, well, my portfolio has earned 4% or 5% or 6% for this year, but I see that the S&P 500 might be up 15 or 18%. What gives?" Well, the vast majority of the return has been earned just by a handful of stocks. And because of that, and those handful of stocks also happen to be the largest companies in the

S&P 500 and have such a large weighting that they're dragging the whole index up, while everything else is doing well, just not nearly as well as what those handful of stocks are.

So it can be a moment that can be difficult for investors that take their eye off the ball because it can be very easy to look at that and say, "Well, geez, why don't I just put everything in the S&P 500?" But if you do that, you're really not putting everything into the S&P 500. You're putting a substantial amount of money, almost 40% at this stage, into just a handful of stocks, individual companies. And even if just one of them, particularly the largest, NVIDIA, and/or Apple, either or, if just one of them underperforms, then the S&P 500 would end up taking a substantial hit from that. And the other 499 stocks may do fine, but because the weighting is so large at the top that it's really a moment that we think it's important for investors to understand that context, to not take the eye off the ball and to realize that diversification actually now is probably even more important than ever. Not because we think these stocks are going to falter, but because we want to protect ourselves in case they have, or in case they do in the future.

And I would add, it's not as if that our portfolios hadn't participated in that. I mean, the S&P 500 is one of our largest holdings in the stock portion of our portfolios. And also the DFA High Profitability Fund is one of the largest holdings also that we use in the stock side of the portfolio, and that would have participated in several of these stocks as well. So we actually have two different asset classes that we're using that would participate and has participated in the positive run-up of these seven stocks. We're just trying to make sure that we also protect ourselves in case these seven stocks or any of the individuals end up doing worse than expected going forward.

So it's really, that's the whole idea, right? When it comes from an investment standpoint, you never want to have so much of one thing that you make a killing or get killed by it, specifically when you're talking about retirement investing, where the option of going back to work in case your investment portfolio substantially declines often is not possible. So we need to build portfolios that participate if certain companies do really well, especially the large ones, but also protects ourselves in case any one individual company or handful of individual companies have a rough run.

So with that, that has been the second quarter 2024 investment commentary. As usual, we'll touch base in another three months from now, and hopefully the investment markets continue to run upwards. Thanks, everybody.