February 2025 Market Commentary

Wind of Change

The wind of change
Blows straight into the face of time
Like a storm wind that will ring the freedom bell"

Scorpions – Wind of Change https://www.youtube.com/watch?v=n4RjJKxsamQ

One of the best things about getting older is that you have a front row seat to the changes going on all around us. This lived experience should help us appreciate that even if the future often rhymes with the past, it can also end up being very different. Evolution is very real. We experience life, we learn, we adapt. As we humans undergo constant change, our companies and economies follow along. An example of this, from the investment universe, is the always changing makeup of the S&P 500.

The S&P 500 index is a rather simple concept; roughly speaking, it is the 500 largest companies in the U.S. when measured by their market capitalization, which are then also weighted by their market-caps. Currently Apple is the largest with a weight of 6.86%, and Franklin Resources is the smallest with a weight of 0.01%. The index was created in March of 1957, and only had three sectors; Industrials, Utilities, and Rails. The index is now divided into 11 different sectors.

The folks at S&P Global (the owners of the S&P 500 Index) have constantly tweaked the index to best reflect not only the 500 largest companies but also the changing weights and importance of various economic sectors.

Historical Sector Weightings of the S&P 500										
Sector	**1957**	**1976**	**1990**	**1995**	**2000**	**2005**	**2010**	**2015**	**2020**	**2024**
Technology			6.3%	9.4%	21.2%	15.1%	18.7%	20.7%	27.6%	32.49%
Financials		6.1%	7.5%	13.1%	17.3%	21.3%	16.1%	16.5%	10.4%	13.62%
***Real Estate**									2.4%	2.10%
Cons. Discretion			12.8%	13.0%	10.3%	10.8%	10.6%	12.9%	12.7%	11.26%
Health Care			10.4%	10.8%	14.4%	13.3%	10.9%	15.2%	13.5%	10.09%
****Comm Services**			8.7%	8.5%	5.5%	3.0%	3.1%	2.4%	10.8%	9.37%
Industrials	85%	86%	13.6%	12.6%	10.6%	11.3%	11.0%	10.1%	8.4%	8.16%
Consumer Staples			14.0%	12.8%	8.1%	9.5%	10.6%	10.1%	6.5%	5.53%
Energy			13.4%	9.1%	6.6%	9.3%	12.0%	6.5%	2.3%	3.16%
Utilities	10%	6.5%	6.2%	4.5%	3.8%	3.4%	3.3%	3.0%	2.8%	2.33%
Materials			7.2%	6.1%	2.3%	3.0%	3.7%	2.8%	2.6%	1.89%
Rails	5%	1.6%								

Source: S&P Global

*Real Estate was broken out of Financials sector in September 2016.
**September 2018 Alphabet (Google), Meta (Facebook), Netflix, Disney, Comcast as well as other internet media companies were added to the new Communications Services sector, which replaced the old Telecom sector that was mostly AT&T, Verizon, and CenturyLink.

Observing how these sectors have grown and shrunk over the decades tells us a lot about how our economy and society have also changed. The table above shows us how technology has grown from a minor part of our economy to the by far the largest component of our economy.

And while technology has grown into the dominate sector, other sectors have obviously had to decline in importance.

A favorite exercise of mine is to look at the current S&P 500 sector weights versus where they have been historically, and **then try and forecast how it will look in five years**. The goal is to be exposed to where the money is going to flow, and be underweight the areas that will be declining in relative weight.

All active equity managers are tasked with trying to find ways to outperform their benchmarks, and in the case of the S&P 500 one way to outperform is to make an active decision on each and every sector. Deciding to be sector neutral to the S&P 500 is also a decision you may make.

Over the years the S&P 500 (as well as the U.S. economy) has certainly evolved into an index dominated by the best and biggest companies. The thing about capitalism (especially the form practiced here) is that success begets success. The best attract money, money attracts talent, which leads to more success, which leads to the ability to out-invest the competition on every front. The strong get stronger.

This growth and dominance are not fait accompli, the corporate graveyards are littered with former industry leaders, but if companies are successful, it is becoming increasingly hard to dethrone them. Perversely, one of the main reasons for entrenchment is technology. While technological advancements are often thought of as a way to level the playing field between the haves and have-nots, the sheer cost of many of these new technologies means that those with the most money are able to invest the most to maintain and widen their moats.

An important side note. Maybe we shouldn't put a lot of weight in market valuation models that compare historic valuations to the present. For example, is it relevant to compare the price-to-earnings or price-to-sales of the S&P 500 today to the S&P 500 in 1975? Back in the 1970's Energy and Basic Materials (highly cyclical sectors with volatile earnings) made up about 30% of the S&P, today they make up about 5%. You don't pay the same amount for highly cyclical earnings as you do for stable earnings growth. I believe that this is a major reason that "rules" based valuation models have a rather dismal record when used to forecast the future.

While understanding sector weights are important, it is also imperative to understand which companies are driving those sector weights. In other words what individual companies are driving the weights and therefore the performance of each sector. For example, when we think of Financials we often think first of Banks, but only two banks are even in the top five of the sector.

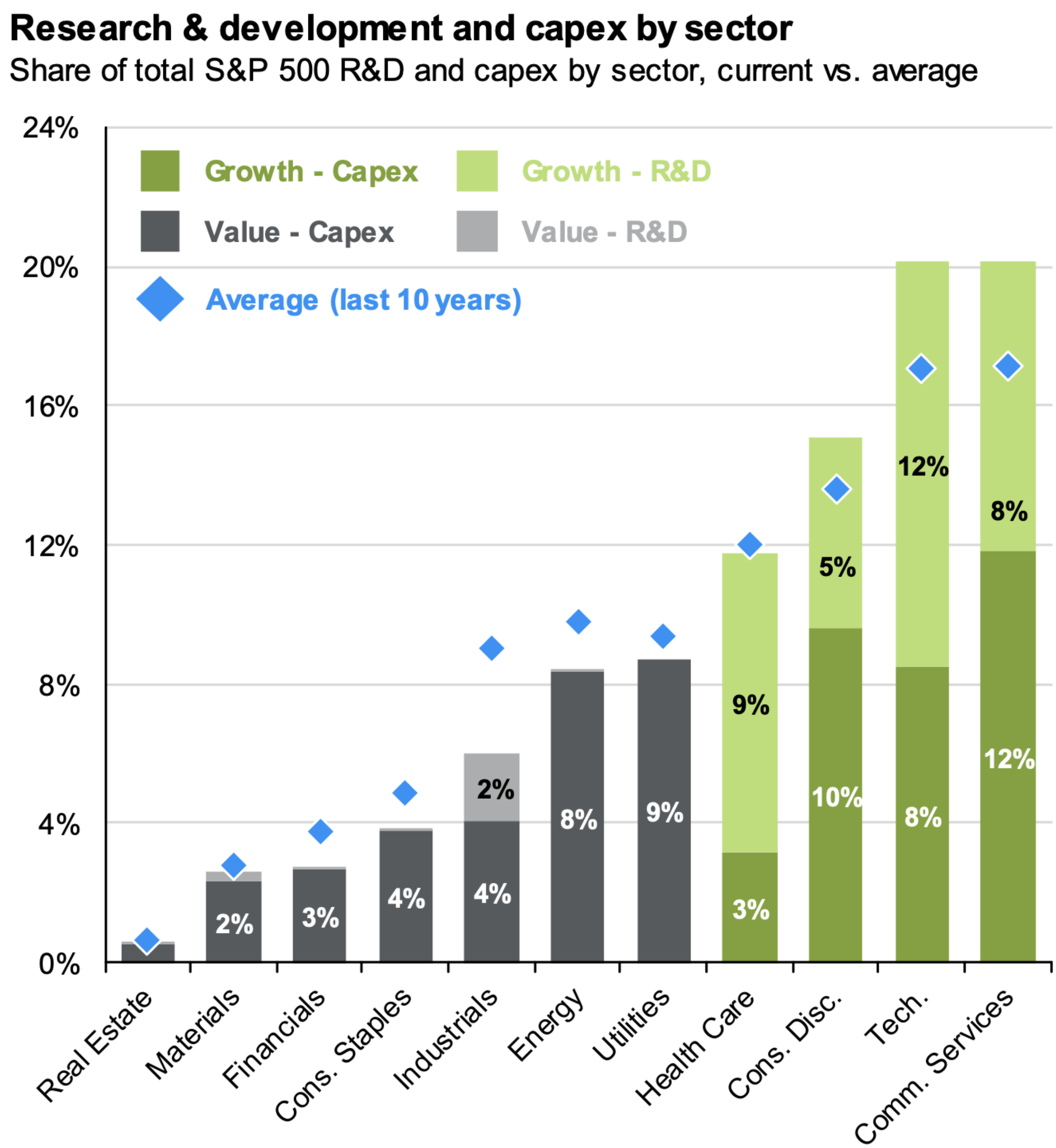
The table below shows the five biggest stocks in each sector and their weight within that sector.

Top Individual Stock Weights as Percentage of Sector						
Sector	**2024**	**#1**	**#2**	**#3**	**#4**	**#5**
Technology	32.49%	Apple 15.1%	NVIDIA 13.9%	Microsoft 12.7%	Broadcom 5.9%	Salesforce 3.4%
Financials	13.62%	Berkshire 12.2%	JPMorgan 10.0%	Visa 8.0%	Mastercard 6.3%	BofA 4.4%
***Real Estate**	2.10%	Prologis 9.3%	Equinix 8.8%	AmTower 8.1%	Welltower 7.1%	DLR 5.3%
Consumer Discretionary	11.26%	Amazon 21.1%	Tesla 17.2%	HomeDepot 6.3%	McDonalds 4.7%	Booking 4.5%
Health Care	10.09%	Lilly 12.2%	Unitedhealth 9.2%	J&J 6.9%	AbbVie 6.3%	Merck 5.0%
****Comm Services**	9.37%	Alphabet 19.4%	Meta 18.9%	Netflix 6.7%	AT&T 4.6%	Disney 4.6%
Industrials	8.16%	GE Aero 4.5%	Caterpillar 4.3%	RTX 3.8%	Honeywell 3.6%	Union Pac 3.4%
Consumer Staples	5.53%	Costco 9.8%	P&G 9.5%	Walmart 9.5%	Coca-Cola 5.9%	PepsiCo 5.0%
Energy	3.16%	Exxon 22.7%	Chevron 15.3%	ConocoPhil 8.1%	Williams 4.7%	EOG 4.5%
Utilities	2.33%	NextEra 12.6%	Southern 7.7%	Duke 7.1%	Constellation 6.5%	Sempra 4.7%
Materials	1.89%	Linde 21.0%	Sher-Will 8.2%	Air Prod 6.7%	Ecolab 6.2%	FCX 5.8%

Source: Morningstar

If our job is forecasting the future, then it is pretty imperative that we understand present; what companies are currently driving each sectors performance, what types of moats do they have, and will they be able to maintain that advantage? One of the keys to maintaining a competitive advantage is the ability to invest in research and development as well as maintenance capital expenditures (Capex).

The following chart shows what I mean about the ability of the largest winners to outspend their smaller rivals. The Technology and Communications Services sectors account for over 40% of the S&P 500's research & development and Capex spending. And most of this spending is happening in the largest companies.



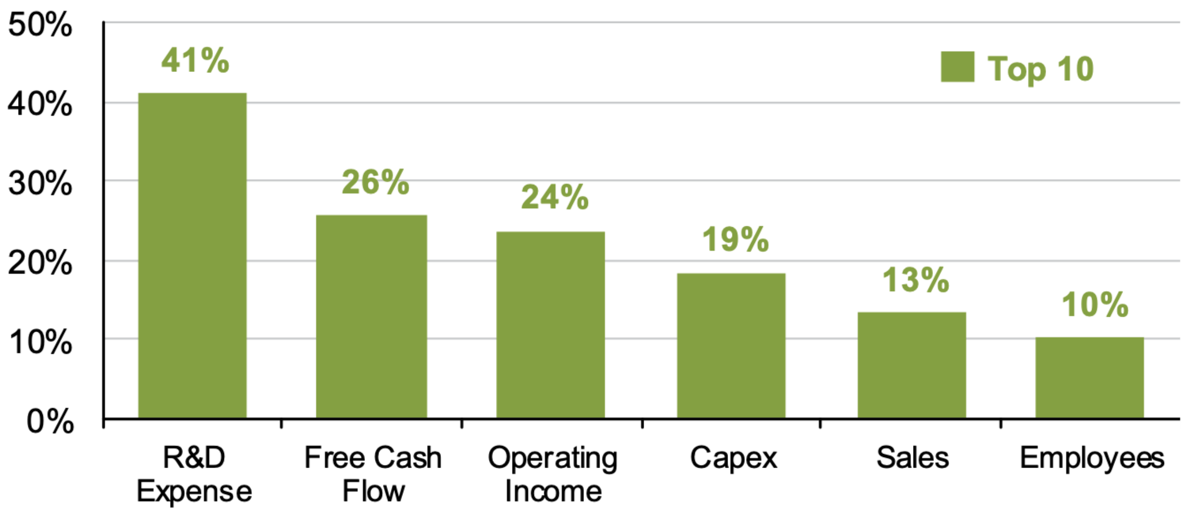
Another way of looking at this is by breaking down the Top 10 stocks in the S&P 500. These Mega-cap stocks are now at a record high 38.7% weight of the S&P 500. And, as a group they account for 41% of the R&D and 19% of the Capex.

Weight of the top 10 stocks in the S&P 500

% of market capitalization of the S&P 500

Economic concentration in the S&P 500

% of S&P 500 metric, 3Q24



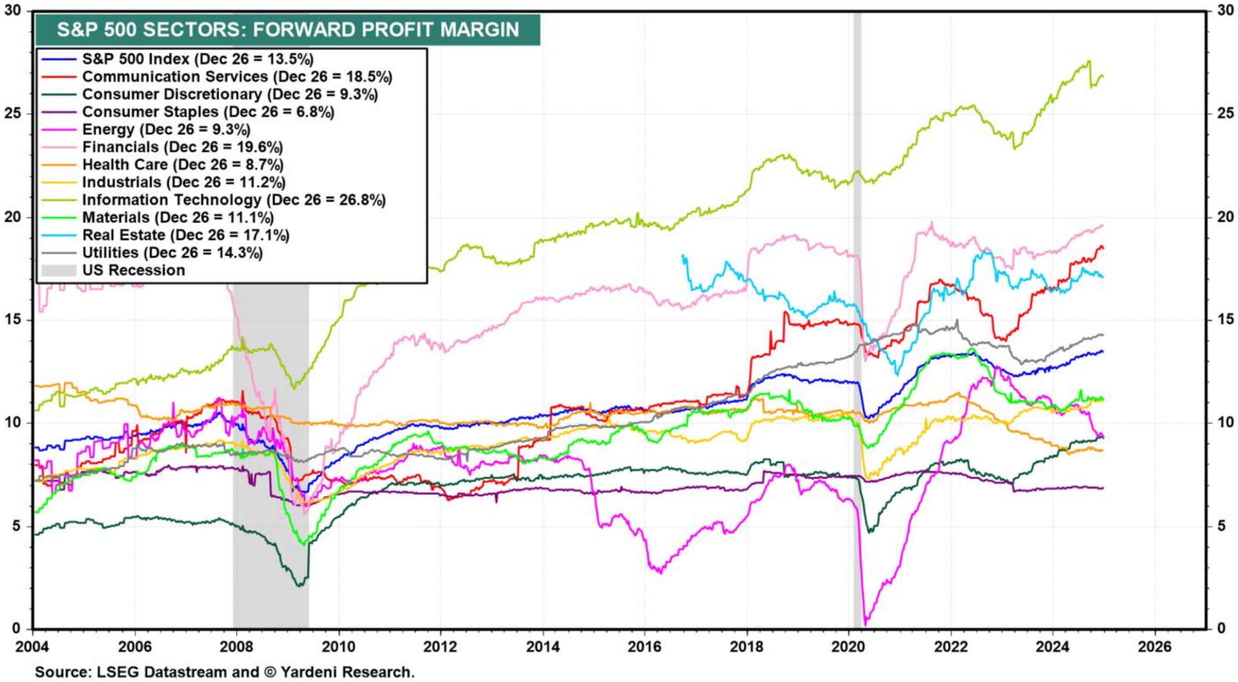
Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each quarter. As of 12/31/2024, the top 10 companies in the index were AAPL (7.6%), NVDA (6.6%), MSFT (6.3%), AMZN (4.1%), GOOGL/GOOG (4.0%), META (2.6%), TSLA (2.3%), AVGO (2.2%), BRK.B (1.7%) and JPM (1.4%). The remaining stocks represent the rest of the 492 companies in the S&P 500.

Guide to the Markets – U.S. Data are as of December 31, 2024.

This ability to spend has resulted in the Technology and Communication Services sectors to generate the highest earnings growth rates and the highest profit margins over the last 22 years.

S&P 500 Sector Statistics 2002 - 2024		
Sector	**EPS Growth**	**Profit Margin**
Technology	15.4%	21.4%
Financials	4.1%	15.0%
***Real Estate**	3.4%	16.5%
Cons. Discretion	10.0%	9.8%
Health Care	7.4%	7.3%
****Comm Services**	5.7%	19.0%
Industrials	6.6%	9.8%
Consumer Staples	5.9%	6.9%
Energy	7.0%	8.4%
Utilities	3.6%	16.2%
Materials	4.7%	8.5%
S&P 500	8.4%	11.8%

*Real Estate was broken out of Financials sector in September 2016, data from 2009.
**September 2018 Alphabet (Google), Meta (Facebook), Netflix, Disney, Comcast as well as other internet media companies were added to the new Communications Services sector, which replaced the old Telecom sector that was mostly AT&T, Verizon, and CenturyLink.



Of course we don't know what the future holds, but I'm a big believer of following the money. Profitability and innovation attract both talent and money. Those companies investing the most in the future are often the ones that will drive their sector.

<u>The Steelers & Portfolio Management – Here We Go….</u>

About the only thing I've been doing longer than managing money is rooting for the Steelers. Unlike managing money, where you have some control over your portfolio, being a sports fan means that you relinquish control to the owners and their coaches. Of course, that doesn't stop us from telling them how to run their ("our") team.

If I had a few billion dollars lying around, and the Rooney's were willing sellers, here's how a portfolio manager would look at the team with fresh eyes. First, a review of recent performance and the current portfolio. It is widely known that coach Mike Tomlin has delivered 18 years without a losing season, in my mind that is basically market performance, like an index fund with fees. Our goal, and supposedly "The Standard" here in Pittsburgh, is to make deep runs into the playoffs and win Championships. Our last Super Bowl appearance was 14 years ago, and our last victory was 16 years ago.

Some stats - Steelers Rankings over the last four seasons (out of 32 teams):

- Total Yards: 27th
- Yards/Play: 29th
- 1st Downs: 25th
- Total TDs: 29th
- Passing Yards: 23rd
- Rushing Yards: 23rd
- **Overall Offense Ranking: 24th**
- Opponents Pts/Game: 8th
- Opponents Yards/Game: 16th
- Opponents TDs/Game: 13th
- **Overall Defense Ranking: 16th**

The nice thing about the NFL is that they have a salary cap, where each team ends up spending about the same amount of money, it's up to the owners/coaches to determine how that money is divided. At the beginning of this missive, I talked about making allocation decisions between the various sectors in the S&P 500, how it should be an exercise in looking forward, not backward.

The Steelers have decided on a lopsided allocation; they have the leagues highest paid Defense and lowest paid Offense. Some of this is a function of age, they are the 9th oldest team overall (27.3 yrs), but have the oldest defense (28.4 yrs) and third youngest offense (26.2 yrs).

A casual observer of the NFL over the last decade or two would easily be able to tell you that the league is much less violent than it used to be, and that many (most/all) of the rule changes have been about protecting offensive players, and making it tougher on defenses to impact the game. Nearly all teams making deep runs into the playoffs and winning championships have also been near the top in offensive production, and are also led by "franchise" quarterbacks.

It seems like the Steelers ownership still lives a bit in the past, remembering and trying to recreate the glory years of the '70's when the Steel Curtain ruled. No matter how much we loved the brutality of Mean Joe Green, Jack Lambert, and Mel Blount, etc., the present and the future seems to be tilted much more towards offense. It's like believing a portfolio dominated by the 70's Energy darlings will continue to dominate the future when the rules have changed.

As a new owner/portfolio manager, it is clear to me that we need a new coaching staff that is geared towards the offensive side of the ball. Defense is great and still essential for a well-rounded team/portfolio, but we're not going to win championships or outperform our benchmark with a portfolio overweighted in Staples, Energy, or Utilities. The rules of the game have changed to dictate that a dynamic offense, led by a few superstar play makers is the way to win.

Unfortunately, in the NFL we can't all have Patrick Mahomes or Lamar Jackson as our starting quarterback, but in the stock market we can. There is no rule in the stock market against owning the best companies, that's exactly why the top ten companies in the S&P 500 make up nearly 40% of the overall markets weight. Investors vote with their pocketbooks every day, and they vote to build their portfolios with winners versus losers. Today, that means offense over defense.

Sometimes it's hard to part with an aging player who has fulfilled his role, and it's difficult to bet on someone younger with less experience, but change is the constant. Whether we're talking about life, investment portfolios, or football, it's important to look forward and embrace the future and not get bogged-down in the past.

The future s in the air
I can feel it everywhere
Blowing with the wind of change"

As always, be careful out there.

Chris Wiles, CFA

Where Trust is Earned

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