That ETF Might Be Riskier Than You Think

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Following a challenging 2022 for most markets, in the first half of 2023 markets have seen a return to many of the key themes that have driven returns in recent years, with the US markets achieving strong results despite macro headwinds. At the top of the list was the Nasdaq 100 Index, which rose 39.3%[i] in the first half, achieving its best result on record. Other markets also saw strong gains in the first half, with the S&P 500 Index rising 16.9% and the MSCI ACWI Index rising 13.9%. Even more improbable is the fact that this was all achieved in what would normally be considered a challenging macroeconomic environment, with increasing expectations of a recession; interest rates at the highest level in sixteen years and rising; a regional banking crisis in the US; continuing geopolitical tensions between China and the US; and the ongoing war in Ukraine.

It is worth noting, however, that while the strong performance of the indices globally was widespread, a significant amount of the strong performance of these indices was driven by a small handful of the index constituents – in most cases, US Technology companies. The first half saw many of the mega-cap FAAMG stocks (a widely used informal benchmark for US mega-cap tech[ii]) rise considerably. The strongest of these, Meta (nee: Facebook) was up 138.5% in the first half, while the weakest, Alphabet (nee: Google) was up a still-impressive 35.7%. Even moving beyond the favorites, the broader sector saw a strong rally, which to us appears to be a result of expectations of a pause or reversal in interest rate hikes, the emerging craze around anything containing the letters "AI," and good old animal spirits following a rough 2022.

The easiest way to illustrate the concentrated nature of performance in the first half is to look at the S&P 500 from both a capitalization-weighted ("cap-weighted") and equal-weighted perspective. The cap-weighted S&P 500 (the most widely used version of the index and the one that underlies the three largest US ETFs by assets) achieved a return of 16.9% in the first half of 2023. However, looking at the S&P 500 Equal Weight Index, which has the same constituents but allocates weights equally across the index's 503 holdings, we get a very different result, with the index rising only 7.0% – less than half that of the cap-weighted index. **<u>Given that most US ETF investors in this strategy are invested in ETFs based on the cap-weighted version of the index and thus experienced the stronger performance, you may ask, "So what?" The reason to worry is that this concentrated performance can cut both ways – down as well as up.</u>**

Many investors buy ETFs to gain diversified exposure to a market through a vehicle that, ideally, performs in-line with the index underlying it (less of fees). The prevailing wisdom amongst many people is that this (passive investing) is safer than active investing, where a manager (or the investor) buys a portfolio of stocks. Passive investing is believed to give exposure to markets without the risk that an active manager could significantly underperform the relevant index. As outperforming an index is a challenging thing to do, the prevailing wisdom amongst many investors has been "if you can't beat them, join them" – leading to many investors indexing because they think that the index gives them exposure with adequate diversification by default. We are worried that passive investors may think their ETFs are more diversified than they are and are not yet aware of the historic level of concentrations within many of these passive vehicles.

Following 15 years of low interest rates, which have driven up the performance of a range of both profitable and profitless technology companies, many indexes that have historically been thought of as widely diversified appear to us to have become less so. As of June 30, 2023, of the top ten constituents of the S&P 500, eight are tech stocks – including all five of the FAAMG stocks. We believe that much of the market's imputed value for many of these tech securities is based on profits expected to be generated in the future; as such, the entire group is likely more sensitive to movements in interest rates than the average stock in the index, increasing their correlations to each other (in addition to the business level attributes – similar customer bases, consumption patterns, business risks, etc. – that they already share), which could be a problem when they make up a relatively large portion of the index. Additionally, given the – in our opinion – exceedingly high multiples that most of these mega-cap tech companies currently trade at (NVIDIA trades at over 40x sales, for example), today's valuations reflect what we think are very optimistic future results – which, if not achieved, could lead to declines in price.

In fact, not only do the majority of the Top 10 stocks consist of companies that have some similar underlying valuation drivers, leading them to be more highly correlated to each other, in our opinion, but the strong performance over recent years by this small subset of the index has led to a situation in which the index has reached a historic level of concentration. **Today, the Top 10 companies in the index account for nearly 30% of the index, compared with 25% reached during the tech bubble of the late-1990s and an average of 20% over the past 35 years, according to Morgan Stanley[iii].**

At the same time, the Information Technology sector now accounts for 28.3% of the Index – near the 2000 peak of 35% and well above historic averages (the median since 2002 is 16%)[iv]. We believe that this figure actually *understates* the exposure, as the Information Technology Sector classification doesn't capture all tech companies, with behemoths such as Amazon, Alphabet, Tesla, and Meta not categorized as Information Technology stocks (they are Consumer Discretionary or Communication Services). **We estimate that recategorizing these four as technology stocks would bring the Index's allocation to technology stocks to almost 40%.**

In line with this, for the first time in our memory, the Nasdaq 100 Index – the index most widely associated with technology stocks – recently felt that the concentration of technology stocks within its own index was such that it announced its intention to undertake a "special rebalance" at the end of July 2023[v], reducing the index's exposure to mega-cap technology stocks by a bit, following their massive outperformance and increasing concentration of the index. As of this writing, none of the other major indices have yet announced their intention to follow suit. While no one knows what the future holds, this increasing degree of concentration is something investors should pay attention to.

Risk Needs an Adjective

At Moerus, we believe that you should not use the term "risk" without an adjective to describe the type of risk you are talking about. To most investors, risk is a generic term representing the chance a stock price will decline. From an investing perspective, risk is widely perceived to be one form or another of a statistical measure of volatility, generally derived from looking at the historic price movements of a stock. **We at Moerus believe that risk is significantly more complex than just a statistical measure of historic price movements and, as such, always use a qualifier to specify the type of risk we are talking about.**

To understand the potential threat that we worry may be lurking today in some indices (and, by extension, ETFs), it is helpful to understand the difference between howe we define Market Risk, Price Risk, and Business Risk:

- **Market Risk** is probably the concept most people think about when they refer in general to the term risk, but, to us, it represents the forward-looking potential variability (up and down) in a stock's price.
- **Price Risk** is the risk created when the market's optimistic expectations for the future are priced in to a security, creating downside risk for a stock if reality doesn't live up to those high expectations.
- **Business Risk** is the forward-looking risk that the net asset value of the business underlying the stock could be fundamentally impaired in a permanent way.

At Moerus, we embrace Market Risk as a positive, as it creates opportunity for long-term investors such as ourselves, while we seek to avoid both Price Risk and Business Risk. Simplistically, we tend to buy *stocks* that are perceived to have high Market Risk (i.e., significant perceived variability in price movements), as we believe this provides upside potential from the gap between what the market is pricing in and what we believe the company may be worth in the long term. In looking for these stocks, we seek out *companies* that we believe have limited Business Risk (i.e., limited risk of a significant impairment of capital). **Separating the Market Risk of *the stock* from the Business Risk of *the company* is key.** For a more in-depth analysis of risk, we suggest taking a look at our Investor Memo *Perspectives on Risk: How You Can Lose Money – Let's Count the Ways!*, a 25-page analysis outlining many of the ways you can lose money in investing. At Moerus, the focus is – and always will be – primarily on trying to avoid losing money. This is not to say that the securities we purchase will not go down in price (they often do in the short term), but rather that we seek to minimize the Business Risk of a loss of our capital through a fundamental impairment of the underlying business over the long term.

As noted above, we try to avoid the stocks of companies which we believe have excessive Price Risk – i.e., we think that the expectations of future fundamentals priced into the stock by the market may reflect overly optimistic scenarios. To do this, we seek to buy stocks that trade at significant discounts to our estimate of their intrinsic value in the "here and now." Specifically, we avoid buying stocks that appear expensive to us based on the here and now, but which may trade at a discount to some predicted future value that is based on overly exuberant expectations of what will happen in the future (high Price Risk). In our opinion, while these situations may come with high upside potential in other people's view, we also believe that when lofty expectations are priced in, this comes with high downside potential if those expectations are not met.

To be clear, our crystal ball is no less foggy than everyone else's, and this may end up being corrected by the rest of the index constituents catching up with the performance of the mega-cap tech companies, but from a Price Risk perspective, this degree of concentration in stocks that have achieved very high multiples is something we seek to avoid.

Tech: Back to the Future

One idea we keep in mind at Moerus is that a good company does not necessarily make a good investment. While the potential end markets for many of these mega-cap technology companies may be immense and the impact of AI may well be revolutionary – an assertion we do not necessarily disagree with – in our opinion, in many cases, these future "assets" are being priced into the stock prices today and then some. This creates a situation where the winners are yet to be determined, but still a wide array of companies are priced as if they have already won. While the AI craze does not mimic the dot-com bubble exactly, it certainly feels to us like it has echoes of it. In today's case, we believe that stocks have priced in expected fundamentals that are uncertain at best, creating significant Price Risk (to the downside, if reality doesn't live up to expectations). **We believe that Price Risk, when it rises to high levels with a skew towards the potential downside, combined with the increased concentration of these types of companies in the index, create the potential for inflicting lasting damage to capital, even if the underlying businesses turn out to be successes.**

Market history has no shortage of examples of situations where new technologies were expected to revolutionize the world – and in several cases did – but where investors nonetheless lost significant capital as the market got ahead of itself in bidding up stock prices and building up Price Risk by attributing success to the wrong companies – or to the right companies but at the wrong stock price. **Said another way, investors in these scenarios lost significant capital owning stock in companies that themselves ultimately proved to be massively successful as businesses.**

There are many examples of highly valued companies from the dot-com era that were priced as the winners but that did not pan out, or even disappeared completely (remember pets.com?). However, even companies that stood the test of time to become profitable, highly successful businesses nevertheless proved to be dismal investments for many years for those who bought during the bubble, regardless of valuation. Microsoft's business, for example, grew its revenues from $23 billion in 2000 to around $208 billion currently – quite impressive performance, yet those who invested in Microsoft stock on January 1, 2000, would have suffered a paper loss of 63% the following year, and would not have recouped their original investment until around July 2014, almost 15 years later.

Back in January 2000, it probably also would have been difficult to predict that Cisco Systems would emerge as the lone survivor among telecommunications equipment heavyweights Lucent, Nortel, and Alcatel, all of which also had rich, multi-billion-dollar valuations at the time. Like Microsoft, Cisco as a business has stood the test of time, growing revenues from around $19 billion in 2000 to roughly $55 billion today. Yet those who had invested in Cisco stock *on January 1, 2000,* would have suffered a cumulative paper loss of over 75% over the following three years, and still wouldn't have recovered their original capital until February 2018, 18 years later.

Other darlings from the dot-com era, such as Intel, Oracle, and Qualcomm, which also turned out to be "winners" from that time, surviving and thriving as businesses that have grown quite well, have nevertheless had similarly poor long-term results for investors who bought the stock regardless of valuation in 1999-2000. **This is because if you're a long-term investor who pays an extraordinarily high price for a stock, you essentially need the business to perform extraordinarily well, merely to earn commensurate returns given the ex-ante risk that you had assumed at the time.** While this may not be the case for the future – and no one knows what the future will bring – we believe it is worth thinking about, given the parallels with the current market.

Perhaps some of these unfortunate investors back in 1999 were hoping to save for their children's college education, or for their eventual retirement. These are risks that many investors cannot afford to take, yet in our view, Price Risk is particularly pernicious because we believe that it is often veiled by exciting growth prospects and a cheerful market environment whose recent history has been long on rewards and short on discipline and risk awareness. Price Risk tends to be less obviously visible to many just when, in our opinion, it is at elevated levels that call for greater prudence. The risk involved in an investment in a wildcat oil explorer, for example, or a company operating in a country with heightened risk of political or civil unrest, or a biotech with no drugs yet approved on the market, is (or ought to be) readily apparent or visible to anyone who invests their hard-earned money in such an enterprise. But when many consider an investment in a flourishing business that is successful, rapidly growing, and has the potential to continue to do so going forward, we believe that it is sometimes tempting to underestimate the danger of doing nothing wrong other than simply paying too much for that growth.

After more than a decade in which markets have mostly risen (2022 excepted), central banks have provided ample liquidity, and household name stocks have continued to go up with little regard for underlying value, we suspect the temptation of overlooking valuation might be greater than usual – even after the dismal performance of many of the companies in 2022. It is exactly this strong performance that has resulted in the increased concentration of these highly valued securities in the index.

How could such successful *businesses* (the eventual winners from the dot-com era) be associated with such poor long-term *stock* performance? Because valuation matters, even for tech stocks! In the above cases, overly optimistic assumptions of future growth in earnings and cash flows were already priced in, leaving significant downside potential for shareholders if the eventual outcomes were to fall short of those lofty expectations.

Going With the Flow Doesn't Mean You Can't Drown

Thinking about Price Risk in an environment where fundamentals are strong and expectations are high seems counterintuitive, but as noted above, **we believe that is precisely the time investors need to think about it most**. Coupled with the fact that these **tech securities represent an increasingly large proportion of major indices,** we are in a situation today where there may be more risk in the ETF than people realize, despite many people being happy with the choice to go passive – and why not, as the ride has largely been one way over the past decade? While no one can predict the future – the way out may well be a wave of strong performance beyond mega-cap tech companies – it is worth knowing the risk being taken.

As such, responsibility today is left largely to investors to take diversification into their own hands, looking beyond just passively owning an index. Absent indices following the Nasdaq's lead with a "special rebalance," one area where we believe investors can diversify some of this risk is by complementing passive index holdings with allocations to active management. Specifically, by looking for active managers that have a very high Active Share (measure of differentiation between a portfolio and an index), investors can counter the growing concentration risk within their passive allocations. We believe that these strategies could be less correlated with the markets – something even more valuable at a time like this.

Importantly, we believe that the inverse of this historic level of concentration is a great opportunity for investors willing to look where the market's light is not shining. Having a global opportunity set and a contrarian perspective can shed light on a wide array of attractive opportunities largely ignored by others in the clamor for exposure to AI, which can be bought at what we think are significantly more compelling valuations. We view our portfolio as a collection of these opportunities, each with its own story and timeline – a portfolio of investments that have characteristics that are less tied to the direction of the overall markets, but more driven by individual corporate events and developments (M&A, asset sales, recapitalizations, share buybacks, etc.).

While one can't estimate the timing of these developments, we believe that buying at a deep discount to Net Asset Value increases the chances of resource conversions like these, and that these developments are generally less correlated to market-level movements. In markets like today, when there are historic levels of concentration in the index – and the holdings making up this concentration may be more and more correlated to each other – we believe that a market-independent approach is a prudent allocation for all investors.

No one knows what the future will bring, but what we believe is that the current makeup of the index has created elevated levels of Price Risk, something all investors would do well to think about.

About Moerus Capital Management
Moerus Capital Management was founded in 2015 and is a 100% employee-owned organization. We run one global, deep value investment strategy that utilizes an opportunistic approach that results in a portfolio of 15-50 securities in developed, emerging, or frontier markets where we are seeing the most attractive long-term opportunities. The investment team led by Amit Wadhwaney, Portfolio Manager and Co-Founder, has worked together for more than 15 years and has experience investing in most countries around the world.

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[i] Source for index and stock returns: Bloomberg

[ii] FAAMG stocks consist of Meta (Facebook), Apple, Amazon, Microsoft, and Alphabet (Google).

[iii] https://www.morganstanley.com/ideas/concentration-risk-high-s-and-p-500-q2-2023

[iv] https://einvestingforbeginners.com/historical-sp-500-industry-weights-20-years/

[v] https://www.nasdaq.com/press-release/the-nasdaq-100-index-special-rebalance-to-be-effective-july-24-2023-2023-07-07