FERGUSONJOHNSON
WEALTH MANAGEMENT

The Summer of Uncertainty

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"A bigger problem than price inflation is expectations inflation: A constant increase in what you need to be satisfied. "
– Morgan Housel

Third quarter results didn't exactly take a nosedive; many asset classes remained positive year-to-date. But, there's no sugar-coating that downturns in stock and bond markets in August and September made for a lousy quarter. In comparing recent results to the growth spurt just prior, analysts have been describing current market conditions with words like "retrenchment," "sputters," "sideways performance, or "running out of steam."

It's curious because, in many respects, our economic situation is largely unchanged from three months ago. Economic conditions are still a mixed bag. There are some aspects of the economy that are at historic highs and there are other parts that seem utterly broken.

The labor market continues to show strength. Unemployment is below 4%. Prime-age labor force participation is over 83%[1]. Everyone is working! The narrative of "young people don't want to work anymore" that has made the rounds on cable news is completely false. The last time this many people were working was nearly three decades ago.

Inflation seems to be in an "okay-ish" place. We're under 4%, but not quite to the 1-3% zone we existed in for the better part of the last two decades. The real problem we seem to have psychologically with inflation is that "good" inflation news doesn't mean that that prices have gone down. It just means that prices aren't going up as quickly as they were before. We see the sticker price on eggs and get irritated because we remember how much eggs used to cost. So, we get angry all over again at inflation, the economy, the politicians, at whatever because we didn't used to have these emotions on a simple grocery trip.

The big problem that appears to be on the table now is housing. Home prices have held steady amidst the dramatic rise in mortgage rates which currently sit around 7.5% for well-qualified buyers. For a $750,000 mortgage, a monthly payment at 2.75% that could have been obtained two years ago would have been $3,062. That payment is now $5,244, at today's rates.

Fortunately, the majority of our client base has been insulated from the spike in housing affordability. Those of us who already own homes that are either paid off or were refinanced at the low rates from the end of the last decade are sitting pretty. But, this jump in rates has thrown a wrench into plans to move or purchase a second home. Many of our client's children or grandchildren are now put in situations where owning a home is currently out of reach until something gives.

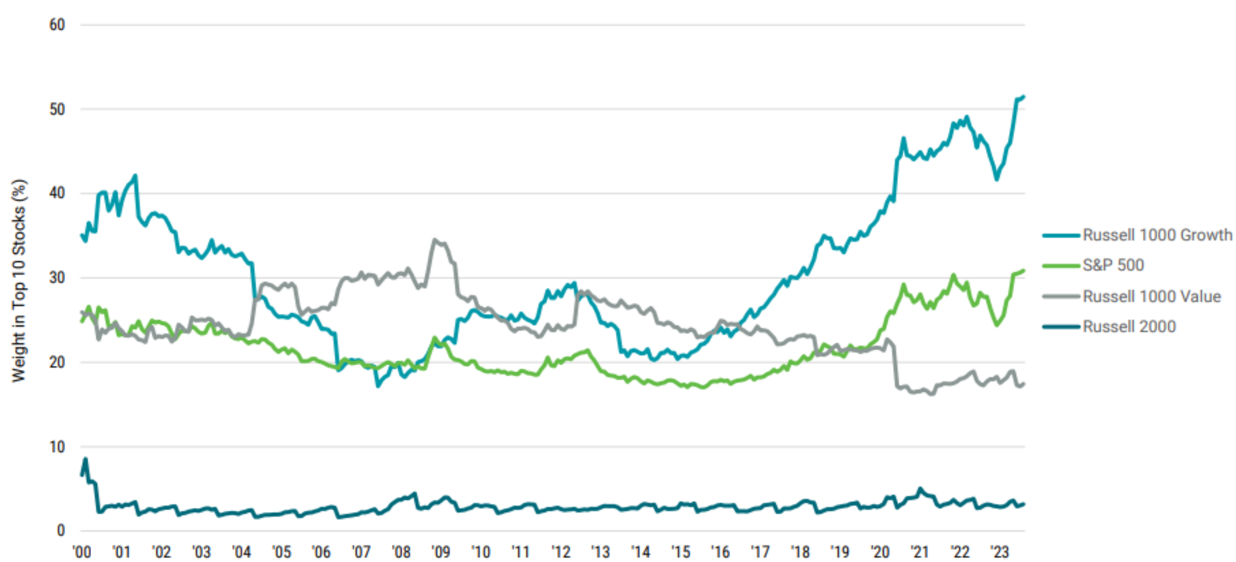
Mega Caps Driving the Market

The idea behind market indexes is that they are designed to be a representative slice of the segment of markets from which they are composed. In most cases, an index holds hundreds or thousands of companies such that the performance of each individual company has a largely negligible impact on the performance of the index as a whole. This is a good thing for investors. Investing in an index-style allows for broad diversification from getting exposure to those hundreds or thousands of companies.

Most indexes are market capitalization weighted. This means the index holds the companies in its portfolio in weights comparable with the total value of those companies. As an example, a company that is worth $20 billion dollars would carry twice the weight of a company that is worth $10 billion dollars. Academically, this makes sense as a larger company likely has more impact on the overall economy than a smaller one.

However, over the past several years, the explosive gains of companies like Nvidia and Microsoft have led to record levels of concentration in popular indexes like the S&P 500 and Russell 1000 Growth. The chart below illustrates the concentration of the top 10 companies in various indexes over time:

Share of Index Represented by 10 Largest Companies over Time



Source: Avantis Investors. Data from 1/31/2000 to 8/31/2023.

We believe the implications of this overconcentration is clear. These indexes, and more importantly the funds that track them, are likely to behave in a less diversified manner until the concentration levels subside. Until that time, the overall portfolio results – good and bad – will be largely dictated by the performance of these few companies rather than diversified across the many other constituents in the portfolios.

We are very cognizant of this risk and believe well-constructed portfolios should be designed to balance returns and risk carefully. While we do favor a more passive and long-term approach to investment, strict indexing has drawbacks, as illustrated. We believe slight tweaks to the index formula can enhance the risk-adjusted returns our client's experience. Generally, the funds we select for client portfolios avoid over-concentration, such as this. Maintaining a clear understanding of the risks embedded in investments is an aspect of our job that we take very seriously.

[1] *Source: FRED data as of 10/10/2023.*

Past performance is no guarantee of future results.