Cetera® Investment Mangement

# Commentary

## Don't Get Lost in the Crowd

July 19, 2024

- The S&P 500 had a huge rally (+37%) since the last correction low in October 2023.
- There are concentration risks in major indexes, but there are ways to mitigate these risks.
- We expect more volatility, but diversification can help, and market breadth is improving.

Over the past 30 days, we have seen rotation within stocks. Growth stocks, which have led the market higher this year, have struggled and are down roughly 1.5% as measured by the Russell 1000 Growth Index. On the other hand, the Russell 1000 Value Index is up 3%. Small cap stocks have been doing even better, up nearly 8% over the past 30 days as measured by the Russell 2000 Index. We have seen a more pronounced trend since the release of June's soft CPI report last week. Stocks that were mostly ignored over the past 12 months are starting to catch up. This wider market breadth can be a sign of a healthier stock market.

We have spoken at length about the importance of diversification as the performance in major indexes like the Russell 1000 and S&P 500 has been primarily driven by a handful of Mega cap growth stocks that make up a significant amount of the indexes. These indexes are weighted by company size, so the larger the company, the larger the weight in the index. When very large companies do well, so do the indexes. The opposite can also be true. Before the recent selloff, the top 10 stocks in the S&P 500 made up over 38% of the index. By comparison, the top ten stocks were less than 20% ten years ago. This ratio was only higher when it went over 40% at the dot com bubble peak.

Well diversified portfolios were not keeping up with these concentrated indexes. While the indexes appear to be diversified because they are comprised of hundreds of stocks, the diversification can be misleading because the weighting of these stocks is skewed heavily. The top ten largest stocks are mostly technology-oriented, growth stocks, pushed higher by the artificial intelligence optimism. Valuations in these stocks have soared. The price-to-earnings (P/E) ratio in the technology sector is near 40, something we also haven't seen since the dot com bubble. High valuations can mean more risk. If these highly valued companies miss earnings or growth projections, their stock prices will likely fall.

It's easy to get excited about the new AI innovations, but it is important to remember that good companies can be overpriced, just like bad companies can be underpriced. Buying a stock only based on their industry is not prudent. One must do their homework and understand a stock's value relative to its price. While these growthy sectors can offer higher potential returns, the risks are significantly higher. Thus, it is always prudent to diversified into multiple industries and sectors.

Understanding a portfolio's exposure to technology and growth stocks is important. One may also want to own stocks or indexes with exposure to different industries, sectors and sizes. Long-term investors must stay focused on their own risk and return objectives, understanding that underperforming a concentrated index, that only focuses on large domestic companies may be okay. It's easy to race with the crowd, chasing popular indexes or stocks, but when the crowd heads to the exits, it is also easy to get lost in it.

More volatility is likely if the economy continues to weaken, election uncertainty grows, and investors try to anticipate Fed rate cuts. Diversification can help mitigate this volatility. If volatility escalates, we think it could be short-lived as the Fed is likely going to cut rates soon and the labor market is strong. There is a lot of cash in savings accounts and money market assets that could be deployed to buy the dips. Furthermore, corrections and pullbacks are a normal part of investing. Your financial professional can help you stay focused on your personal financial goals. As always, please contact your financial professional with any questions about tailoring your portfolio to your personal situation.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

A diversified portfolio does not assure a profit or protect against loss in a declining market.

**Glossary**

The **S&P 500** is an index of roughly 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of large cap universe.

The **Russell 1000** index is a stock market index that tracks the top 1,000 stocks by market capitalization in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index.

The **Russell 1000 Growth** index is a subset of the Russell 1000 as measured by three factors: sales growth, the ratio of earnings change to price, and momentum.

The **Russell 1000 Value** index is a subset of the Russell 1000 as measured by three factors: the ratios of book value, earnings, and sales to price.

The **Russell 2000** index is comprised of 2000 small-capitalization companies. It is made up of the bottom two-thirds in company size of the Russell 3000 index.