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Investment letter – 2nd Quarter 2024

# Navigating the Index Concentration Dilemma: The Case for Active Asset Management

## Heavyweights dominate index performance

In our latest investment report, we addressed the question of whether the technology sector is overvalued and concluded that this is not fundamentally the case. Looking back at the first half of the year, it is tempting to examine this issue from a different perspective.

In particular, the large technology companies, after another strong rise, are not only highly weighted in the benchmark indices but also responsible for a large part of this year's performance. This is most pronounced in the Nasdaq technology index, where the 10 largest companies have a weight of 52% and are responsible for 94% of this year's performance. In the more broadly diversified MSCI World Index, the 10 largest companies make up 25% of the index and have contributed 62% to the performance.

Economic growth is low, interest rates are high, and the outlook is uncertain. At the same time, we are experiencing euphoria in the field of artificial intelligence, and in the middle of it are the largest corporations, which have the financial means to invest in the data centers that produce the necessary computing power. Even without earnings from artificial intelligence applications, the earnings growth of these large corporations is already considerable. The combination of these factors has raised investor expectations, and as a result, the 10 largest companies are now twice as expensive as the overall market. At the same time, the weighting in the indices has risen sharply. As recent as 2018, the 10 largest companies in the MSCI World had a weighting of 12%, compared to 25% today.

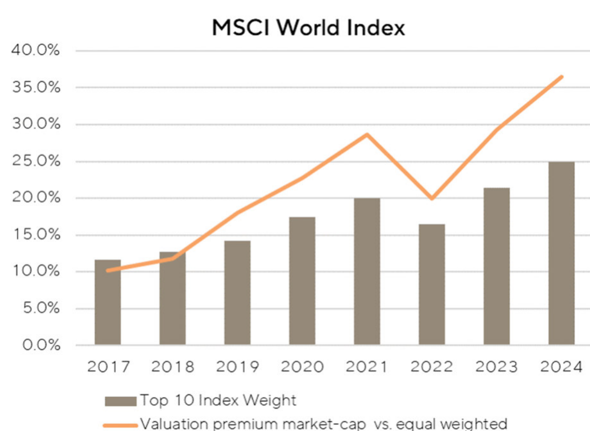
## Analysis of the valuation dynamics

Meanwhile, there are countless indices that weigh all stocks in the index equally to achieve a broader distribution of invested capital. Interestingly, these indices outperform cap-weighted indices in the long term. However, the phases in which cap-weighted indices generate excess returns are often long. This can possibly be explained by the fact that fundamental earnings drivers first justify the price increase of dominant companies, but are then replaced by exaggerated expectations, which consequently lead to a valuation correction. It has yet to be definitively assessed which phase we are currently in. The potential of artificial intelligence appears promising, the possible changes

are far-reaching. But the risks are also multifaceted, from technological disruption to new competitors to government intervention.

A high index weighting and valuation premium do not necessarily mean that these companies are overvalued. They may be fairly valued in view of the potential scope of artificial intelligence. However, fairly valued also means that a positive scenario for earnings growth is already discounted in the price. If the priced-in scenario proves to be realistic, the future price increase will be driven more by actual earnings growth than by a further widening of the valuation premium. Therefore, the probability of a renewed development on the scale of the past few years is significantly lower. The risk/return ratio, which is essential for investing, has deteriorated accordingly.

This poses various risks for investors. Passive investors are disproportionately invested in highly valued large caps. Active investors are often measured against benchmark indices whose weightings are based on the market capitalization of companies. If the performance of these benchmark indices, as is currently the case, is driven by a few stocks that additionally and because of their strong price performance have a high media presence, the pressure increases to weight them in a similar way to the benchmark indices.




### Added value through active asset management

As a Swiss investor, one is well aware of the downside of index dependence. Nestlé, Roche, Novartis, and UBS make up more than half of the SMI Index and are partly responsible for the fact that the index has not been able to keep up with the performance of the MSCI World Index for years. The fact that large corporations have a dominant weighting in indices is not unusual globally and in historical context. However, the fact that they outperform the overall market in the long term is. Away from the media attention and expectations of trend investors, a multitude of companies are generating attractive profit growth without having to pay a valuation premium for it.

Active asset management can again become crucial in the near future if one takes an independent path away from benchmark indices and can withstand the occasional strong pressure to neglect diversification and valuation criteria. We at Valvest Partners do not consider the current time to be opportune to weight the large companies analogously to the benchmark indices. For this reason, we have made reallocations and reinvested in companies where we see a more attractive risk/return ratio.

Zurich, end of June 2024