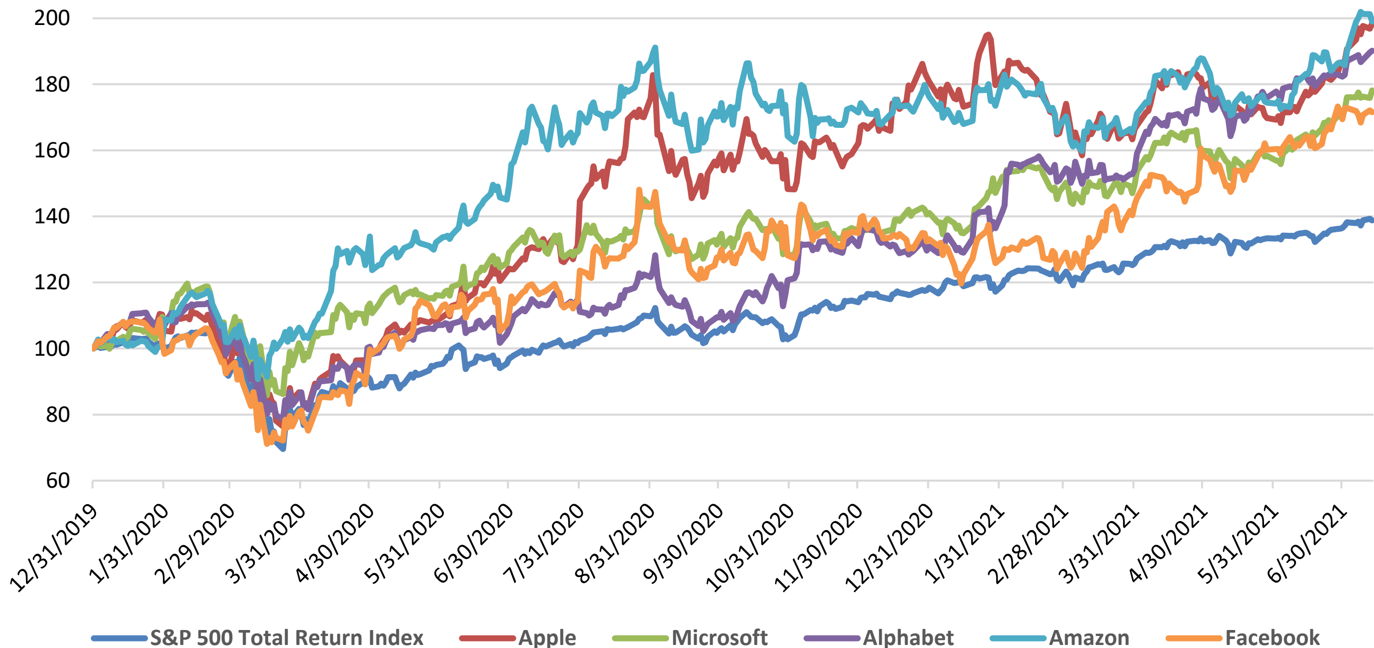
The S&P 5(00)

Since the start of 2020, the S&P 500 Index has achieved a total return of just under 39%.[1] A remarkable run in the face of extraordinary economic disruption. While many stocks have performed well post-pandemic, the story of the index is really the story of five companies colloquially known as FAAMG: Facebook, Apple, Amazon, Microsoft and Google (or Alphabet). These five stocks alone have accounted for over 42% of the S&P 500's gain. Put another way, if the remaining 495 stocks in the S&P 500 were flat over the last 18 months, the index would still be up over 16.3% based on FAAMG returns. They are so dominant to the U.S. market structure that we may well as start calling the S&P 500 the S&P 5.



Most of our portfolios have exposure to several or more of these stocks and have benefitted handsomely from owning them over the years. Given their reasonable valuations relative to the rest of market, as well as their still impressive sales, profitability and cash flow growth rates, we see no reason to lighten these positions (unless their weight in an individual portfolio becomes too large for comfort). The FAAMG stocks each operate in markets where they benefit from growing network effects – where competitive dynamics naturally lend themselves to winner-take-all, or oligopolistic type market structures. Yes, antitrust actions and regulatory policies in the U.S. and Europe remain potential headwinds, but for several years now these concerns have done nothing to hinder business operations or share prices (and given the conservative bent of U.S. courts, any action short of congressional legislation is likely to face a high barrier to judicial success).

As depicted in the below graphic, FAAMG stocks now account for over 23% of the S&P 500 Index weight – the highest concentration in the top-5 stocks going back to at least 1980 per a recent Goldman Sach's study on market concentration.[2] The key issues for investors aren't whether these firms are worth owning or overvalued (we would argue they are worth owning and are not overvalued); rather, investors need to decide where to allocate long-term capital outside these mega-cap technology firms and what the impact will be on portfolio performance if their stock returns level off.

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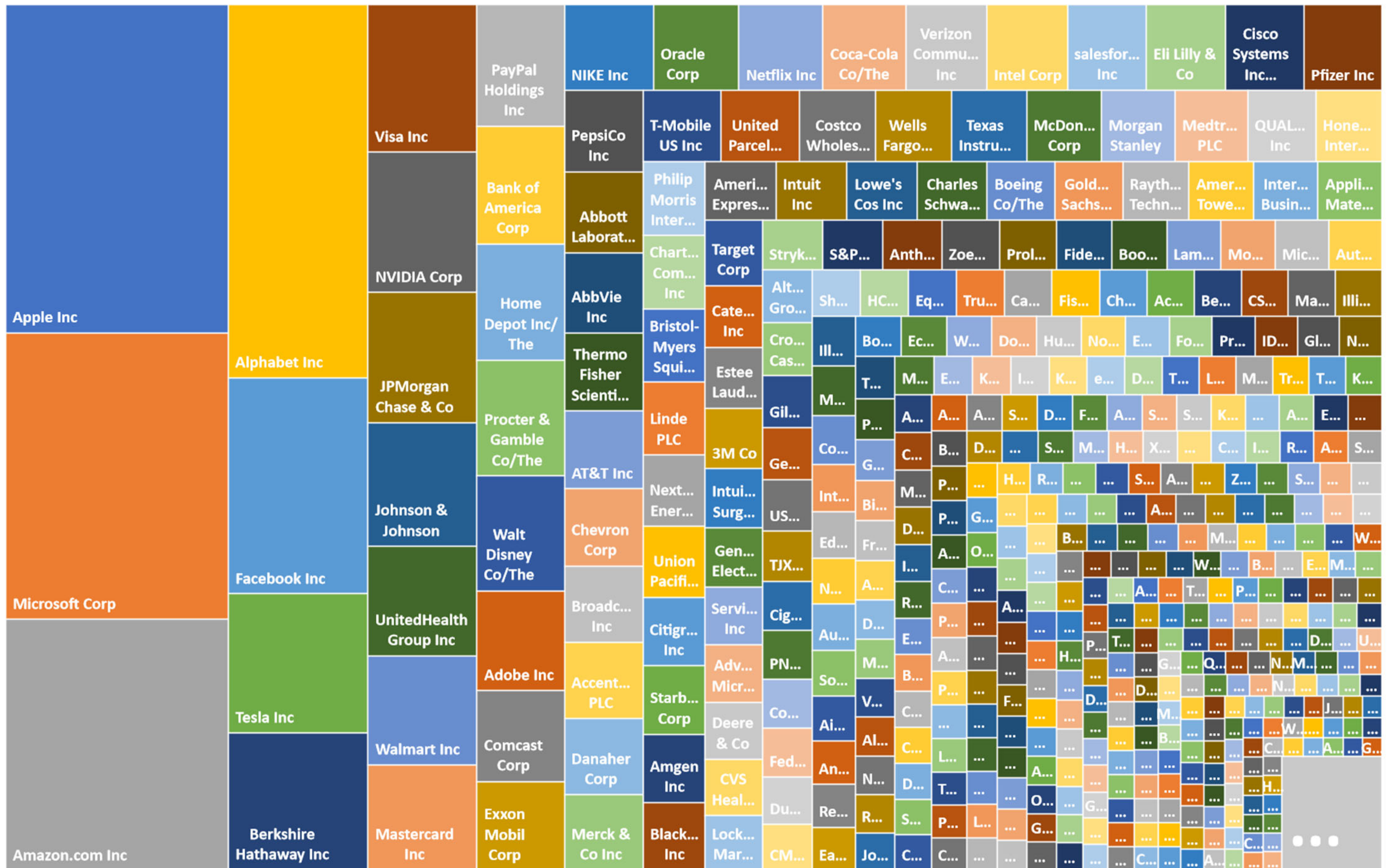
S&P 500 Index Composition by Company Size



Unfortunately, there aren't easy answers to these allocation questions. Over-allocate to mega-cap tech and you may carry more portfolio concentration risk than you can tolerate. Under-allocate and you may underperform the index if these companies maintain their pace of share price appreciation. Another key variable in determining allocation is what will prevailing economic conditions look like once we are past this pandemic (and whether we will even get past Covid anytime soon given the rapid spread of new variants like the Delta variant). With bond yields falling over the last month and large cap tech stocks again rising, the market is sending a signal that concerns over inflation are likely to abate and the economy will return to the slow growth type of environment that defined the 2010s. We are not so sure a return to pre-Covid economic conditions will be the ultimate outcome, or whether recent signs of increased inflation will prove durable along with higher sustained economic growth. If the post-Covid world ends up resembling the pre-Covid world, then large cap tech/growth stocks whose businesses can thrive despite operating in a low GDP growth environment should continue performing well.

Previously, we have shared an analytical framework from the firm Gavekal Research that we find helpful in determining the optimal portfolio strategy for four different sets of economic conditions.[3] Per the below chart these are: (1) inflationary boom, (2) inflationary bust, (3) disinflationary boom and (4) disinflationary bust. We doubt we are headed toward any sort of bust given the immense fiscal spending by global governments and accommodative monetary conditions. The key question is are we likely to experience conditions closer to an inflationary boom or disinflationary boom. The latter description marked the decade following the 2008 financial crisis. Prices were stable and economic growth – though unexceptional – still trended in a positive direction.

Karmin Capital
600 Central Ave, Suite 365
Highland Park, IL 60035
(847) 559-9700
www.karmincapital.com

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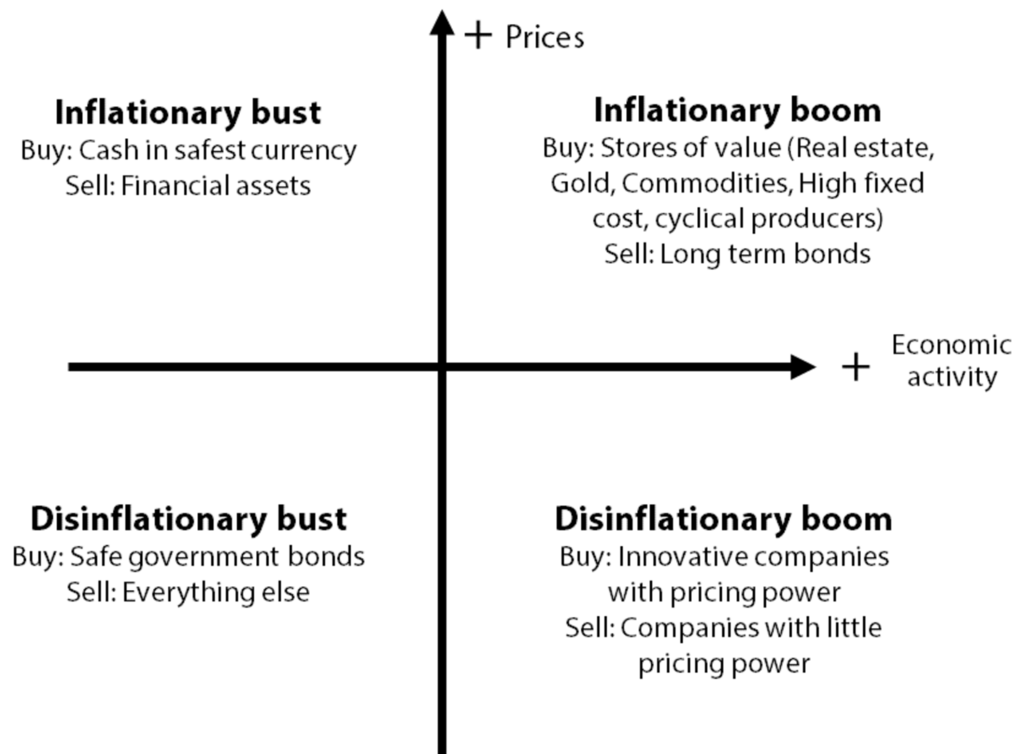
As stated above, this set of conditions favored FAAMG-type stocks. However, a more robust growth environment marked by higher prices would likely favor a completely different set of companies. Particularly firms whose operations are more sensitive to economic conditions (which tend to be asset heavy companies with cyclical businesses in the energy, industrials, materials, financial and consumer discretionary sectors). The underlying businesses of the S&P 5 would be just fine in an inflationary boom, but their stock prices might lag (as was the case from October last year through this May when investors positioned for an inflationary boom-type outcome).



On the question of inflation, the short-term data right now cuts both ways. The year-over-year price comparisons to last year are unsurprisingly high, resulting in some of the sharpest consumer price index (or CPI) readings since the 1970s. Monthly CPI increases are also elevated as the economy reopens and businesses are paying up to attract/retain workers and resolving supply chain disruptions. Inflation can start as a short-term trend before morphing into a longer-term mindset. The biggest risk to sustained inflation is probably consumers and businesses anticipating high future inflation and altering their consumption and pricing habits accordingly. Inflation can be a self-reinforcing mindset. On the other hand, the categories contributing to outsized yearly and monthly price rises may be transitory. Per the following chart from the financial journalist Matthew Klein, a large part of June's CPI increase over May was attributable to what he calls "Pandemic idiosyncrasies."[4] Used vehicles, for instance, are having an outsized impact on monthly inflation. It's hard (but not impossible) to envision a tight auto market for used cars persisting durably into the future.

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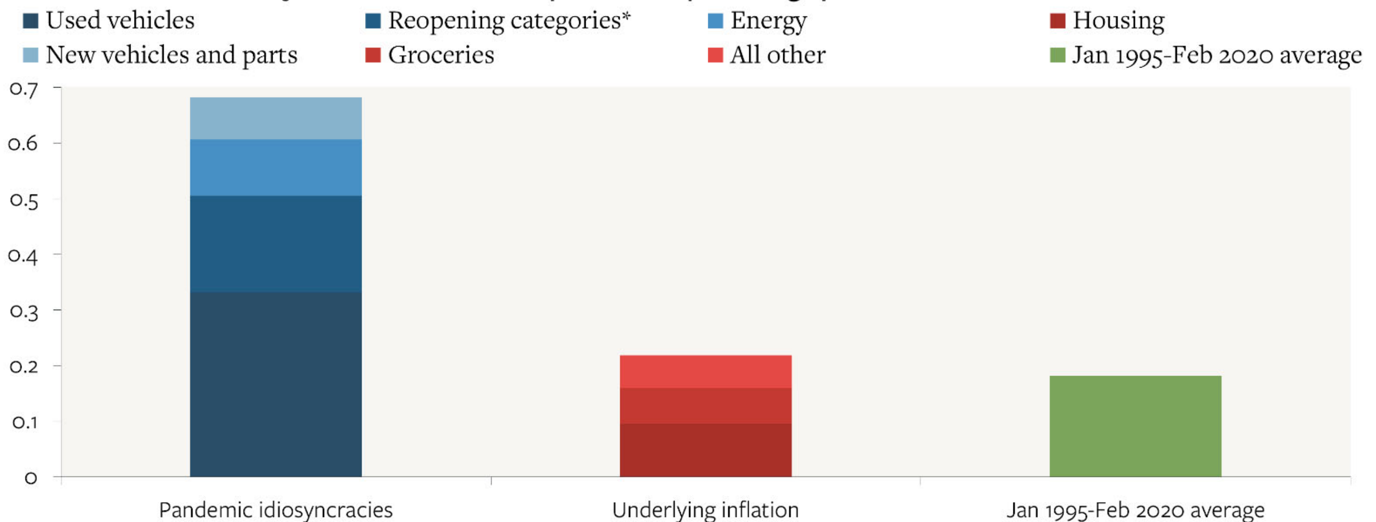

While we have strong and informed thoughts on the likely path forward for the economy, the reality is no one knows what will unfold. Continuing to bet on the FAAMG stocks may very well be a wise one; or it may not be. Good companies don't necessarily make for good stock prices all the time. The background set of economic and market conditions also matters. If you own these stocks, we advise continuing to hold them; and if you are under-allocated, we think they still make sense as pillars in a portfolio. For many of us, though, the challenge is what to do if you already own a fair amount.

If the post-Covid economy begins to look more like that of the 2010s, the FAAMG stocks will serve you well. The risk for portfolios is that the 2020s are different and that the S&P 495 matter more to returns than the S&P 5. To hedge this risk and improve overall diversification, we encourage considering allocations to firms whose businesses would benefit from a stronger growth environment marked by higher prices. So it boils down to if you don't have much cyclical or value exposure, consider adding some.

We hope you and your families are enjoying the summer. As always, please feel free to reach out to discuss any of the ideas covered in this letter or your portfolio strategy.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

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Citations and Disclosures

[1] Bloomberg (as of July 14, 2021). All market data cited herein is from Bloomberg unless otherwise noted.
[2] Goldman Sachs, *Equities, antitrust, and the "inestimable" value of due process* (July 13, 2021).
[3] Charles Gave, Gavekal Research, *The Boom Of 2021* (Dec. 18, 2021).
[4] Matthew Klein, *U.S. CPI inflation* (July 13, 2021), available at: https://theovershoot.co/p/us-cpi-inflation.

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