Risky business

Addressing the concentration conundrum in US equities doesn't have to mean sacrificing returns...

Update
21 November 2024

Analysts:

Jo Groves
jo@keplerpartners.com

It's certainly been an eventful month. On the rugby front, the home nations capitulated to the Southern Hemisphere's big three once again, leaving the mercurial French to teach the All Blacks a lesson. Clearly, the pitch-side cheese and wine tables that James Haskell so fondly recalls from his training sessions at Stade Français have fuelled a winning mentality beyond choreographing moves for the haka.

Staying with our nearest neighbours for a little longer, regular readers of this column will also be relieved to know that Pascal's epic Gallic travails (or indeed travels) with his Mercedes Ad-Blue system have finally concluded (albeit his pocket is now considerably lighter).

Oh, and there was the small matter of Donald Trump winning one of the most fiercely-contested US elections of all time. Throw Trump 2.0 into the melting pot alongside geopolitical conflict and £40 billion of tax rises in the Autumn Budget and it's safe to say that investors have had an awful lot to digest.

On that note, I recently interviewed Charlotte Cuthbertson, manager of **MIGO Opportunities (MIGO)**, on our new **monthly market insights podcast**. We discussed what had surprised her most about stock markets this year, which was markets remaining surprisingly upbeat despite the trifecta of persistent inflation, slower-than-expected rate cuts and elevated geopolitical risk.

It seems that investors are taking macroeconomic and political volatility in their stride as the new normal. Even with a new president (and his trusty side-kick, the ubiquitous Elon Musk), the S&P 500 has remained broadly flat over the last month. And, despite the margin squeeze from the higher labour costs unveiled in the Autumn Budget, the FTSE All Share Index is on course to end the month only slightly in the red. Perhaps a case of expectation management but little seems to have phased the new breed of keep-calm-and-carry-on investors.

As 2024 draws to a close, it seems an opportune time to reflect on which parts of the market have outperformed in a year where uncertainty has remained firmly centre-stage. Unsurprisingly, the US has led the charge among the top-performing Investment Association sectors, with North American Smaller Companies, India and China hot on its heels.

As a result, it's been less the Year of the Wood Dragon (whatever that is) and more the Year of the Tracker: aficionados of the unfortunately-named SPIVA (S&P Indices Versus Active) scorecard will point to 75% of US funds underperforming the S&P Composite 1500 over the last year. Good news for US tracker fans who will be no doubt enjoying a well-deserved upgrade to the Freixenet and turkey crown from Iceland come Christmas Day.

Of course, none of this is a revelation but you don't need to be a quant genius (which is a mercy in my case) to undercover attractive returns beyond the headline indices. And given the current level of uncertainty, harnessing your fortunes to the US technology juggernaut isn't without its risks either.

The extreme concentration of the Magnificent Seven in US and global indices has been a hot topic in our fund manager webinars this year. Strategists from the Bank of America describe the current concentration as "abnormally high", noting that the top five stocks hit a record high of 29% of the S&P 500 this year, easily surpassing the 18% peak in the dotcom bubble.

Meanwhile, their opposite numbers at JPMorgan have also aired their "concerns over a potential bubble", with "excessive stock rallies and 31 new all-time highs this year". They report that, while the S&P 500 rose by an eye-watering 46% from the start of 2023 to mid-2024, subtracting NVIDIA cuts the return to 37% and subtracting the top five halves this to 23%.

In fairness to the Magnificent Seven, the fundamentals remain sound but valuations are undoubtedly lofty and we've seen a few market wobbles in recent weeks, including NVIDIA suffering a record-breaking one-day fall in market capitalisation in September.

Charlotte also spoke about the uncertainty around whether US indices can continue their impressive upwards trajectory over the next year and the merit of diversifying beyond low-cost passive US exposure if the market cools. However, this doesn't have to be at the expense of returns with many active strategies offering the potential for alpha generation beyond the headline indices.

Within the active sphere, many investment trusts are also trading at a discount which can enhance returns, or as Charlotte put it, allow investors to buy 'interesting assets for 70 pence in the pound'. So, with the benefit of hindsight, here's a flavour of some of the trusts that have outperformed the S&P 500 in the last year while providing diversification into sectors offering idiosyncratic drivers to US equities.

First up is **Golden Prospect Precious Metals (GPM)** which has delivered an equivalent NAV total return of 46% over the last year, some 50% higher than the 30% (GBP) return from the S&P 500 Index. GPM provides exposure to a diversifying asset class with gold often showing a positive correlation to equities during risk-on periods but decoupling to an inverse correlation during periods of economic and geopolitical uncertainty, according to analysis by the World Gold Council.

The gold price has risen by 30% to hit a record high this year, helped by strong buying by central banks as countries look to move away from US-dollar assets in the face of sanctions. However, gold miners can offer differentiated returns to the underlying gold price and GPM's flexibility to invest in small-cap miners can also drive alpha generation relative to passive gold funds.

Another contender is **Rockwood Strategic (RKW)** which has also significantly outperformed the S&P 500 with a one-year NAV total return of 44%. Manager Richard Staveley invests in a high conviction portfolio at the smaller end of the UK small-cap sector with a focus on 'self-help' operational, management and strategic changes rather than relying on macro factors.

UK small-caps continue to look attractively-valued against long-term averages and an improving macroeconomic environment could provide the necessary catalyst for a sustained recovery in the sector. Looking over the last five years, RKW has achieved a NAV total return of almost 100%, only just behind the 103% (GBP) return of the S&P 500 and considerably in excess of the 3% return from the FTSE Small Cap index over the same period.

A year from now, I may well be writing the very same column about the stellar returns of the S&P 500, but with macroeconomic and political uncertainty showing no signs of abating, diversification seems a sensible solution to the concentration conundrum of US equities.

Or, to borrow another rugby analogy, South Africa's try-scoring machine Cheslin Kolbe may dazzle fans as he streaks down the touchline but if (or when) the tide turns, your portfolio might be in need of a bit of heft from the Bomb Squad to get returns over the line.

Data as at 18/11/2024

Disclaimer

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR TERMS AND CONDITIONS

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 70 Conduit Street, London W1S 2GF with registered number OC334771.