The hollow crown

Soaring indices look threadbare without the Magnificent Seven, but active managers are being punished by investors for failing to track the index.

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Just over a year ago, in summer 2024, the Nasdaq, S&P 500 and Dow Jones were in freefall – recording their biggest three-day losses since 2022 in August as fears of a recession in the United States began to bite.

A survey that summer by S&P Global found that investor risk appetite had dropped to 29%, to its weakest point since mid-2023.

Investors in the UK, fools that we are, were still hoping that the newly elected Labour government might prove to be even mildly less incapable than the sexually incontinent, lettuce haunted, travelling clown show it replaced.

Even JPMorgan thought things might be on the up for Blighty, saying: "*We think that this time, a Labour win will likely be seen as a positive for the UK markets. The current Labour party has a much more centrist policy agenda*".

How things have changed.

Few would, I feel, put much faith in the near or even medium-term outlook for UK equities as the country lurches toward becoming what feels ever more like a seabound gulag, while the US – far from falling into recession – has gone from strength to strength. Even after a bumpy November, the S&P 500 is up 15% over one year, and more than 26% since August 2024.

It is widely known that much (indeed most) of this performance has been driven by the Magnificent 7 - Nvidia in particular has garnered acres of newsprint lately as the chipmaker's valuation has soared and soared again.

An excellent article in the Washington Post this week showed what would happen if you were to look at the performance of the index but ignored the Magnificent Seven. This new index – perhaps we might call it the 'Ordinary 493' – reveals a far less vigorous market, where ordinary companies that don't bestride the planet from Silicon Valley report sluggish sales and declining investment.

In fact, the Bloomberg 500 index has delivered returns of 1057% since January 2019, but with the Magnificent Seven stripped out, the same index has returned a comparatively paltry 132pc over the same period.

This creates a gordian knot of a problem for active management. If you don't match the index, you are punished as it runs away from you. If you do, why are you more expensive than an ETF?

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Allianz Technology Trust (ATT), is a good example of a trust in this difficult position. It has delivered stellar returns over one, three and five years and yet it trades on a discount of 10% and has been buying back shares all year.

The managers are in a difficult position because of the overwhelming influence of the Magnificent 7 – six of which are the among the largest constituents of its benchmark Dow Jones World Technology Index – in the public mind.

As an active manager, if they diverge from the benchmark, they risk underperforming, and if they don't they risk being labelled as an expensive tracker.

Alliance Witan (ALW) – a broader global equities trust – is in a similar position. After a strong period of performance in 2023-4, returns have slowed and again, the trust's focus on stockpicking managers, who do not simply 'buy the index' may be partly responsible. ALW holds most of the Mag 7's constituents, but only three appear in its top ten.

This distortion isn't just a problem for fund managers. ETFs and index trackers are already popular among ordinary investors in part, I think, because it's easy to sell to them the idea of something which is 'cheap and does what the index does'.

Soaring indices encourage the view that they are the only show in town. What is the point of owning an actively managed fund, apart from keeping nice boys and girls from the home counties in gainful employment, if it cannot keep pace with the index? The smart money is all in ETFs! So the narrative on YouTube goes. 56% of respondents to one survey by the Journal of Financial Planning said they used the streaming platform for investment ideas; so it matters.

The irony is that environments like the one we are currently in are exactly why active management is so important. The current galactic valuation of Nvidia is based upon the idea that the company, which has annual revenues of $200bn, will grow at a rate of more than 60%.

This fantastically optimistic premise may well prove to be true, but we have been here on the plains of Elysium before. Another chipmaker, Intel, peaked at $495bn in 2000 on the back of excitement about a new technology that we thought would change the way we interact with the world and each other forever.

The internet did, indeed, change the world but while some thought in 2000 it was the herald of a global community for humankind it turned out rather more focused on cat videos, soul consuming vanity feeds, pornography, and shrieking at one another about racism in 280 characters. Intel, in which Nvidia is now the largest shareholder, at the end of last year was worth a quarter of what it was at the height of the dot.com boom, and perhaps our lives are all a little less than they were too.

With seven stocks dominating the next 493 largest companies in America now, more than ever, we need strong active management – and a strong message on why it is important. With that in mind, we are planning to launch a new website in December, which includes a selection of funds chosen by our analysts because they believe each one offers something unique, different or better than its peers.

The new site will include investment trusts, but for the first time we will also be looking at open-ended funds and exchange traded funds – the latter because we know people are interested in them, and because we believe they do serve a purpose; but that purpose is not to serve as a replacement for intelligently governed portfolios led by skilled human beings.

We will be particularly focused on providing research and ideas for investors who have less experience in managing their own portfolios; aiming to deliver insight in clear, simple, actionable terms without patronising our readers.

If you would like us to share the first edition with you, please do let us know by clicking **here**.

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