HARRIS ASSOCIATES

PRIVATE WEALTH MANAGEMENT

Unafraid of Heights

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The new year has gotten off to a strong start. The S&P 500 Index, the index frequently used to gauge the health of the overall economy, generated the largest returns in a first quarter since 2019, reaching 22 all-time highs. This strength has come at a moment of mixed inflation results, uncertainty around the timing of interest rate cuts, pronounced geopolitical tensions and election-year dynamics. While investors are generally happy with the market, these macroeconomic challenges and high equity valuations generate prevailing concerns around whether these levels are sustainable. At Harris Associates, we are comforted by our consistent, long-term philosophy that enables us to view investments through full economic cycles.

What has set the stage for these new heights?

A handful of companies. The first-quarter return of the S&P 500 continues to be driven by only a handful of stocks. In 2023, the top five companies contributed to 51% of returns and the top five stocks in the first quarter of 2024 have contributed to 50% of returns. Technology services, like Nvidia, Microsoft and Meta Platforms, took the lead for the quarter, followed by Amazon and Eli Lilly. This increasingly concentrated market continues to provide opportunity for active managers, such as ourselves, in areas that are otherwise forgotten. A balancing of market returns should tilt the scale in favor of investors focused on valuation versus momentum.

Momentum investors. The stock market is one of the few economic markets where the masses tend to buy as prices go up and sell on the way down. These investors, known as momentum investors, exacerbate the all-time highs we see in the market today by buying as prices rise. In one week of March, investors added a record $60 billion into U.S. funds[1] at a time when the S&P 500 was trading at a price-to-earnings multiple of 26x. This means an investor is willing to pay $26 for $1 of earnings, which is fueling a historically expensive market (the long-term average is around 20x).

Artificial intelligence (AI)/generative AI (GenAI). When an innovative tool has the power to disrupt markets, investors take notice. In the late 1990s/early 2000s, investors rapidly added to almost any stock that mentioned a new and revolutionary technology: the internet. The speculative frenzy that led to inflated stock prices during the dot-com bubble inevitably collapsed due to their failure to turn profits. Investors' eagerness to capitalize on potential, no matter the price, set the stage for the dot-com bubble. While we certainly cannot predict the future, a comparison to the current AI boom seems unwarranted as today's AI-focused companies typically have real cash flows and earnings. At Harris Associates, we try and assess the way in which this technology impacts business value.

Why do these heights not scare us?

We are active managers. While persistent all-time-high records in the S&P 500 may frighten some investors, our active share of the index is just north of 89%. In other words, over 89% of the equities in the average private client portfolio differs from the index. This allows us to manage concentration risk unlike the current S&P 500 market-weighted index. A decade ago, the 10 largest companies in the S&P 500 accounted for 17.8%, which is in sharp contrast to today's 32.2% (close to the all-time high).

"Mimicking the herd invites regression to the mean (merely average performance)." – Poor Charlie's Almanack by Charles Munger

A method of viewing the S&P 500 sans concentration risk is looking at the S&P 500 equal-weighted index. In the past year, the S&P 500 equal-weighted index returned 19.38% versus the S&P 500 (market-weighted) return of 29.88%. Over the past 10 years, the S&P 500 equal and market-weighted index returned 10.92% and 17.50%, respectively (as seen in the chart below). The recent significant dispersion highlights the narrow market we are experiencing today.[2]

Source: FactSet Research Systems, Inc.

We manage relatively inexpensive portfolios. The equities in an average private client portfolio are currently trading around 13x price-to-earnings, which is a significant discount to the market. When valuations are high, we focus on capturing profits and reallocating capital to undervalued assets. We find this leads to the increased return-on-equity figures we see in our portfolios today. Despite the lower price-to-earnings ratios of our current portfolios, the return-on-equity figure (measure of a company's profitability) is currently nearly 20% versus an S&P 500 return-on-equity of 17.5%. This combination has set the stage for a particularly promising time for active managers.

We are exposed to AI, just not at any price. While we are not making speculative bets on AI, the broad impact it is having across all industries is hard to ignore. There are obvious ways to directly invest in the AI "boom" through chipmakers like Nvidia and Advanced Micro Devices, but these high-quality businesses are trading at multiples that do not currently offer attractive risk-reward profiles for our style of investing. We are exposed to the benefits of AI through our companies that are adapters of the technology. A recent Boston Consulting Group study found that 85% of executives plan to increase AI and GenAI spending in 2024.[3] We believe these indirect investments will allow us to benefit from the upside, while increasing the downside protection through owning generally stable companies with strong balance sheets, such as big banks.

AI has already been used as a tool for banks to improve fraud detection, risk management and marketing for many years. From amplifying marketing and sales through hyper-personalized content to enhanced underwriting capabilities in risk and compliance,[4] the possibilities to improve bank capabilities through GenAI have broadened significantly. We can see from companies that have already begun implementation that the rollout is oftentimes quick due to the scalability of the technology. Specifically, big banks stand to benefit by improved efficiency, reduction in risk and increased capital efficiencies.[4]

"We are working with a clear hypothesis that AI is going to be a substrate, or a part of pretty much everything that we do, whether in new experiences being offered to customers, in operations, hyper-automation, or in terms of unlocking new insights… AI is going to become a core component of pretty much all of these dimensions." – Chintan Mehta, CIO Digital Innovation at Wells Fargo

As we look out from these new heights, we see untapped value yet to be recognized by the market. Our focus, as it was in the late 1990s/early 2000s, is to invest in companies we believe are trading at a discount to what we think they are worth. Whether it is the internet, AI or robots roaming the earth, we will continue investing in businesses we believe are undervalued, have growth potential and are managed by teams that think and act like owners.

As always, we thank you for entrusting us with your investment assets and your continued support. Lastly, the best compliment we can receive is a referral from a satisfied client. We appreciate your referrals and handle them with the utmost care.

Emily S. Neumark, CIMA®
Portfolio Manager

Back Row: Andrew Gluck, Zorica Zdravkovic, Kaylin Price, Mike Mangan, Kate Feit, Mark Small, Alexander Cyrus
Front Row: Ian Horvath, Alix Havey, Emily Neumark, Tom Delaney

[1]https://www.nytimes.com/2024/03/22/business/stock-market-rally.html
[2]https://www.invesco.com/us/financial-products/etfs/product-detail?audienceType=Investor&ticker=RSP
[3]https://www.bcg.com/publications/2024/from-potential-to-profit-with-genai
[4]https://web-assets.bcg.com/98/7c/86f3097241aa88d57fdbb0cf3117/a-genai-roadmap-for-fis.pdf

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