



THE GREAT **REVERSION** WHITE PAPER

WHAT HISTORY TEACHES US ABOUT THIS
OPPORTUNITY.



THE GREAT REVERSION.

Due to large and increasing levels of index concentration, a wide valuation discrepancy, and significant disparity in medium-term outperformance, we believe an alpha opportunity exists for large, mid, and small-capitalization stocks relative to mega-capitalization stocks as these elevated measures unwind. Mega-cap stocks have become stretched in these three areas for rational reasons, including outsized fiscal stimulus, a flight to safety, and rising interest rates. There are equally compelling reasons, however, to believe that stocks outside of the mega-cap cohort will outperform in the coming regime, including historical precedent, a favorable economic backdrop, and falling interest rates. In fact, there is evidence that a sustainable broadening of market performance beyond mega-caps has already begun.

For the purposes of this paper, we will be focusing on stocks in the Bloomberg US 1500 index (B1500), which can be broken down into the Bloomberg US Large Cap (B500), Bloomberg US Mid Cap (B400), and Bloomberg US Small Cap (B600) indices. The B500 is Bloomberg's version of a US large cap index, roughly equivalent to the S&P 500 Index. We define large, mid, and small-cap stocks accordingly. When we reference mega-cap stocks, we are talking about the very largest stocks in the B500, generally the top 10. Any indexes discussed are unmanaged and are meant to reflect the performance of certain market segments. It is not possible to invest directly in an index. More information regarding these indexes is provided in the disclosures (page 10).

What is going on with mega-cap stocks?

OUTPERFORMANCE

Small and mid-cap stocks have been mired in underperformance relative to large/mega-cap stocks for much of the last decade. Notably, that underperformance reached a critical low of less than -20% over 2 years as of the end of the third quarter of 2024 for both small and mid-cap stocks. Historical precedent is limited, but noteworthy. Over the last 30 years, there were two other occurrences of small/mid-cap underperformance by 20% or greater over a two year period - once in the late 90's and then again in the 2020 pandemic period. In both cases, a recovery by small/mid-cap stocks was later achieved. In the case of the 2020 pandemic period, for example, small-cap stocks outperformed large-cap by 19% for the two years ending 3/31/2022. Mid-caps outperformed large by 3.5% over this same period. In the case of the early 2000s, an extended period of outperformance for small and mid-caps began. Both beat large-cap by 9% or greater on an annualized basis for the five years ending on 12/31/2005.

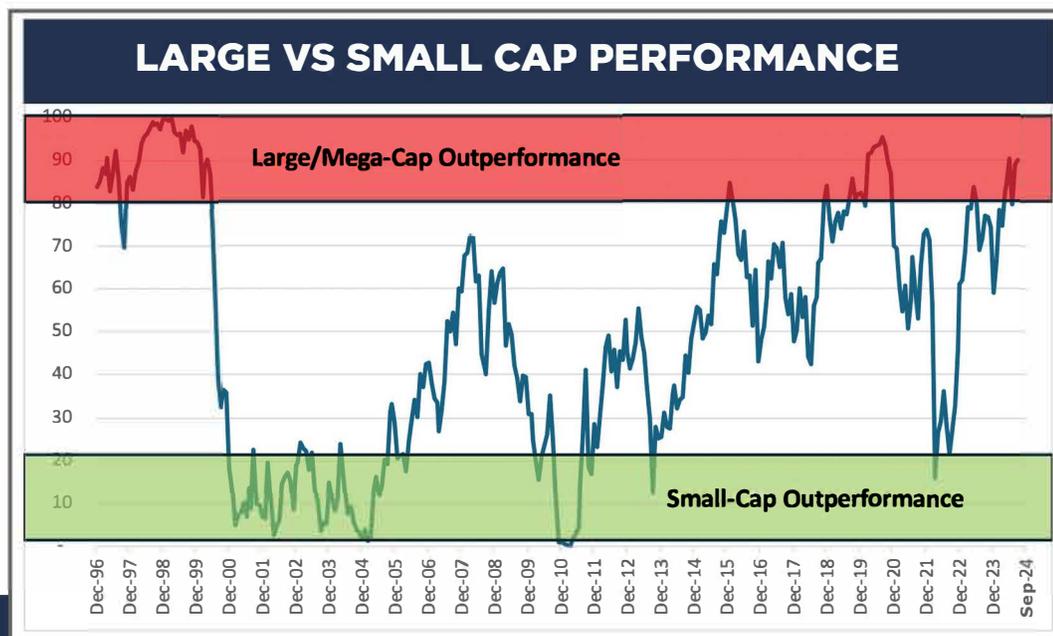


Figure 1.

Trailing 2-year return of large/mega-cap (B500) minus small-cap (B600) indices from Dec 1996 - Sept 2024. This differential is percentiled, with the percentile shown on the Y-axis. A high number indicates large cap outperformance, while a low number indicates small cap outperformance. Data source: Bloomberg.

Periods of even modest outperformance by one cohort tend to precede swings in the opposite direction, such as in 2008 and 2022. Performance differentials can persist for some time, but there is historical precedent for large swings in the opposite direction after periods of large differences.

To highlight the dominance of mega-caps more precisely, we also evaluated the top 10 stocks in the B500, with the top 10 constituents of the index taken monthly from the beginning of 2023 through September 2024. During this period, the B500 returned a total of 55.3%. A portfolio of the top 10 stocks of the B500 returned a total of 105%. A portfolio of the rest of the index, the “B490”, returned only 37%. Mega-cap stocks are a significant part of the index by weight but have been dominating returns even more.

Table 1.	
	Jan 2023 – Sept 2024
B490 Total Return	37.4%
Top 10 Total Return	105.3%
B500 Total Return	55.3%

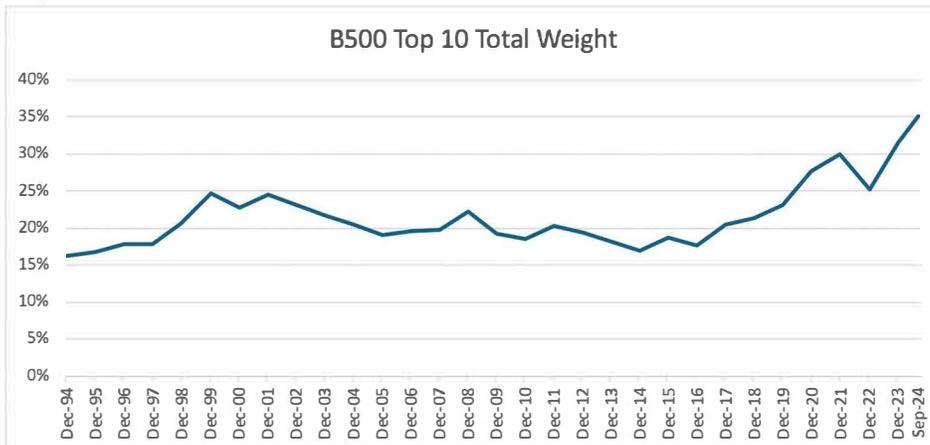
Table 1. – Bloomberg 500 Index (B500) is a float market cap-weighted benchmark of the 500 most highly capitalized US companies. B500 Top 10 represents a subset of the top 10 US companies by market weight of the B500. B490 represents a subset of the 11th to 500th US companies by market weight of the B500. Performance shown from 12/31/22 through 09/30/24. Monthly rebalancing. Data source: Bloomberg.

Concentration of Market Weight

Large-cap stock indices have grown in concentration of the largest mega-cap constituents. The top ten stocks in the B500 made up 35% of the index as of September 30, 2024 — an all-time high. This metric began a significant rise above the 25-year high of 25% in 2019 and has accelerated since that point.

Figure 2. – Total weight of the ten largest stocks in the B500, taken annually. 2024 is as of 9/30. Data source: Bloomberg.

Figure 2.



In addition to mega-cap concentration, large-caps have also become more concentrated in sector weights. Following a similar timeline as the above chart, technology has been the largest sector of the B500 since 2018. Since then, its weight has grown significantly, far surpassing the previous high for concentration in any sector (also technology, set at the peak of the dot-com bubble in 2000).

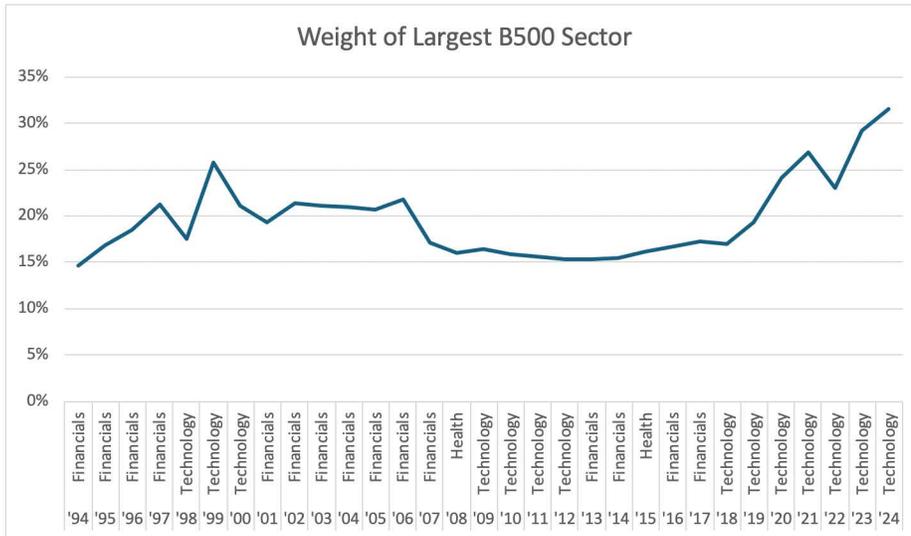
Figure 3.


Figure 3. – Weight of largest B500 sector, taken annually. Over the last 30 years, Finance or Technology have had the largest weight, except for two years when Healthcare took the mantle. Note that 2024 is as of 9/30/24, while all other years are as of 12/31. Data source: Bloomberg

Valuation Discrepancy

As mega-cap stocks have outperformed, their earnings, while growing, have not kept pace. This has led to increasingly extended valuations of mega-cap stocks relative to their history and to other capitalization ranges. The B500 is currently trading at a price to earnings ratio (P/E) that is 35% above its 30-year average. Compare this to the mid-cap B400 or the small-cap B600, each of which are trading near their 30-year averages.

One of the interesting things this chart shows is that mid and small-cap indices have historically averaged a higher P/E than large-cap, but this relationship is currently flipped, with large-cap more expensive. This reversal occurred after the run-up and fall-off of valuations in the pandemic and immediate post-pandemic market. It could be argued that small and mid-cap companies ought to be more expensive than large-cap on the whole, because of their higher potential for large growth. However, it appears that the relative safety of large-caps (better balance sheets, stability, etc.) is currently a more dominant force in the relative valuation of the market cap ranges.

Table 2.

	30-Year Avg P/E	Curr P/E	Ratio	Percentile
B500	20.4	27.6	1.35	89
B400	21.2	21.9	1.04	66
B600	24.0	25.4	1.06	59

Table 2. – Average and current P/E for large, mid, and small-cap indices. Bloomberg 500 Index (B500) is a float market cap-weighted benchmark of the 500 most highly capitalized US companies and represents large-cap companies. The B400 and B600 are each a subset of the B1500. They represent mid-cap and small cap companies, respectively. More information regarding these indices is provided in the disclosures (page 10). Percentile represents the percent that the P/E ratio has been lower than its current P/E over the last 30 years. Information as of 9/30/24 and dating back to 12/31/1994. Data source: Bloomberg.



THE MARKET IS RIPE FOR CHANGE.

With extreme performance disparity, favorable economic indicators like declining interest rates, and emerging signs of increased market breadth beyond mega-cap dominance, the stage may be set for a reversion.

WHY HAVE MEGA-CAPS BEEN SO DOMINANT?

Earnings Recession for Non-Mega-Caps

There is fundamental support for the outperformance of mega-caps and the commensurate rise in their concentration and valuations. When we consider the 2023-2024 timeframe, earnings growth, here measured by percentage change in quarterly earnings per share (EPS) year over year, ranged from -5% to 7% for the cohort of stocks outside of the B500 Top 10 until the middle of 2024, when it became modestly positive at 9%. Meanwhile, mega-cap earnings growth accelerated through the end of 2023 into 2024 and remained high and significantly above that of non-mega-cap.

Figure 4.



Figure 4. Earnings growth (EPS, quarterly year over year) for the B500 top ten stocks vs the B490. Month end numbers. Numbers for 9/30/24 and beyond are estimates based. Data source: FactSet, Bloomberg.

Only now is that relationship starting to change. The B500 Top 10 still are outpacing the B490, but their growth is expected to decline while the B490's accelerates. Starting in the middle of 2025, the B490 is expected to match or exceed the B500 Top 10 in growth. It is not surprising that mega-caps would perform better in such an environment up to now, but the tide appears to be changing direction.



Mega-Cap Share of Total Profits is Outsized

OUTPERFORMANCE

Furthermore, mega-cap companies have been much more efficient at turning invested capital into profit. Economists often look at a measure called Economic Profit, which is calculated as:

(Return on Capital - Cost of Capital)

*Invested Capital** In simple terms, if you borrowed \$1 million at a rate of 5% and invested it into your company and your company grew profits by 10% from your investment, you would have made (10%-5%)

**\$1 million = \$50,000 of economic profit.*



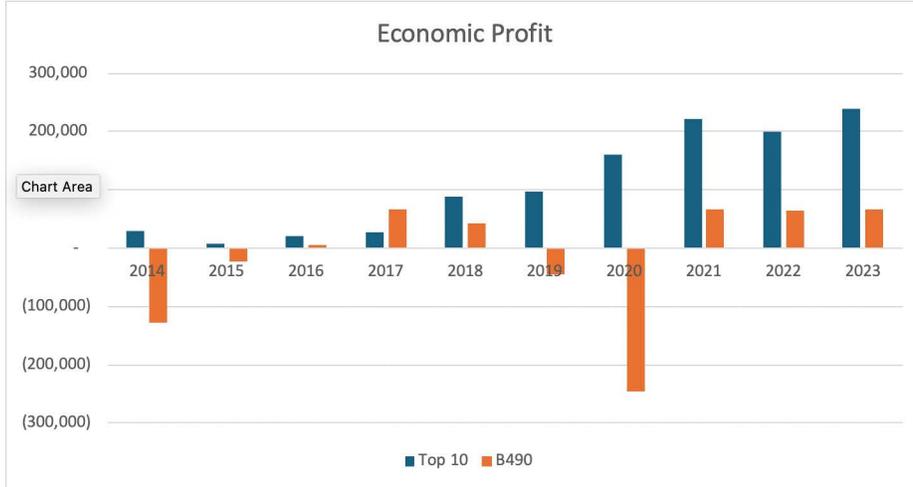
Figure 5.


Figure 5. – Economic profit in millions of dollars (Y-axis) of the B500 top 10 vs the B500 bottom 490, ex-Financials and Real Estate, Data Source: Bloomberg. Information as of year-end 2023.

The share of total economic profit of the top 10 companies has been significant over the last 10 years. From 2014 through 2023, the B490 received a total of -133 billion in economic profit, while the top 10 received +1.09 trillion. This lopsided economic profit generation for mega-cap stocks helps to explain why they have been so dominant in market performance.

Table 3.

Stock Ticker	Quality	Low Volatility	Growth
AAPL	2	46	60
MSFT	20	35	11
NVDA	1	97	0
AMZN	36	72	17
META	15	89	13
GOOGL	12	64	11
AVGO	45	86	5
LLY	29	62	8
TSLA	21	98	16
BRK/B	33	1	65
Average	21	65	21

Table 3. – Comparison of quality, low volatility, and growth for the B500 Top 10 as of 9/30/2024. Lower numbers indicate higher quality, lower volatility, and more growth. Source: CooksonPeirce.

Flight to Safety

Finally, when investors are concerned about the direction of the economy, the natural course is to favor stocks that offer reliability, consistency, lower volatility, and predictable growth prospects. In recent years, with pandemic-related uncertainty, inflation, and high interest rates capturing investor mindshare, mega-cap companies have been a fantastic option in which to ride out the potential storms. They offer exactly what investors desire in these times: high quality (strong balance sheets and proven profitability), low volatility, and earnings/sales growth. Even if a mega-cap name does have higher volatility, that is typically compensated for with very high earnings growth, such as in the case of Nvidia (NVDA). Table 3 is a ranking based on our propriety scores for the B500 Top 10 as of September 30, 2024. Scores range from 0 to 100, with lower numbers indicating better quality, lower volatility, and higher growth.

The average quality and growth scores of this cohort are extremely strong, while volatility is at the mid-point. The average volatility is brought up by names like Tesla (TSLA) and Nvidia (NVDA), but these have very strong quality and growth scores.

It is not difficult to see why investors would flock to names with these profiles in difficult times. They have strong balance sheets and cash on hand, growth at a time when that is difficult to come by, and are generally either highly predictable or pay for excess volatility with an outsized growth profile.

WHY WILL THIS MEGA-CAP DOMINANCE LIKELY COME TO AN END?

Historical Precedent of Reversion from Extremes

Figure 1 (page 2) shows historical large vs small-cap performance. This graph shows that we are currently in the top quintile of large-cap outperformance, the red band at the top. Historically, relative returns have not stayed at these extreme levels for a long period of time. When they do leave this band, it is often with a quick and deep swing in the opposite direction to small-cap outperformance. While nobody can predict exactly when the tide will turn, in our opinion, having notable assets in the small/mid-cap areas of the market positions investors well for the inevitable turn.

In addition, small and mid-cap stocks are undervalued relative to mega-cap and are fairly valued relative to their own history. This is supportive of the view that there is room for these names to run.



Strong Economy

It appears that the Federal Reserve has successfully tamed inflation by raising interest rates without tipping the economy into a recession. Unemployment rates, earnings growth, and jobs data all point to a soft landing. A rate-cutting cycle has now begun, which will be stimulative, especially to cyclical, higher debt companies that are more represented in the small and mid-cap segments of the market. Historically, small and mid-caps have performed well during periods of lower interest rates.

As Figure 6 shows, when the 3-month T-bill yield is greater than 5%, mid and small-cap stocks underperform large caps. This is the environment that characterizes much of the 2023-2024 timeframe. When short term rates are 3-5%, mid and small-cap stocks outperform large. This is the environment we are in as of the end of 2024. Finally, both small and mid-cap stocks outperform large to an even greater extent when short term rates are less than 3%. We may find ourselves in this environment again sometime in the coming years.

Figure 6

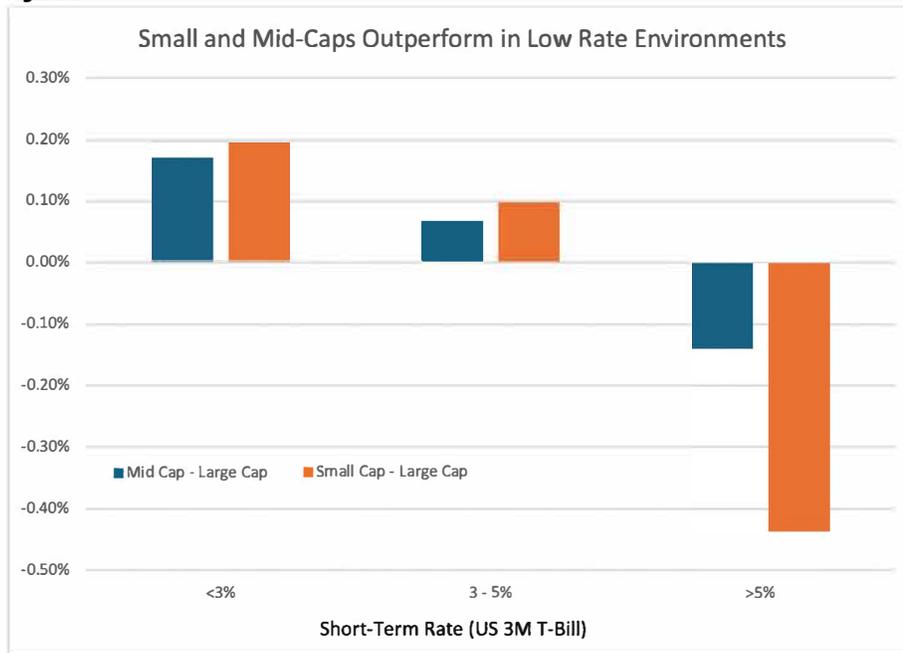
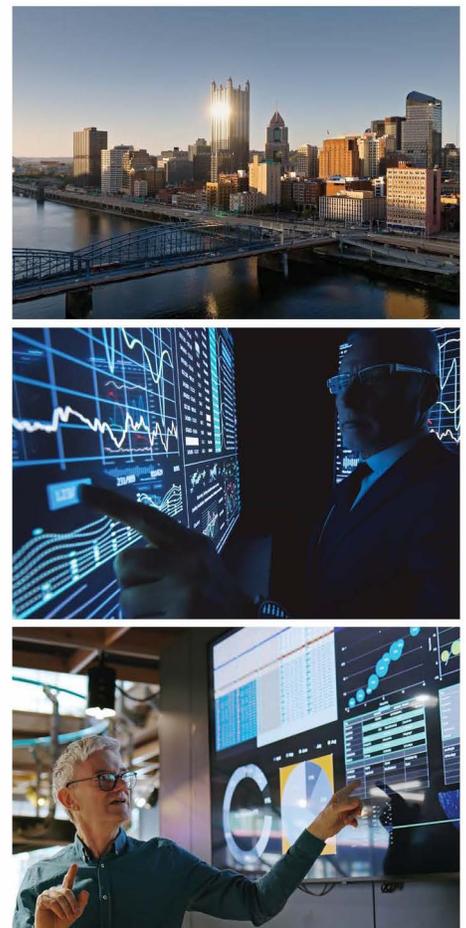


Figure 6. - Comparison of performance for the following: mid-cap vs large-cap and small-cap vs large-cap in different rate environments. Large, mid, and small-cap stocks represented as B500, B400, B600, respectively. Performance is average monthly percent. Data source: Bloomberg. Date as of 12/31/1994 through 9/30/2024. Past results do not indicate future performance.



Evidence of Changes Already

Looking at year to date (YTD) 9/30/2024 performance and 6/30/2024 - 9/30/24 performance, a story is potentially emerging.

Table 4.		
	YTD (9/30/24)	6/30/24-9/30/24
B500	21.8%	5.8%
B400	14.2%	8.6%
B600	9.5%	8.8%

Table 4. - Performance of large, mid, and small-cap stocks represented as B500, B400, B600, respectively from 12/31/2023 to 9/30/2024 and from 6/30/2024 to 9/30/2024. Data source: Bloomberg.

While large-caps have greatly outperformed small and mid-cap stocks on a year-to-date basis through 9/30/2024, that outperformance occurred exclusively in the first half of the year. Since then, small and mid-caps have outperformed.

Further evidence can be seen in the breadth of the index performance. We have discussed the narrow breadth of performance in large cap stocks. That is, a small number are responsible for most of the index's gains.

Figure 7.

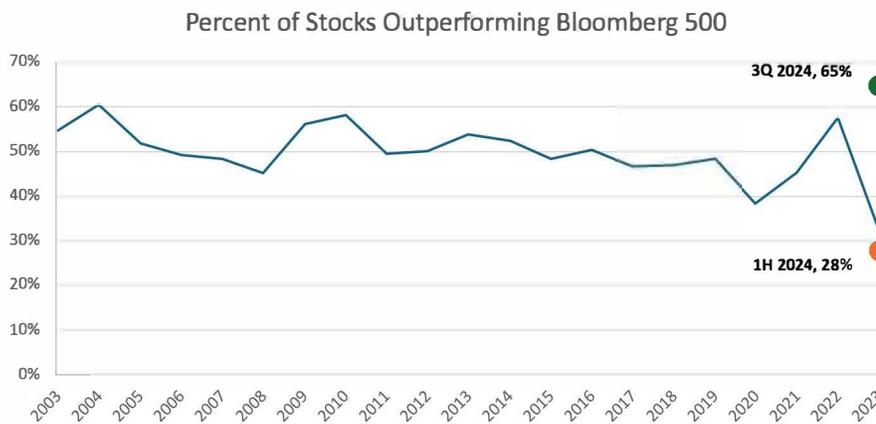


Figure 7. - Percent of stocks in the B500 outperforming the B500 Index performance each year from 2003 through 2023. Also shown are the standalone 3Q 2024 and 1H 2024 numbers. Data source: Bloomberg.

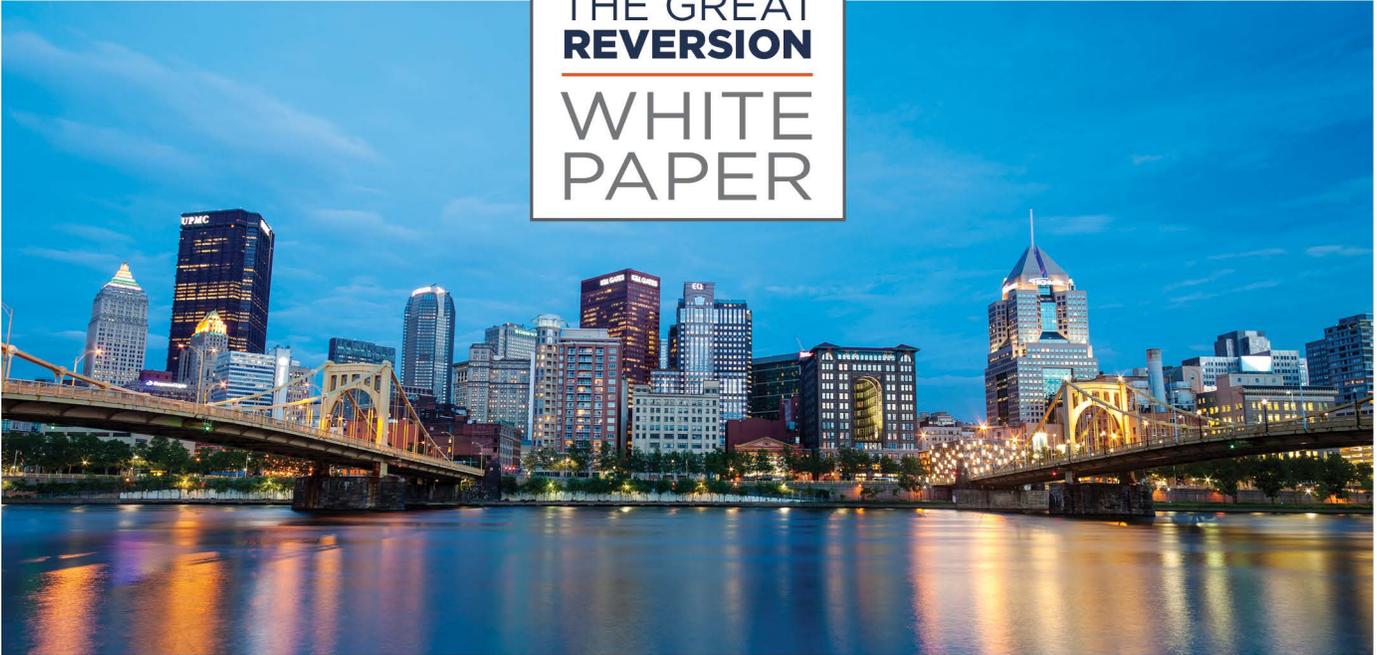
Figure 7 highlights this narrow breadth but also that the trend has been reversing for the last quarter. This chart shows the percentage of stocks within the B500 that have done better than the total index return on a yearly basis going back to 2003. As one might anticipate, this number hovers around 50% - half do better and half do worse. However, in 2023 only 32% of stocks produced a return better than the average. For the first half of 2024, only 28% were better than the average. (Both of these were all time lows when they were set.) But, in just the third quarter of 2024, 65% have beaten the average. In other words, there was a large recovery of the average stock in the 3rd quarter relative to the overall average. The concentration of returns in a few names has unwound significantly as of late.

Mega-capitalization firms have significantly outperformed all other size classifications of stocks for much of the past decade. Justification exists for this phenomenon, but catalysts for change are emerging. Historical precedent and a durable economic recovery propagated by falling rates could compel a shift in leadership characteristics. In fact, evidence of this evolution is beginning to mount. Investors would be wise to consider the improving risk-reward characteristics of stocks outside of the mega-cap cohort.



THE GREAT REVERSION

WHITE PAPER



Important Disclosures

The purpose of this letter is to provide access to analyses prepared by CooksonPeirce Wealth Management (“CP”). The letter enables CP to share macro themes and newsworthy updates, good and bad, across our investment universe as they arise. The letter represents the opinions of CP. The securities discussed herein do not represent an entire portfolio and in the aggregate may only represent a small percentage of a strategies holdings. The issuers discussed may or may not be held in such portfolios at any given time. The issuers discussed do not represent all of the investments purchased, sold, or managed by CP. It should not be assumed that any or all of these investments were or will be profitable.

Projected results and statements contained in this letter that are not historical facts are based on current expectations and involve risks, uncertainties and other factors that may cause actual results, performance or achievements to be materially different from any future results.

These opinions are current opinions as of the date appearing in the relevant material and are subject to change without notice.

This letter is not intended to be, nor should it be construed as, an offer to sell or a solicitation of an offer to buy any security. The information provided in this letter is not intended as investment advice or

recommendation to buy or sell any type of investment, or as an opinion on, or a suggestion of, the merits of any particular investment strategy.

This presentation should not be construed as legal, tax, investment, financial or other advice. It does not have regard to the specific investment objective, financial situation, suitability, or the particular need of any specific person who may receive this presentation and should not be taken as advice on the merits of any investment decision.

Risks of Investment Securities: Diversity in holdings is an important aspect of risk management, and CP works to maintain a variety of themes and equity types to capitalize on trends and abate risk. CP invests in a wide range of securities depending on its strategies. The investment portfolios advised by CP are not guaranteed by any agency or program of the U.S. or any foreign government or by any other person or entity. The types of securities CP buys and sells for clients could lose money over any timeframe. CP’s investment strategies are intended primarily for long-term investors who hold their investments for substantial periods of time. Prospective clients should consider their investment goals, time horizon, and risk tolerance before investing in CP’s strategies and should not rely on CP’s strategies as a complete investment program for all of their investable assets.

Indices

Bloomberg US Aggregate Equity Index includes all investable companies in the U.S.

Bloomberg US 1500 Index (B1500) is a subset of the Bloomberg US Aggregate Equity Index. It represents the top 1500 companies sorted in descending order of total market capitalization and the cumulative free-float market capitalization is calculated for each company.

Bloomberg US 500 Index (B500) is a subset of the Bloomberg US 1500 Index. It represents the securities ranked 1 to 500 by market capitalization.

Bloomberg US 400 Index (B400) is a subset of the Bloomberg US 1500 Equity Index. It represents the securities ranked 501 to 900 by market capitalization.

Bloomberg US 600 Index (B600) is a subset of the Bloomberg US 1500 Index. It represents the securities ranked 901 to 1500 by market capitalization.



COOKSONPEIRCE

555 Grant Street, Suite 380, Pittsburgh, PA 15219-4421
PHONE: 412.471.5320 • FAX: 412.471.4563
www.cooksonpeirce.com