Seymour
INVESTMENT MANAGEMENT

July 18th, 2024

U.S. mega-cap equities continued their global outperformance during the second quarter with the S&P 500 Total Return Index (S&P 500) increasing 4.3%. The S&P TSX Composite Total Return Index (TSX) lagged, declining 0.5% during the quarter. Global developed markets similarly experienced slight declines with the MSCI EAFE Index Price Return declining 0.4% in the quarter.

The concentration of equity performance to a handful of mega-cap companies has been a defining characteristic of US and Global equity performance. The ten largest companies in the S&P 500 now make up almost 35% of the index. The American influence extends to global indexes, many of which are now heavily skewed to include U.S. exposure. Currently the MSCI World Index, which tracks large and mid-cap companies across 23 developed markets, has more than 72% in U.S. equities.

While the returns of the U.S. mega-cap companies have been nothing short of eye-watering over the past year and a half, questions are continuing to be asked: how long can such divergences persist?

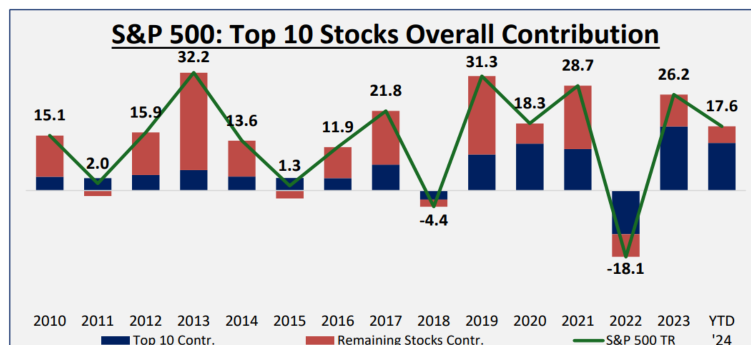
A Tale of Two Markets

With U.S. Mega-cap companies dominating the S&P 500 in terms of both size and returns, any story about the U.S. market is a story about the mega-cap companies. However, even within the U.S., there are two very different narratives at play. One is that of excitement and frenzy with continual all-time highs being achieved week after week. The other, is of lackluster performance and a small, technical correction.

The ten largest mega-cap stocks have driven more than 75% of the 19% S&P 500 year-to-date return, as depicted in the chart below. This concentration has condensed even further recently to three mega-cap names (Microsoft, Apple, and Nvidia) representing over 20% of the index and driving market highs.

The largest ten companies of the S&P 500, represented more than 75% of the year-to-date returns

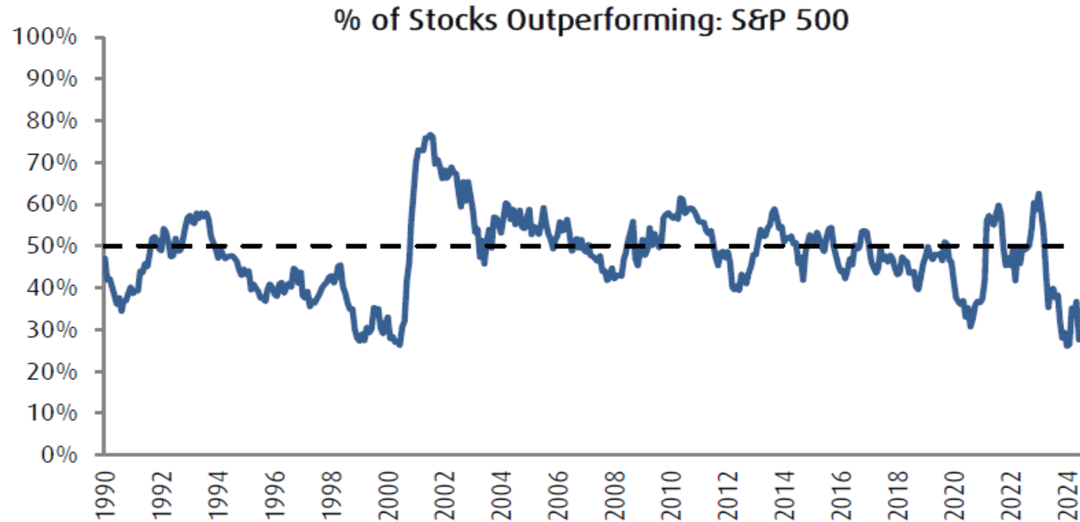
Exhibit 1: Largest Ten Stocks Represent more than 75% of the Year-to-Date Returns



Source: Wolfe Research Portfolio Strategy, Standard & Poor's, Bloomberg

Despite the S&P 500 Index being at an all-time high, more than half of the stocks in the S&P 500 are already in a small correction. As demonstrated in the graph below, more than half of the stocks in the S&P 500 are trading below their 50-day moving average.

Exhibit 2: More Than Half of the S&P 500 Stocks are Below their 50-day Moving Average



Source: BMO Capital Markets Investment Strategy Group, FactSet, Trailing 12 Months

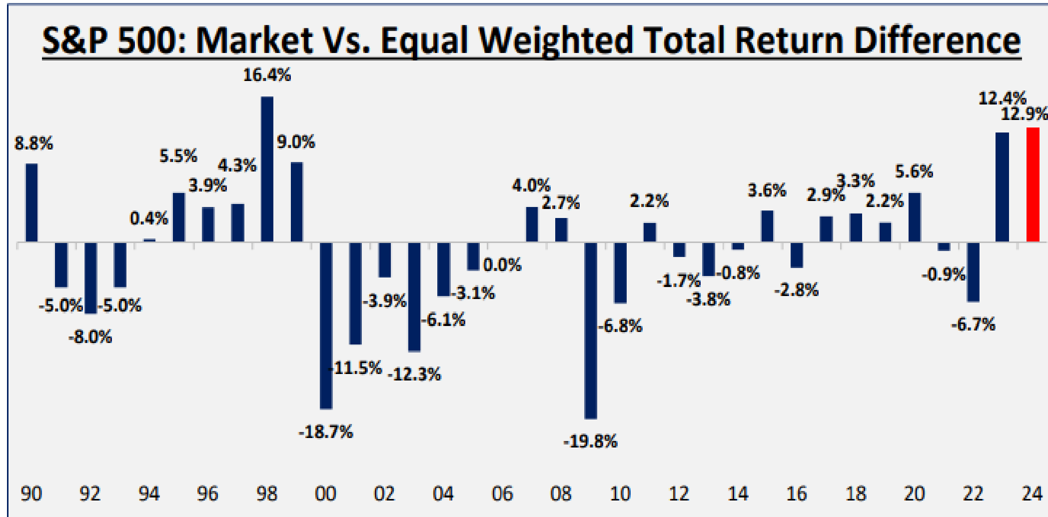
This divergence between the largest ten and the remaining 490 companies has resulted in significant valuation gaps. The graph below demonstrates the divergence earlier this year.

Exhibit 3: Price to Earnings Multiple of the S&P500 Top Ten and Other 490

Source: Compustat, IBES, FactSet, Goldman Sachs Research

This gap results in a substantial spread between the S&P 500 market-cap weighted index, which includes companies proportional to their size, and the S&P 500 equal weighted index, which includes companies with equal weight. The current spread between the S&P 500 and its equal-weighted counterpart is the widest it has been in 15 years.

Exhibit 4: Market cap Cap-Weighted Dominates Equal Weighted



Source: Wolfe Research Portfolio Strategy, NASDAQ, Standard & Poor's, Russell, Bloomberg

Much good news and high expectations are already reflected in the valuations of U.S. mega-cap companies. Work conducted by RBC's strategists suggests that the Magnificent 7 would have to grow their aggregate earnings by approximately 23% every year for the next 15 years to justify their current valuation premium versus the rest of the market.

Small-cap stocks have fallen to their lowest point relative to large caps in 22 years

In contrast, small public companies are trading well below their historical valuation averages. As measured by the Russell 2000 Index, small-cap stocks have fallen to their lowest point relative to large caps in 22 years.

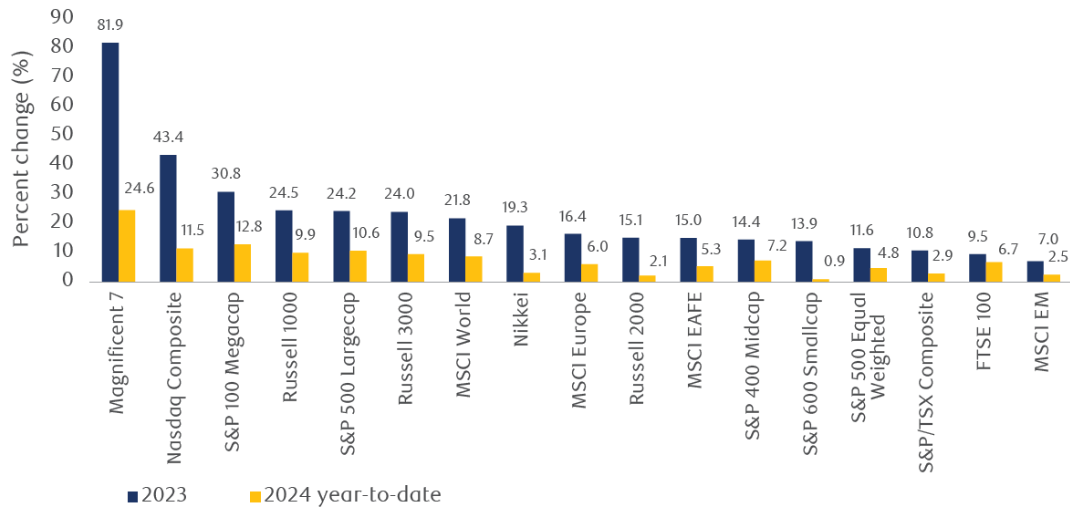
Exhibit 5: U.S. Small Caps vs. Large Caps, Russell 2000 relative to S&P 500

Source: Bloomberg, RBC GAM

Driven by the recent outperformance, the S&P 500 is close to one standard deviation above the modelled estimate of fair value based upon normalized earnings and valuations. Other major indices, including Canada, Europe, the UK and Emerging Markets, are close to or more than one standard deviation below their own fair values.

As a result, the underperformance has been widespread to include Canadian Equities, global equities, U.S. small-cap stocks. Nearly all of which have delivered single digit returns so far this year, as demonstrated by the graph below which depicts global returns to May 31st in U.S. dollar terms.

Exhibit 6: Major indices' price changes in USD 2023 and 2024 YTD

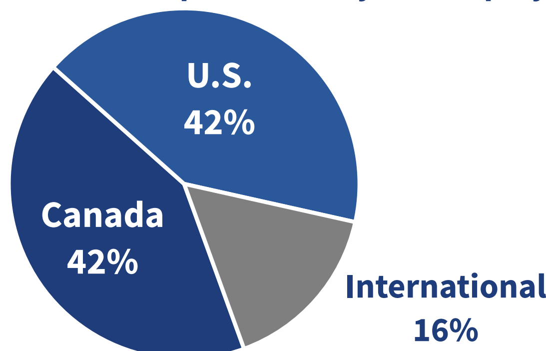


Source: Bloomberg, RBC GAM

Although returns between the US and Canada (and the rest of the world) suggest a large gap between the relative performance of these markets, in reality, many of the companies on both sides of the border exhibit similar financial performance.

With trade, workers, ideas and revenue moving between countries with greater ease than decades past (despite some recent deglobalization political rhetoric trying to onshore more revenues), it is no surprise that many Canadian companies generate material revenue in the U.S. and abroad. Businesses today are very global in nature. This is something we follow on a company specific level often as many of our holdings generate their revenue predominantly outside of Canada.

Exhibit 7: Geographic Revenue Split of the Seymour Equity Pooled Funds



Source: FactSet

By virtue of the type of business we are attracted to, we often prefer companies that have developed a sustainable competitive advantage; chances are if they have found that niche, they are not just going to exploit that across Canada, but across the world. As demonstrated by the graph above, more than half of the revenue generated by the companies that are held in the three equity pooled funds, is generated outside of Canada.

More than half the revenue generated by companies held in the Seymour equity pooled funds, is generated outside of Canada

When will Undervalued Companies (and Countries) be Recognized

Many of the companies we own, along with global and small-cap companies more generally, continue to trade below their previous highs. Despite the stagnated prices, these companies have continued to generate significant earnings growth during the past couple years and as a result valuation multiples are trading at the low end of their historical range.

Markets can trade at the low end of their historical valuation range for quite some time; however, whether it be by the public markets or by private equity, strategic buyers or other, the value of these businesses will eventually be realized.

The dislocation of under-owned small- and mid-cap segments of the markets present attractive buying opportunities of high-quality Canadian companies. This has been exemplified with the uptick in merger and acquisition activity we have seen over the past seven months. During which time, four of the companies held within the Seymour Equity Funds have received bids to be taken private at significant premiums to their closing price. We discuss this more in our commentaries and will likely continue to write about it in months to come.

This is an encouraging sign for equity investors who have patiently experienced the recent underperformance of ‘everything-but-the-magnificent-seven’ that we may be in the early stages of an equity market re-valuation.

Sincerely,

The Seymour Team