The Sixth Sense

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It's right about the time that investors may be looking at their quarterly statements to understand how their investments performed during the first half of the year. The markets have been roiled with volatility this year as an endless stream of headlines sparked investor anxiety. Despite all of this, the U.S. equity markets have posted positive returns. However, not all returns are created equal. A handful of stocks have dominated returns up to this point, with just six stocks responsible for most of the market's gain this year. Apple, Microsoft, Amazon, Facebook, Alphabet (still known as Google to most of us) and Netflix are responsible for more than 96% of the gains in the S&P 500 and 80% of the gains in Nasdaq 100 index this year. These six stocks make up only 15% of the S&P 500 index and 46% of the Nasdaq 100. Finally, to place all of this in context, the S&P 500 is up 2.65%, while the Nasdaq 100 is up 10.65% for the first half of 2018.

Company	Percent of S&P 500 YTD returns	Percent of Nasdaq 100 YTD Returns	YTD Total Return
AMAZON	34%	32%	45.35%
MICROSOFT	18%	14%	16.31%
APPLE	16%	12%	10.25%
NETFLIX	14%	11%	103.91%
FACEBOOK	7%	5%	10.12%
ALPHABET	7%	6%	13.81%

Source: Bloomberg as of 06/30/18.

Why did returns come from such few stocks?

The simplest explanation for these outsized returns is the fact that this is how capitalization-weighted (or "cap-weighted") indexes work. Market capitalization-weighted indexes – such as the S&P 500 – weight their securities by market value as measured by capitalization, which means they multiply the security price by the number of outstanding shares. In a cap-weighted index, changes in the market value of larger stocks have a greater impact on index returns than changes in the value of smaller stocks. This means there is a significant amount of equity-market capital invested in indexes that have very concentrated sector and stock holdings. Technology, for example, has dominated the growth narrative since the financial crisis due to the global nature of the internet and the rapid pace of product innovations in the space. Within that powerful investment realm, a handful of names has taken much of the overall economic and capital market gains. This is not exactly a new phenomenon. In 2017, the so-called FAAMG (Facebook, Apple, Amazon, Microsoft and Google) stocks dominated market returns for the first half of the year. During 2011, four stocks (Exxon, Apple, IBM, and Pfizer) accounted for more than 100% of the total return of the S&P 500.

What does this mean for investors?

Portfolio returns are driven by the types of investments within the portfolio. If an investor were invested solely in a total market or S&P 500 index fund or ETF, then his or her returns would likely be driven by a handful of stocks. This is simply the way market cap weighting works, for better or worse. On the other hand, having a diversified portfolio or using active managers outside of the market cap-weighted indexes could generate returns that are

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potentially drastically different than what the broad market or these specific stocks may have produced. Investors often do not link the concentration of returns in the stock market as one of the reasons for diversifying their investments. It is an important takeaway, however, as investors may not always have the sixth sense to pick the exact winners each year, but can remain well positioned to capture returns wherever they occur and hopefully smooth out some of the bumps in the road.*

*Diversification does not ensure a profit or guarantee against loss.

Index Definitions

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses.

The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The NASDAQ Composite is a stock market index of the common stocks and similar securities (e.g. ADRs, tracking stocks, limited partnership interests) listed on the NASDAQ stock market. Along with the Dow Jones Average and S&P 500 it is one of the three most-followed indices in US stock markets.

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