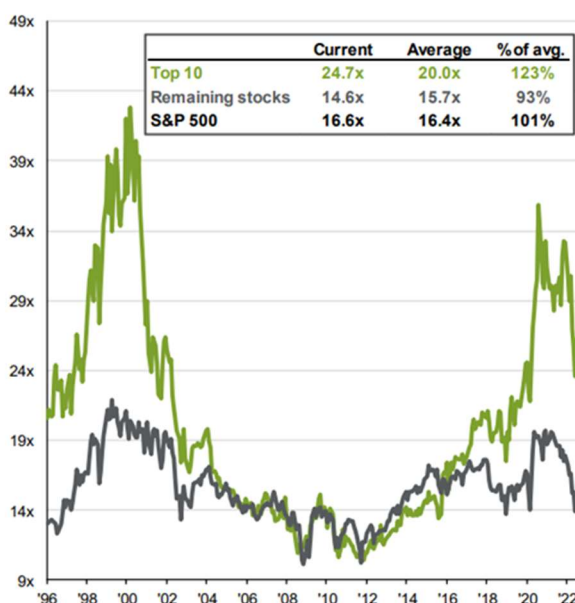


Deconstructing the S&P 500

The green line in the chart below shows the price/earnings ratio of the Top 10 stocks in the S&P 500 compared to the remaining stocks in the S&P 500 (black line). The Top 10 stocks include Apple, Microsoft, Amazon, Tesla, Alphabet Inc, Nvidia, Berkshire Hathaway, Meta Platforms, Inc, and United Health Group. These 10 stocks make up about 25% of the S&P 500, so that 25% of new money flowing into the S&P 500 is invested in these stocks. This demand, at least in part, explains some of the outperformance of these stocks in recent years. Likewise, 25% of funds flowing out of the S&P 500 is divested from these stocks.

P/E ratio of the top 10 and remaining stocks in the S&P 500
Next 12 months



The valuation of the top 10 stocks has been declining and the price/earnings ratio is now 24.7x next twelve-month earnings compared to its 25-year average of 20x. There may be some more valuation contraction to be expected in those 10 stocks as interest rates rise and fundamental expectations are modified downward for some of the companies...and as demand for the S&P 500 softens. It seems the vulnerability to these stocks may be higher if the market correction continues.

The market has some clear challenges ahead – inflation, rising rates, quantitative tightening, recession, continued supply chain challenges, Ukraine, European energy shortages to name a few – but one thing we have learned over our careers is to not overreact to either good or bad news. We focus on buying stocks where the company's value is not fully reflected in the current stock price. While the S&P 500 is at its 25-year average valuation, many stocks in the index are selling at discounts. Opportunities exist in the remaining stocks in the S&P 500, so this is where we spend our time. We focus on knowing the company's fundamentals, valuing the stock properly, using common sense, and having patience. This approach has a good outcome more times than not.