3rd Qtr. 2024 Investment Counsel Report

Market Summary

Over the past 3 months, stocks continued their advance and added to gains banked in the first half of 2024. As we had written and observed in our prior report, the level of gains has been very unevenly distributed between various market segments. Recent results showed a meaningful reversal of some trends, but there is still a historic gap between stocks in certain sectors.

The large cap stocks of the S&P 500 Index rose 5.9% in the third quarter of 2024. This strong result actually lagged both small stock measures and international stock measures, but still leaves a whopping lead for the year to date. The S&P 500 Index for the YTD stands at +22.8%.

Smaller stocks of the Russell 2000 Index rose a more robust 9.2% for the trailing 3 months, and displayed an +11.1% return for the year thus far. While gaining some ground relative to larger stocks, small stocks still stand at less than half the return of larger stock peers YTD - an enormous gap even after recovering meaningful ground. International stocks represented by the EAFE Index likewise were up a stronger 7.3%, but stood far behind the S&P 500 for the YTD with a gain of +13.5%.

Aurora Perspective

An important factor in the gigantic and atypical outperformance of the S&P 500 Index relative to the rest of the market is the extreme overweighting of the "Magnificent Seven" stocks. While the name the "S&P 500" implies broad diversification among hundreds of stocks, in practice the members of the index are weighted by the value of the stock they have issued - by Market Capitalization. The largest seven stocks (Apple, Microsoft, Nvidia, Amazon, Meta, Alphabet, and Berkshire Hathaway) are clearly all but one technology related businesses. Beyond that sector exposure, the weight of the S&P 500 Index attributed to these 7 stocks is roughly 30%. Put another way, the "other" 493 stocks contribute only 70% towards the total return of the index. Seven stocks (1.4% of 500) are magnified to contribute 30% of the return.

The evidence of how this weighting has led to the recent dramatic outperformance of the S&P 500 Index can be shown when observing the performance of the same 500 stocks - but instead equal weighting each company's share contribution. This "equal weighting" of each stock should in theory closely track the more commonly tracked S&P 500 Index - the same stocks make up both measures after all.

Data Range 12/31/2023 to 9/30/2024					
Benchmark	Total Return	Difference		P/E Ratio	Difference
S&P 500 Equal Weighted Index	15.16%	-6.92%		19.24	-5.04
S&P 500 Index	22.08%			24.28	

Source: Bloomberg

The chart above shows that the difference in performance between the "equal weighted" 500 stocks versus the traditionally observed S&P 500 Index is approximately 7% in 2024 YTD. That is an enormous difference, and is an anomaly that shows how narrowly focused on these giant high-tech names the stock market has been.

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Valuations excluding the Magnificent Seven and their unusually high multiples are about in line with macro-modeled forecasts, and earnings growth may continue to punch above macro-based expectations as long as the Mag Seven remain dominant.

While parsing the different trends and returns for market segments isn't typically insightful, given the magnitude of recent variances, we find some important observations that may have bearing on future stock market returns. While Aurora clients know we make no claim to short-term forecasting abilities, understanding market history and dynamics can help us stay focused on the long-term and what really matters.

Stock prices follow earnings. Intuitively this is easily understood, as the definition of stock ownership includes owning a share of owner profits (earnings). As earnings in a business increase, so too does the value of one's ownership share. Aurora pre-screens any potential stock holding to ensure that the stocks we hold on behalf of clients possess both current profitability and growth potential. Traditionally, smaller businesses (such as those in the Russell 2000 Index) have exhibited faster earnings growth and potential - given their typically younger posture and the potential benefits of adding scale to a smaller base. Such characteristics have also come with greater variability, and thus risk and volatile stock prices.

What seems to have changed among the current population of small growth companies born over the past few years, is that many small company stocks that have recently come public are still loss-making enterprises. In other words - they are not profitable and spend more in expenses than they take in revenue. Obviously, this is not sustainable. While sometimes new and rapidly growing businesses can run “cash-flow-negative” for a short while on the way to investing towards profitability, these risks make them unattractive to Aurora's discipline.

The influence of these “loss-making” smaller companies explains a portion of the recent performance gap between the S&P 500 Index and the Russell 2000 Index.

Aurora Outlook

While we are uncomfortably aware that Aurora's returns have struggled to keep up with the market-cap-weighted benchmark of the S&P 500 Index recently, with perspective we can remain resolute. Aurora's Growth At a Reasonable Price (GARP) strategy is delivering nicely positive gains this year to date. Our returns are consistent with the earnings progress the companies we invest in have delivered, and we are avoiding the over-concentrations and overpriced fundamentals risks that our clients prefer to avoid. We are confident that the opportunity to deliver on our clients' growth needs with appropriate risk consideration remains into the future.

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