Wealth Management Report

Dear Investors:

The 1980s and 1990s were periods in stock market history when mutual fund managers became household names based on their investment track records. Two of the most well-known during the period were Peter Lynch and Bill Miller. Lynch and Miller both had different investment approaches, but they shared a philosophy of researching individual stocks. Lynch popularized the term "ten-baggers" (stocks that rally at least 1,000%), while Miller's approach was to invest his Legg Mason Value Trust in companies with the potential to multiply future free cash flows. Some of Miller's biggest home runs, like AOL, Dell, and Amazon.com, were among the last companies investors would have thought of when they heard the term "value" at the time.

Peter Lynch oversaw Fidelity's Magellan Fund, averaging an annualized gain of 29.2% from 1977 to 1990, during which assets under management increased from $18 million to $14 billion. While the 1980s belonged to Lynch, Bill Miller took the crown in the 1990s. From 1991 through 2005, he outperformed the S&P 500 for an unheard-of 15 straight years.

While Lynch ceded his crown to Miller, Miller didn't wear it forever either. The next era of the market belonged not to a stock picker, but to indexing.

As the dot-com bubble burst and investors experienced major declines in formerly high-flying stocks, the sting of losses sparked a craving for more conservative approaches. For investors who still wanted exposure to the stock market, investing in the indexes provided a more attractive alternative to the risks inherent in individual stocks. Along came ETFs to provide an easily accessible, tradable, and much more affordable way to invest in "the market." After nearly 20 years of ETF dominance, however, we have to ask, are we once again on the verge of a new stock-picker era?

Answering that question means looking past investor track records and into the underlying characteristics of the market itself. Specifically, are we seeing an environment of return dispersion that makes stock selection worth the trouble? Low return dispersion means stock picking is less useful, while stock selection becomes more important as return dispersion increases.

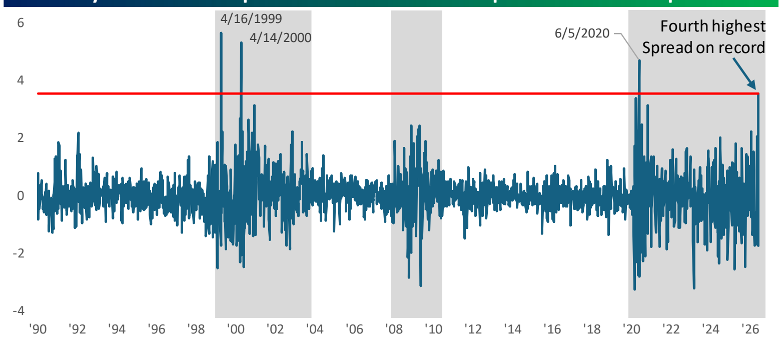
As passive investing grew coming out of the Financial Crisis in the late 2000s up until COVID hit in early 2020, investors could basically throw a dart to pick stocks because everything was generally trending higher. This was a period when return dispersion was extremely low. Since COVID, return dispersion has been a bit higher than it was during the 2010s, but it has been increasing quite dramatically in the last year or so. The increase in the importance of stock selection has coincided with the AI Boom. Because of the massive disruption AI is expected to have across all sectors of the economy over the next decade, investors are making decisions on which companies will thrive with AI, which companies won't be disrupted much at all, and which companies might eventually die. We highlight three charts on the following pages that show why stock selection is getting more important.

The first chart below shows the weekly performance spread since 1990 between the S&P 500 (weighted by market cap) and the S&P 500 Equal Weight index, which essentially tracks how the average stock is doing. From 1990 until 2020, there was a clear trend where weekly performance dispersion between the cap-weighted and equal-weighted indices was relatively muted during bull markets and elevated during bear markets. Beginning in early 2020, the weekly performance spread blew out again as the COVID bear market began.

When the market bottomed in 2020 and a new bull market emerged, though, the weekly performance dispersion between the two indices remained high and has pretty much stayed that way ever since. The culprit has been the rise of the mega-caps, which impact the cap-weighted index more than ever even though they have very little impact on the equal-weight index.

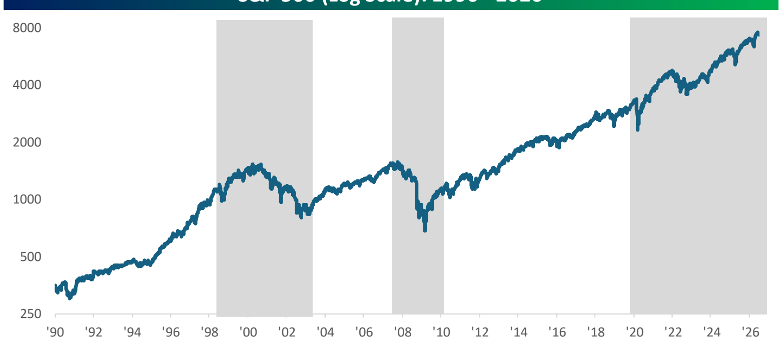
You could look at this chart and say that today's elevated dispersion is a warning of a looming bear market, pointing to the two prior periods when the gap between the two indices widened by similar amounts.

Weekly Performance Spread Between S&P 500 Equal and Market Cap Indices



Weekly performance spread between S&P 500 Equal Weight Index and S&P 500 (percentage points).

S&P 500 (Log Scale): 1990 - 2026



That the bull market has continued for years while dispersion remains elevated suggests that the four most dangerous words in investing may apply, and that *this time is different*. In both prior episodes, wide dispersion coincided with falling markets. This time, the spread has persisted through a rising market, a sign that individual stocks are moving on their own expectations and in reaction to geopolitical and technological forces whose impact falls unevenly rather than in lockstep. That is exactly the backdrop in which stock selection, rather than market direction, drives returns.

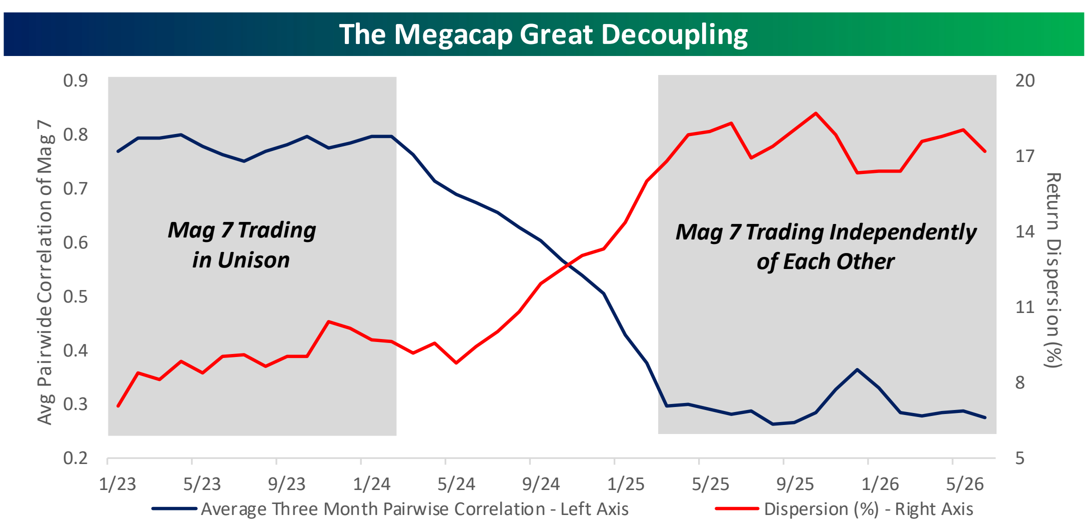
We're not smart enough to know exactly when the next bear market will begin. However, the now regularly wide performance gaps between the two indices suggest that we're well removed from a "rising tide lifts all boats" investment landscape where "any stock will do." Instead, the environment looks more favorable for stock picking than it has in two decades.

Remember the Mag 7? The group of mega-cap stocks comprised of Microsoft (MSFT), Apple (AAPL), NVIDIA (NVDA), Alphabet (GOOGL), Amazon.com (AMZN), Meta Platforms (META), and Tesla (TSLA) were not only the largest stocks in the S&P 500, but they also practically traded in lockstep with each other early in the bull market that began in late 2022. Not any longer.

The chart below shows the average three-month pairwise correlation between the seven stocks along with the dispersion in their monthly returns. In plain English, the pairwise correlation measures how closely these seven stocks mirror each other's daily ups and downs over any three-month period. When this line is high, they are moving in lockstep with each other, and when it drops, they are trading on their own individual news. Additionally, the dispersion line measures how far apart the best-performing stock and the worst-performing stock finished at the end of each month. A small gap means they all had similar returns while a wide gap indicates some had big gains while others moved lower.

In the early days of the current bull market through early 2024, the high correlation and low levels of dispersion meant that these seven stocks were all bunched together like runners at the start of a marathon. Just like a marathon, though, as the miles stack up, separation between the runners widens, with some sprinting ahead while others fall behind.

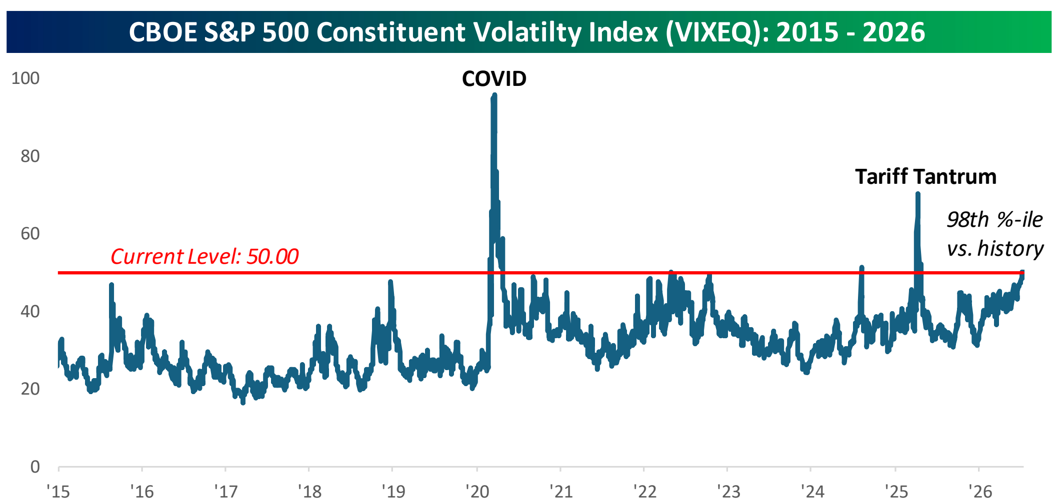
Just as stock selection across the broader market has become more important lately, it has clearly gotten more important for the market's biggest stocks as well. As the AI Boom continues, we expect that some of the mega-caps will thrive and grow even larger, while others will make mistakes, lose relevance, and slowly work their way off the list of the world's largest companies.



Mag 7 is defined as Microsoft (MSFT), Apple (AAPL), NVIDIA (NVDA), Alphabet (GOOGL), Amazon.com (AMZN), Meta Platforms (META), and Tesla (TSLA)

Along with the prior two examples highlighting the increased importance of stock picking as the 2020s progresses, there's an actual indicator that tracks stock dispersion among S&P 500 stocks. We're all mostly familiar with the CBOE Volatility Index (VIX), which measures the volatility of the S&P 500, but the CBOE S&P 500 Constituent Volatility Index (VIXEQ) measures volatility within the S&P 500's individual components. A high VIXEQ indicates that individual stock performance is varying widely, which is an environment ripe for individual stock selection.

As the chart below illustrates, from 2015 through 2019, the VIXEQ rarely exceeded 40 and averaged a level of 25.6. During COVID, the VIXEQ spiked up near 100. While it didn't stay there long, it settled into a much higher range between 20 and 50, averaging a level of 36.0. As we write this quarter's letter, the VIXEQ sits just above 50 at a level in the 98th percentile relative to all other periods. This level has only been meaningfully exceeded during COVID in early 2020 and during the Tariff Tantrum in early 2025.



You could look at the two prior examples and think to yourself that one is random while two is a coincidence, but adding the VIXEQ into the mix, three indicates a trend.

What does this mean going forward? We are not calling for a bear market, and we take no comfort in dispersion for its own sake. But a market that once again separates winners from losers rewards the investors who can tell them apart. This is exactly the type of environment we prefer, and one where we intend to earn our keep.

Justin + Paul