The Best Days for Mega Cap Tech are Over — November 2022

Mega cap tech stocks have dominated the market over the last decade and ushered in an era of multi trillion-dollar market capitalizations, while winning over the steadfast loyalty of a generation of investors. Buying and holding these companies over the long haul has made careers and minted millionaires. Importantly, maintaining exposure has been critical to having any chance of outperforming the large cap indices of that period. However, those that have been in the markets long enough to remember how prior cycles ended will appreciate the dangers of extrapolating success in perpetuity. All good things eventually come to an end, and we think given the massive weights in the benchmarks, mega cap tech market dominance is over. These are great businesses with unassailable moats in many cases, but that does not mean that the stocks will outperform in the years ahead. We expect different market segments to emerge as new leadership going forward.

Why? The ingredients of a market shift are evident, as are historical analogs that give us a roadmap for how to navigate this change.

- Covid and the flood of liquidity precipitated the melt up of mega cap tech and markets - **unsustainable trajectory**
- Under the surface was an influx of fresh capital buying passive funds (momentum investments by design) which put a consistent bid under, and benefitted most greatly, the biggest stocks in those cap-weighed indices (i.e. big cap tech), while leaving others for dead - **momentum market**
- Inflation and finally a Fed policy response dramatically increased discount rates which disproportionally impacted long duration secular growers - **catalyst for a leadership change**
- Historical analogs teach us that when cycles change what led last will not lead in the next cycle, and often times will dramatically underperform - **time to shift capital allocations**

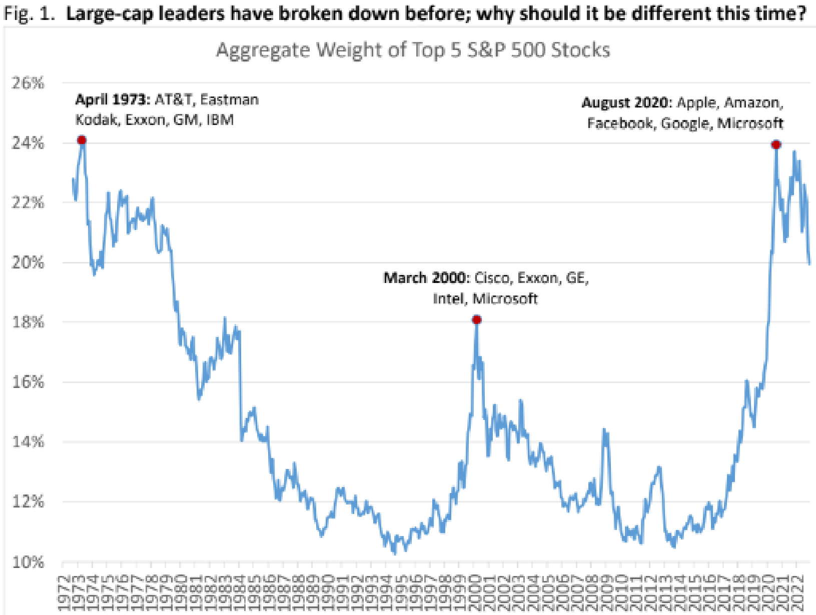
A combination of current macro conditions, historical lessons, and current underlying fundamentals lead us to the following market expectations:

- **Mega cap tech is entering a period of relative underperformance** vs. the overall market - better investment options elsewhere
- As the wind comes out of the sails of mega cap tech, so too should the relative outperformance of cap-weighted indices over equal-weight alternatives
- **Small cap will outperform mega-cap** - relative valuations are compelling and earnings outlook are much better
- **Industrials, Materials, and Energy over mega cap tech** - even a small incremental shift out of big cap tech could have a material performance impact on these market segments

Covid created the ingredients for a melt up.

In the 8 months from the end of 2019 to August 2020, FAAMG index constituent weight increased by 30%+ and their aggregate market cap increased by 50% - the ultimate beneficiaries of the crisis and the concomitant flood of excess liquidity.
History suggests peaks like this are followed by long periods of relative strength for smaller cap stocks.

Fig. 1. **Large-cap leaders have broken down before; why should it be different this time?**



Source: FRP, FactSet; as of 11/1/22

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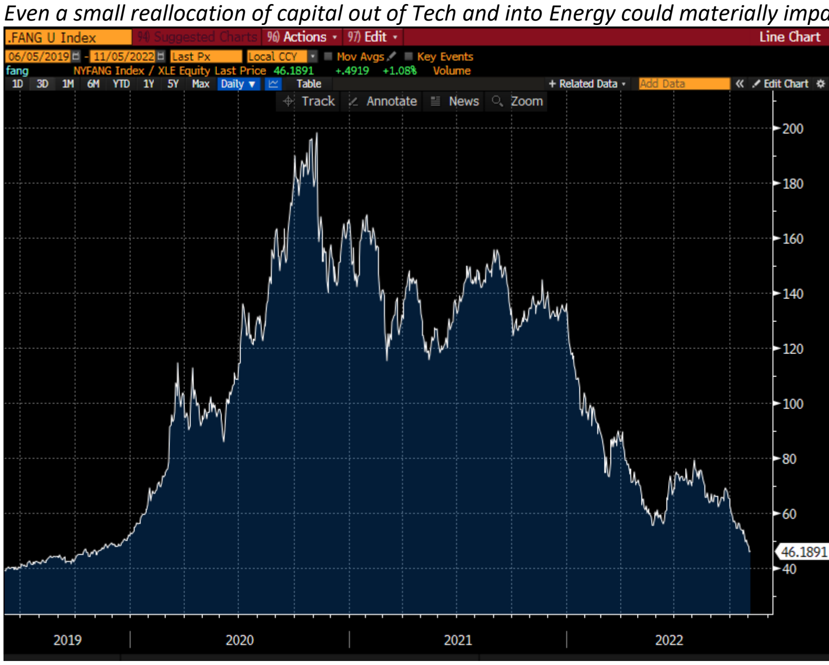
Since the peak in August of 2020, mega cap tech has trailed the Energy sector - a trend we expect to continue.
Even a small reallocation of capital out of Tech and into Energy could materially impact stocks in the group.



Source: Farzin Azarm, Mizuho Americas; Bloomberg

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