Mega Cap Stocks: Making Money in Large Cap Growth
A Method to the Madness: Introducing the KCR Large Cap Growth Model

"Didn't we just learn that pouring trillions of dollars into technologies with uncertain profit profiles we didn't fully understand was a bad idea? Tech investors seem to be most aggressive when they have the least visibility on the IP and valuation provides them with no margin of safety." -Zac M., KCR Subscriber

After the entirely predictable and crushing losses in novelty tech stocks and the collapse of the market's leaders post the Covid peaks, both groups are ripping in 2023. The market continues to follow the 2001, post dot.com, precedent with uncanny reliability. Today, like then, investors are piling back into novelty and high-quality tech stocks alike. We explained this precedent in our pieces [ARKK vs. QQQ in the Dot.com Bust](#) and [Specious vs. Spurious Correlation](#).

By definition, mega-cap stocks are generally the principal fodder of index funds. But never more so than today. This note will explain the magnitude of the issue and suggest a balanced alternative for those seeking a sane path to participate in the performance of these leviathans while also explaining the incredible high-growth bargains available by investing in some smaller stocks.

To summarize our earlier work: if you own [Large Cap Core](#) or [Large Cap Growth Index Funds](#), you have massive exposure to the popular mega-cap stocks, including the usual suspects like Apple, Nvidia, and others. By delegating your investment decisions to a methodology that pours capital into the largest companies in a valuation-agnostic fashion, index investors today have an epic and unwitting loading on the growth factor.

Despite frequently reporting flat to negative sales, profits, and cash flows, the mega stocks that dominate these indexes have been on a tear. There has been no end to the documentation of how concentrated performance has been in 2023. We'll add our two cents with the chart below.

The line shows the 12-month rolling batting average of stocks in the Russell 1000 Growth Index has hit dot.com lows eclipsed only at the peak of the Covid mania. This has historically been a sub-optimal time to chase the performance of one of the most crowded and concentrated trades in history.

12m Rolling Batting Average of R1000 Growth Index
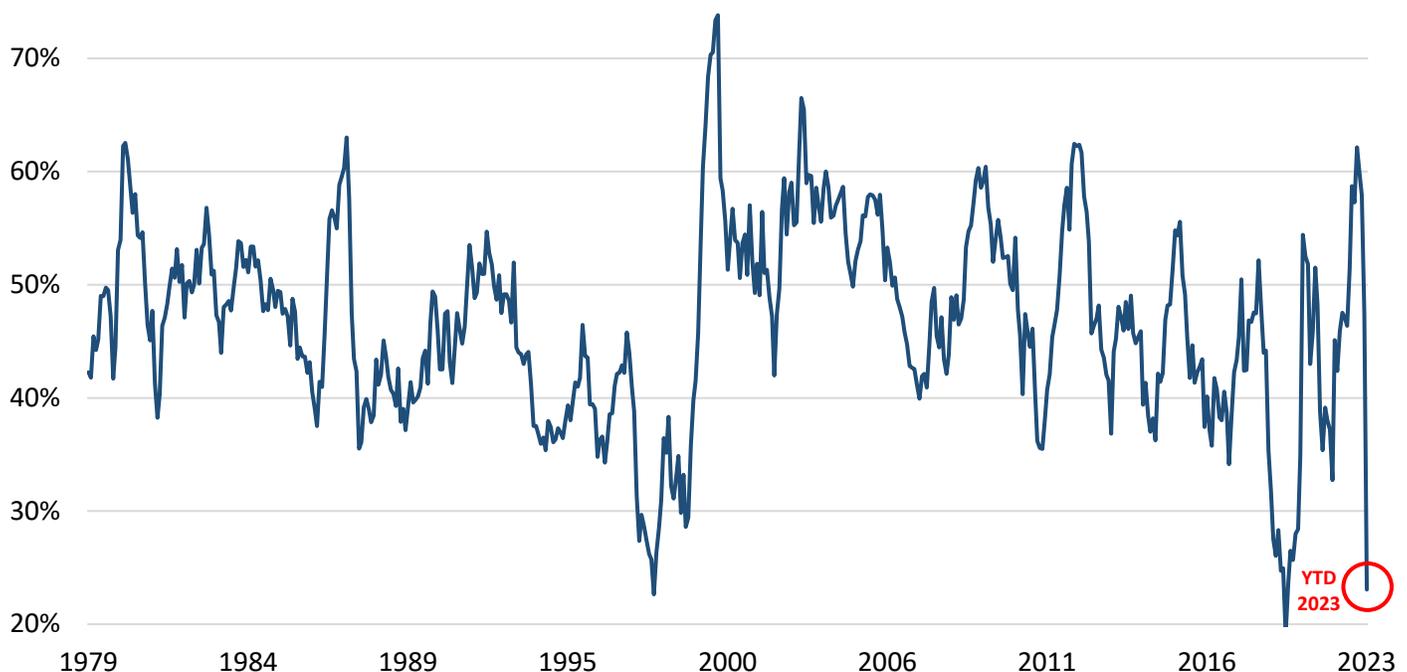
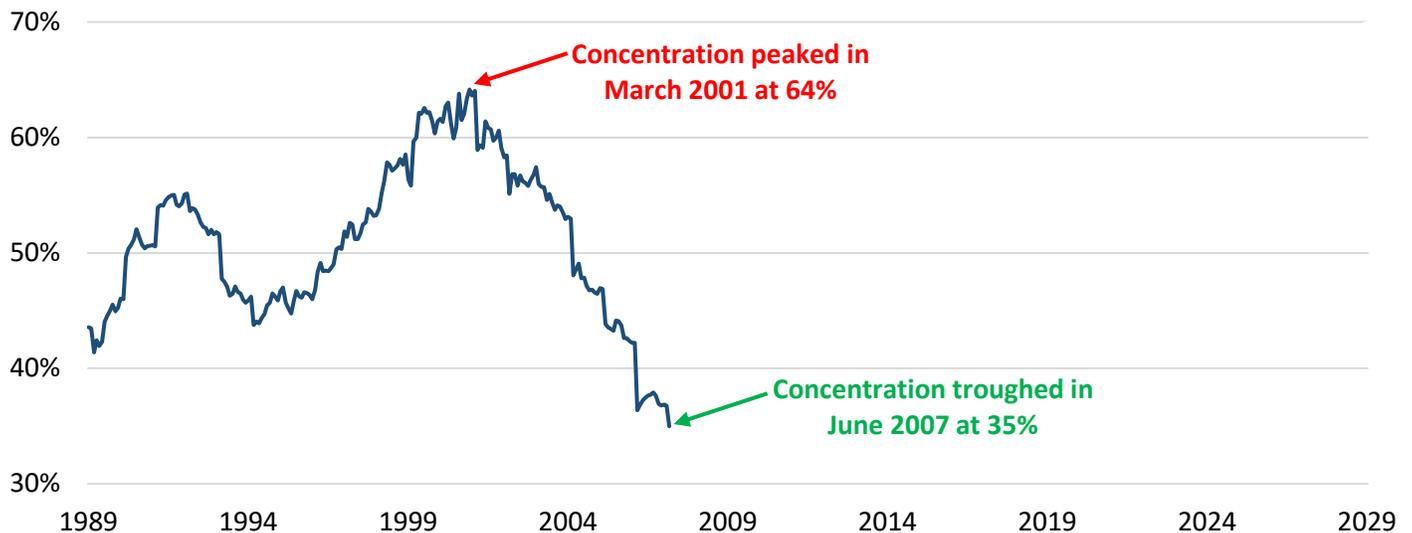Source: Kailash Capital, LLC, Bloomberg; Data from 1/1/1979 - 5/31/2023

Mega Caps: What Happened in the Dot.com Boom?

The chart below shows the weighting of the top 30 stocks in the Russell 1000 Growth Index into and out of the dot.com bubble. (We'll fill the rest of this chart in on the next page, but we believe history is worth revisiting.)

You might notice that the point of peak concentration occurred **after** the peak of the dot.com bubble. Concentration peaked in **March of 2001** at **64%**. After the more speculative tech and IPO stocks were shattered on the rocks of reality, investors proceeded to crowd into the *quality* names in technology under the erroneous belief that valuation did not matter.

From their peak weighting**,** the 30 largest stocks in the Russell 1000 Growth Index would plummet to **35%** by June 30, 2007.[i] Conveniently, this 6-year stretch was also nearly perfectly coincidental with the next market peak before the great GFC plunge. So peak-to-peak, the top 30 stocks took a beating.

Index Weight of the Largest 30 Firms in the R1000G

Source: Kailash Capital, LLC; Data from 4/30/1989 - 6/30/2007

The chart below shows the returns of the 30 largest stocks from the point of peak concentration. All but six of them would experience brutal underperformance as investors learned a painful lesson: **what you pay matters over the long haul.**

6 Year Forward Excess Returns From Last Concentration Peak
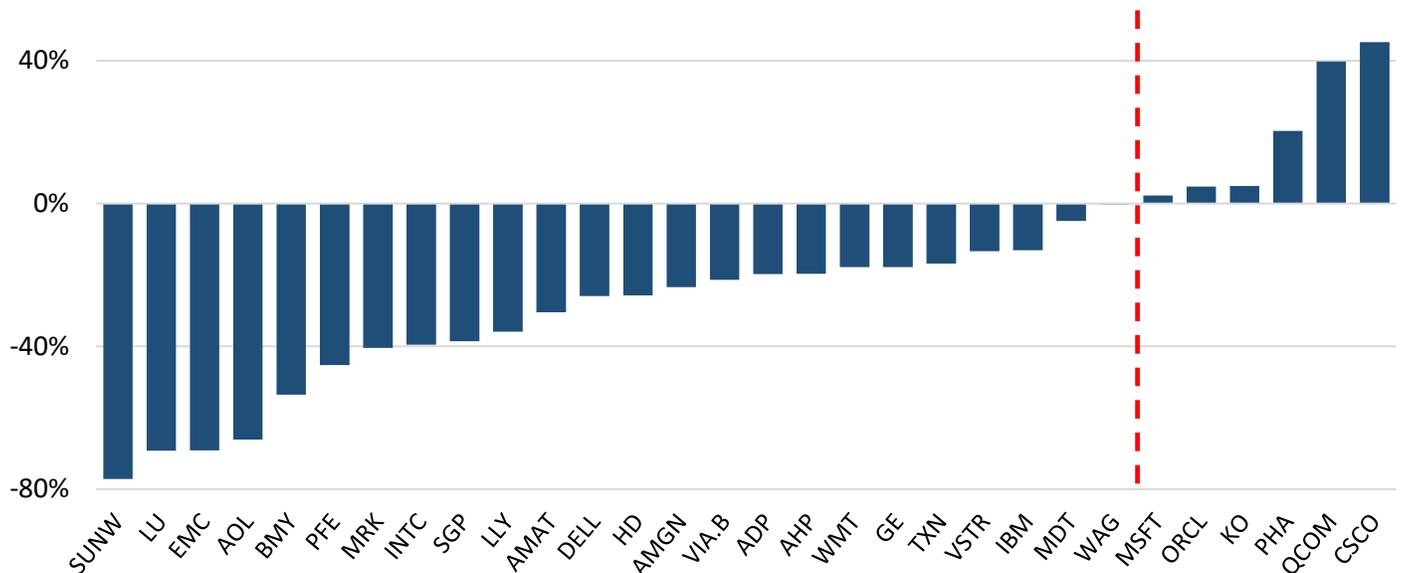
Source: Kailash Capital, LLC; Data from 3/31/2001 - 3/31/2007

### Mega Cap Companies: Where Are They Now & Where Might They Go?

The below updates the chart through today. You can see the weighting of the 30 largest firms in the Russell 1000 Growth Index are, post this year's rally, just below dot.com and 2021 peaks.

We've also modeled out[ii] a hypothetical path for our readers to contemplate. The **"This Time Is Different"** line shows the progression in weights of the top 30 stocks if they outperform the rest of the index by 5% a year for the next six years, leading to a new record in market cap concentration.

Let's pretend you have total confidence that the biggest weights today will keep winning. Let's then pretend you put 100% of your money in just those top 30 stocks, and they did, in fact, beat the broad Russell 1000 Growth Index by 5% a year. Genius, right?

Not so fast. Even with perfect foresight and a 5% annual advantage compounding away for your 30-stock portfolio, you actually outperform the broad R1G index by only 1.7% a year on average! Don't believe us? Check the appendix at the bottom. **The math is a merciless reminder that 1) the index is already incredibly concentrated, and 2) there is very little benefit to making even bigger bets on the top 30.**

Index Weight of the Largest 30 Firms in the R1000G
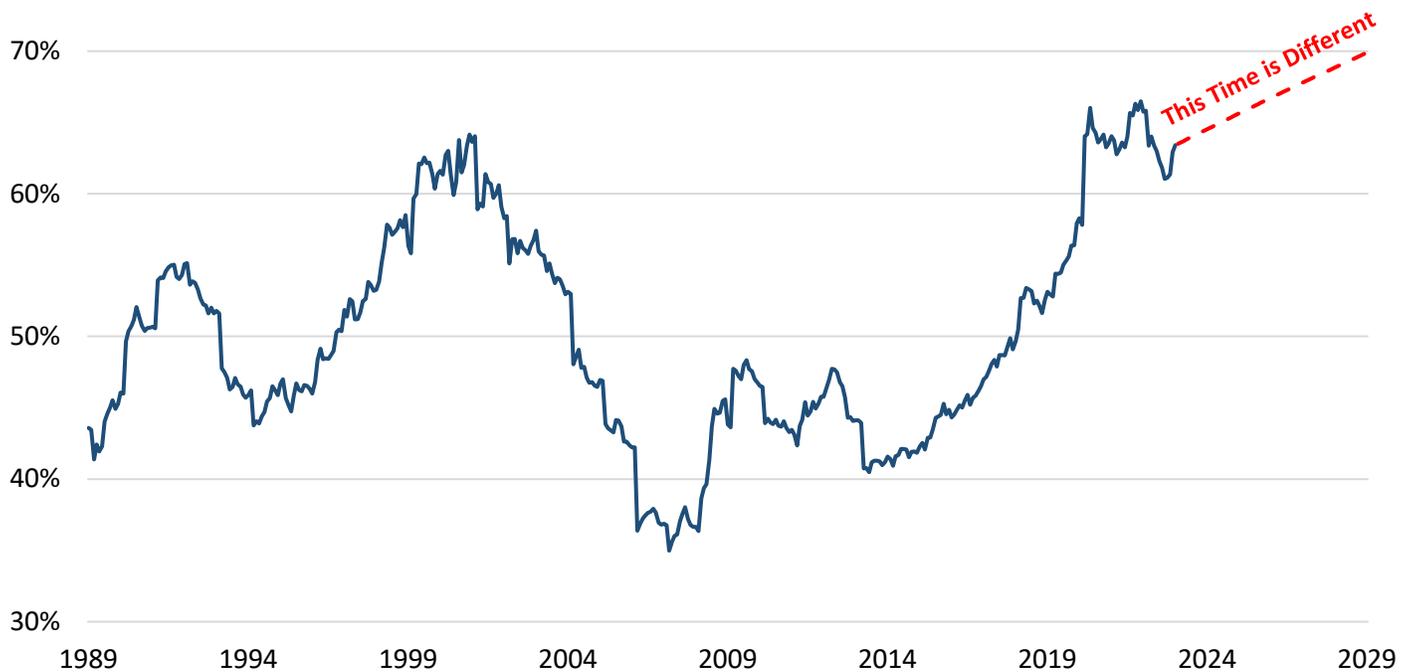
Source: Kailash Capital, LLC; Data from 4/30/1989 - 4/30/2023

Mega Caps Today vs. Dot.Com: A Doppelganger with an Unfortunate "Ding"

The table below shows the basic fundamentals of the top 30 at the prior peak and today. We find it stunning how incredibly similar they look. The only difference we can see is that **today**, the stocks with the largest market capitalizations are actually growing profits at less than a third of the rate they were at the prior peak (49% today vs. 175% then). **To the degree it is different this time….it doesn't look good to us.**

	FCF/EV*	P/S	Fwd P/E	P/B	Total Yield	3 Yr Sales Grth	3 Yr Earnings Grth
Prior Concentration Peak	2%	4x	32x	7x	1%	82%	175%
Today	2%	5x	26x	12x	3%	63%	49%

Source: Kailash Capital, LLC; Data from 3/31/2001 & 4/30/2023 *FCF/EV ex SBC

KCR's Large Cap Growth Model: A Balance of Size & High Quality, High-Speed Growth

At a client's request, we have built a model portfolio designed to beat the Russell 1000 Growth Index. Using a systematic evidence-based process, the ranking engine creates a concentrated portfolio of 30-50 stocks with low turnover and tracking error of ~5%. Targeted excess returns are north of 4% p.a. on a gross basis.

As one might suspect, the model is currently underweighting the top 30 stocks, and is carrying high-conviction overweights in about 20 smaller names from the index. **Finding plenty of other ways to look foolish, KCR's models are based on historical evidence – not forecasts of grand promises in the future.** Considering our team's classic preference for quality at reasonable prices, we were thrilled to find that even in the momentum-rich world of growth investing…. **what you pay matters.**

The chart below shows the Price to Sales ratio ("P/S") of our model portfolio **minus** the P/S ratio of the Russell 1000 Growth Index. **The lower the line, the bigger the valuation advantage of our model vs. the benchmark.**

P/S Spread: KCR R1G Portfolio - R1G Index
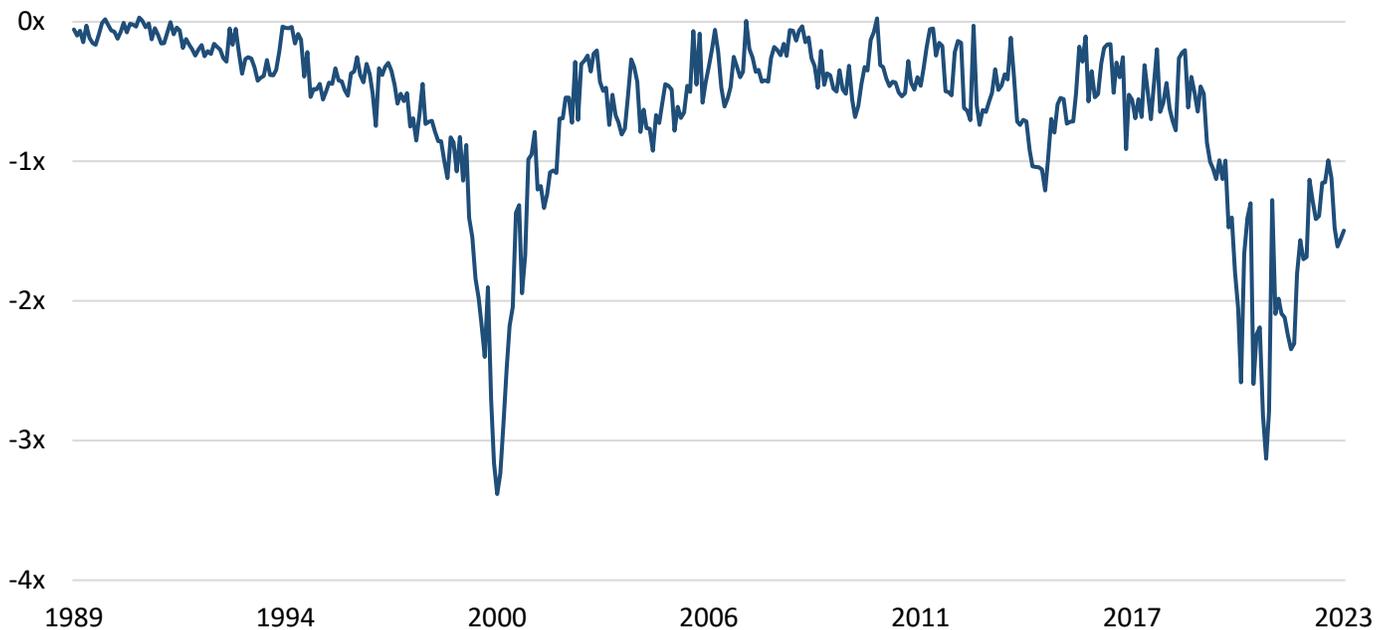
Source: Kailash Capital, LLC; Data from 4/30/1989 - 4/30/2023

While our model's discount has closed a bit since the peak in 2021, we would note that it is still at some of the widest spreads in history. Precisely no one will be surprised to hear that the period post the dot.com peak would have provided rich returns for those using our model portfolio.

The table shows the fundamental power of stepping outside a given benchmark. KCR's model portfolio trades at a 50% discount to the index based on FCF/EV and is paying out that surplus cash to owners while generating profit growth nearly 50% **higher** than the top 30 (72% KCR Growth vs. 49% for the Top 30 Weighted R1G).

	FCF/EV*	P/S	Fwd P/E	P/B	Total Yield	3 Yr Sales Grth	3 Yr Earnings Grth
KCR R1000G Portfolio	4%	2x	22x	7x	4%	55%	72%
R1000G	2%	4x	25x	10x	3%	60%	56%
Top 30 Weighted R1000G	2%	5x	26x	12x	3%	63%	49%

Source: Kailash Capital, LLC; Data from 4/30/2023 *FCF/EV ex SBC

The money managers that write this newsletter sub-advise an All-Cap Index Fund. In an attempt to be transparent and honest, we have been relentless in both hailing the importance of cheap beta and highlighting how the "staple food" of retirement accounts has become an increasingly high-risk bet on a small collection of mega-cap companies trading at exorbitant valuations. **Nowhere is this risk more pronounced than in the world of growth investing, in our view.**

KCR humbly submits that while not quite as fat a pitch as in December 2021, the quality, value, and **growth** spreads active growth investors can avail themselves of have rarely been as high as today. Along the way there will doubtless be bumps on the relative performance side as investor infatuation with quality at any price and AI drives short-term results. But for disciplined investors unwilling to be shaken by the comical claims of market efficiency by the indexing crowd, there are profitable high-growth stocks that the data suggests will compound at rates far above the index.

This stands in sharp contrast to some of the largest companies in the world. With market caps that sum to trillions, the future expectations embedded in them seem unlikely to materialize. Worse, even assuming a simple 10% growth rate would imply that these stocks' market caps would double in just 7 years. While a company like Apple, with a market capitalization of $2.7 trillion, **could** theoretically balloon to $5.4 trillion, it flies in the face of history and the law of large numbers. In contrast, many of the $20bn - $100bn stocks our model portfolio favors strike us as viable candidates to grow by that amount and more.

Please see KCR's Top 25 ranked stocks in the R1G as of April. We will update the picks on June 5th once the monthly data-roll is complete. If you're interested in seeing the model portfolio weights, please let us know. At the request of clients, we currently have both a 30 and 50 stock variant of the portfolio.

KCR Agg Rank	Ticker	Company Name	Market Cap ($m)
1	META	META PLATFORMS INC	628,196
2	BKNG	BOOKING HOLDINGS INC	101,712
3	EEFT	EURONET WORLDWIDE INC	5,517
4	NVR	NVR INC	18,799
5	ADBE	ADOBE INC	173,300
6	Z	ZILLOW GROUP INC	10,200
7	EBAY	EBAY INC	25,026
8	LSTR	LANDSTAR SYSTEM INC	6,324
9	DOCU	DOCUSIGN INC	9,982
10	DHI	D R HORTON INC	37,456
11	AGCO	AGCO CORP	9,246
12	AOS	SMITH (A.O.)	10,274
13	ULTA	ULTA BEAUTY INC	27,772
14	ACM	AECOM	11,540
15	ON	ON SEMICONDUCTOR CORP	31,082
16	RKT	ROCKET COS INC	1,100
17	WDAY	WORKDAY INC	48,022
18	PSTG	PURE STORAGE INC	6,942
19	TDC	TERADATA CORP	3,914
20	LRCX	LAM RESEARCH CORP	70,589
21	WIX	WIX.COM LTD	4,911
22	SPLK	SPLUNK INC	14,215
23	ELV	ELEVANCE HEALTH INC	111,123
24	LPLA	LPL FINANCIAL HOLDINGS INC	16,550
25	TPR	TAPESTRY INC	9,631

Source: Kailash Capital, LLC; Data from 4/30/2023

Appendix:

The table below compares two hypothetical portfolios. The top one has the investor putting $100 in just the 30 largest stocks in the Russell 1000 Growth Index. We then assume the top 30 stocks compound at 5% a year while the rest of the R1G stocks stay constant at 0%. So, the top 30 win by 5% a year vs. the rest of the stocks in the index. You can see that by year six, your $100 turns into **$134**.

Underneath that we show an investor's returns who puts their $100 into the R1G in proportion to the weights. $64 goes into the top 30 stocks, and $36 goes into the remainder of the index. We apply the same logic here - the $64 grows by 5% a year while the remaining $36 stays constant.

You can see that by the end of year 6, that investor has **$122**. So, in return for going **all-in** on the top 30 stocks and betting "this time is different," the top 30 investor only picks up ~1.7% a year over the index. This strikes us as a paltry sum to abandon the optionality of the higher growth opportunities trading at discounts in some of the index's smaller companies. **Please reach out if you'd like to discuss!**

Performance	Top 30	15%	15%	15%	15%	15%	15%
Assumptions:	Rest of R1G	10%	10%	10%	10%	10%	10%
Portfolio	Starting Capital	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Top 30	$100	$115	$132	$152	$175	$201	$231
Rest of R1G	$0	$0	$0	$0	$0	$0	$0
Total Capital	$100	$115	$132	$152	$175	$201	$231
Portfolio Return		15.0%	15.0%	15.0%	15.0%	15.0%	15.0%
Portfolio	Starting Capital	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Top 30	$64	$73	$84	$97	$111	$128	$147
Rest of R1G	$36	$40	$44	$48	$53	$59	$64
Total Capital	$100	$113	$128	$145	$165	$187	$212
Index Return		13.2%	13.2%	13.3%	13.3%	13.4%	13.4%
Annual Outperformance		1.8%	1.8%	1.7%	1.7%	1.6%	1.6%
Index Weight							
Top 30	64%	65%	66%	67%	68%	69%	70%
Rest of R1G	36%	35%	34%	33%	32%	31%	30%

Note: for the purposes of this exercise we disregard any potential impact from Russell rebalancing

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[i] The data in this chart includes not just the performance of the stocks but also the effect of Russell's rebalancing program
[ii] Numbers are hypothetical based on relative performance being the only driver of concentration - we have omitted the potential future impact of the Russell Index rebalances

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