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Transcript

Lisa: Welcome to *Pzena Perspectives*, brought to you by Pzena Investment Management, a global value manager known for our commitment to fundamental research and disciplined value investing.

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Today's episode features Portfolio Manager John Flynn joined by moderator Andy Williams, a Director of Client and Portfolio Services at the firm. Together, they discuss the historic concentration of today's equity indices, why low tracking error may now hide risk rather than reduce it, and possible investment opportunities in sectors that the market fears AI will disrupt.

Andy: Hello and a very warm welcome to the *Pzena Perspectives* podcast. My name is Andy Williams and I'm a Director of Client and Portfolio Services based in our London office. On today's episode, I'm thrilled to be joined by John Flynn. John has been with Pzena for 21 years and is a portfolio manager on our US value strategies. John, it's great to have you on the podcast.

John: Great to be here.

Andy: Fantastic. So, today we're going to be talking about our third quarter newsletter, which touches on several themes that are important for investors today. Now, I'm going to start with the big one, with the most obvious one perhaps, and that's index concentration. It's worrying investors in the US. It's worrying investors in Europe, in emerging markets across the globe. That said, if you look past today's headlines, you and I both know this is not a new story. We've had comparable levels of index concentration in the '70s, with the Nifty Fifty, in the '90s, with the dot-com bubble. What strikes me though about the situation today, which is perhaps different from before, is just quite how alike the index leaders are today. So back in the '70s, the top 10 largest stocks spanned computers, telcos, autos, photography, energy, and retail. Today, nine of the 10 are in one way or another a bet on AI. Let's start with the broadest question of them all. John, why does this matter?

John: That's a great question, Andy, and thanks for having me here. You know, I think you mentioned the '70s, you mentioned the dot-com bubble. We certainly saw, you know, broad market concentration during those periods, but as you said, this time it's, you know, really driven by one theme, AI.

And when you think about that as in terms of the risks you're exposing yourself to, are the top 10 companies even one, even 10 different companies or you're really shrinking it down to a much more concentrated exposure so and end up with a much bigger percentage of the portfolio in this one risk. And I think that's something we're going to talk more about as we go on today. We'll get into a little bit more of the nuance there. But I think that's the big picture question. That's the so what.

Andy: Okay. Yeah. Fantastic. And we'll certainly get more into that. Before we do though, you know, stock markets are forward-looking. And the stock market darlings at any one point in time are almost by definition the most exciting stocks and they should really be the ones with the most attractive opportunities. That's how they get so big. You know, we've been in a winner-takes-all market. I want to zoom out for a moment and maybe you can give some historical context on this. You know, lots of people think today the market leaders of today are going to be the market leaders in five years and in 10 years, you know, is that true? Do market leaders stay leaders for long or in 10 years is this likely to look very different?

John: You know, the history would say that it's likely to look different. If you look back to the dot-com era of the 10 largest stocks back then, Microsoft is the only one that has sustained its place in the top 10. So historically you've seen significant turnover over time, and if you step back and think about it outside of the excitement of the moment, kind of makes sense, right? Because why are these companies getting so big? Because they've got a very attractive market they've addressed. What happens? Other competition comes in. New companies get founded. New technology emerges, right? We progress and as we progress you see turnover in market leadership. And so I don't have a crystal ball. I don't know what we're going to look like in 10 years, but I'd be surprised if we saw the same group of leaders that we see now.

I think another interesting point that comes out of that, too, is, you know, we're value managers. We're looking for, you know, the cheapest 20% of the world, if you look at the leaders in the dot-com era back in 2000, ultimately we ended up owning nine out of those 10 names in our portfolios as things evolved over the subsequent decades. And I think that's an interesting point too is that the market leaders of today can be the value stocks of the future. Maybe when the shine goes away a little bit, they trip up a bit and they fall into our universe.

Andy: So we might get to own Nvidia someday.

John: Never say never.

Andy: Never say never. We'll see. Something that stood out to me in this quarter's newsletter is this concept of effective N. Now this is a measure of diversification that asks how many stocks an index or a portfolio actually behaves like. It requires a little bit of explanation but I think once we get there it's certainly worth it. So the higher the effective N the more diversification you

have and so really in a portfolio you want your effective N and the total number of stocks to be broadly similar.

And I'm going to try and help our listeners understand this better with a little bit of an analogy. So bear with me. So imagine John, you're in a meeting with 10 people. But there are just two people who are doing most of the talking. So in that room, you've got 10 people in the room. So let's say you've got 10 stocks in the room if you like. But you're effectively only hearing two voices. In that room, the effective N of that meeting is two, meaning that two people are dominating the discussion and the debate. And the other eight people might as well not be there. So looking through that lens of effective N, you know, what do we observe about markets today in terms of their concentration?

John: I like that analogy. And I'll use a stock analogy as well. Let's say you had a 10-stock portfolio, but one stock was 90% of that portfolio. Is that really a 10-stock portfolio? No, it's much closer to one, right? Because you have nine stocks carrying 10%. And when you look at that effective N today in the market, it's come down dramatically. Where we've seen it come down the most is in emerging markets. And really that's with the memory stocks dominating those indexes. But it's across the board you see it. Just to give you some numbers, you know, if you were to look, you know, back in 2012 in the emerging markets, the effective N was 161 names. Today that's 27. You know just a massive shrinkage there. In the Russell 1000 in the US again it was actually 161 coincidentally back in 2012 and today it's at 56. So again we've seen that compression in the market in the number of exposures you're exposed to.

Now some of our listeners might be saying well wait a minute 56-stock portfolio that's still pretty good diversification. And I think that's where comes back to that initial conversation we had of the yes, we've seen concentrated markets before, but it's all one exposure. So once you take risk into account, you really aren't even getting the 56 names in the US or 27 names in emerging markets.

And when we think about portfolio construction and building our portfolios from the bottom up, we're really thinking about for a 40-stock portfolio, how close can we get to 40 unique risks, right? We don't want the underlying exposures to be in a perfect world, we don't want them to be correlated. Obviously, it's an imperfect world. There's some overlap, but we're very conscious in the portfolio construction of making sure we get exposure to those different risks. The indexes today are not and I think that's pretty striking. So you want that in the portfolio you want that effective N as I said to be as close to the total number as possible essentially.

Andy: Now that's an extraordinary number you just gave. You say 27, it was 27 stocks in emerging markets for the index. So essentially you know what we're saying there is that the, you know, our concentrated portfolio is effectively more diversified than its benchmark today. Now that's quite extraordinary. And you've touched on this already, but I think it's worth laboring the point a little that that effective N number flatters diversification because the indices are dependent on one theme. So, I kind of think of this as this double whammy. You have high correlation and you have high, you know, and you have high concentration.

John: No, that's 100% correct because it really goes back to that idea of, you know, what's the exposure? What's the underlying drivers of each of these businesses in my portfolio? And when it comes down to it's related to AI, compute and capex data centers, you know, different names of companies but similar drivers.

Andy: Got you. And I do want to dig into the portfolio in a little bit more detail. One thing I want to touch on which is obviously related to indices becoming so concentrated is, you know, benchmark relative risk measures and tracking error being the obvious one. You know, so some investors, you know, do believe or have traditionally believed or the books will tell you this certainly that, you know, that lowering tracking error, sorry, lower tracking error equals lower risk equals high diversification. But at this point, the inverse might be true given what's happened in indices.

And I've actually heard a fund selector say to me that, you know, they had an active portfolio that ran with a tracking error of four or five a year ago and they've done nothing. And now it's optically running with a tracking error 11 or 12 just because of the concentration that we've seen in the benchmark and that's quite extraordinary.

John: Yeah, it's interesting because we don't think about tracking error, right? We think about a bottom-up building the portfolio name by name. But that said, I will say if you're going to have something and keep a low tracking error, you want to make sure the thing you're tracking isn't a hidden risk, right? And I think that's what we're seeing today in this divergence between, you know, active equity portfolios and the indexes people measure them against.

Andy: Certainly, and I think I want to play devil's advocate for a moment because I clearly agree with you but you know this time it's different. We all know they're the four most dangerous words in finance. But the largest companies today you can't deny their extraordinary businesses. I mean, they're hugely profitable. They've kept on delivering, you know, and as a result, when we look since 2018, if you look on a 1-, 3- or 5-year rolling basis, they've outperformed the rest of the index, you know, enormously. So isn't it entirely reasonable or rational that they've become this big and that, you know, that cap-weighted is beating equal-weighted at the moment?

John: Look, I see the numbers too and I think these are some extraordinary companies that make up the 10 largest companies. I certainly agree with that. However, you know, there's a relation between, you know, valuation and what you're actually getting from cash flow and fundamentals. And I think we've seen, you know, a disconnect there on some of the errors.

And you made the point of extraordinary performance. So I want to address that too because it is actually the exception when you look today at the performance of the 10 largest companies over the past 10 years. If you go back to 1926 through 2017 and measure the performance of the 10 largest companies prospectively on a one-year basis they underperformed by about 3%. On a three-year basis it's about 11% that they underperform by. Five-year basis, it's 20 and on a 10-year basis, they underperform on average by 35%. So, history would actually say that this time's the exception. Again, no crystal ball. I don't know how things will play out in the future, but to

say that it's natural for this to occur, it's actually an exception when you look at markets historically.

Andy: So, there are extraordinary statistics. And that underperforms by 35%. I believe that between 2018 and today that's something like an outperform by almost 50%.

John: That's right. Five-year basis is 50%.

Andy: Five-year basis, 50%. And I think it's just worthwhile kind of hammering that message home just how extraordinary this period's been and you know over nearly a hundred years equal-weighted beat cap-weighted and this is a very very strange time should I say.

John: Absolutely.

Andy: You touched on another point there that I'd like to move on to. I think it's the perfect segue, which is to talk about valuations. We've spoken about index concentration. We've spoken about how concentrated the index is. We've spoken about how lots of those positions are also facing one way. That's a perfect segue to actually talk about valuations as well.

(restarting after a production pause) Andy: I think that's the perfect segue to start talking about valuations, John. So indices have concentrated and global equities are also trading at lofty valuations. That's potentially quite a dangerous place to be for the index. So the US equity market is now twice as expensive as its long-run average. If I contrast that with Pzena's portfolios, their valuations are, you know, either in line or even slightly below their long-run averages, you know, how should investors in our funds, you know, be thinking about that contrast?

John: I think it's a very important point. I think starting points matter in investing. And you know as we construct our portfolio as you mentioned it we look at our portfolio today and you compare just on a forward P/E basis versus its history it's cheaper. If you look at the broader market it's more expensive. And so part of what has gone on the past 10, 15 years is that the growth stocks, the market leaders have had an exceptional run. But they're starting from a very high point now going forward.

Contrast that in our funds where we're actually starting at the same point we've been actually cheaper than the same point we've been starting at over the past 10, 15 years and that's exciting to us right and that's where the discipline really comes in as a value investor being you know making sure that you're not paying up for the businesses that you own and that you're really exposing the fund and our clients to the cheapest opportunities out there.

Andy: And that's probably worth unpacking a little more because so what you're saying is despite the headline valuation of the US being so high within the cheapest quintile valuations aren't full at all.

John: No, the valuations are, you know, on the cheaper end of the historical range in the portfolios. Certainly in the small-cap space, we've seen a huge disconnect where they've lagged

their large-cap brethren for years and that's created an extraordinary opportunity from a valuation standpoint.

Andy: I want to read a quote to you that I actually read on Bloomberg recently and it's slightly provocative. But I thought it would be an interesting starting point for a conversation. So the quote went like this. It said there are two days in history like today, and I should say this was in sort of mid-September. It said there were two days in history like today when the S&P 500 rallied at least 1% to within 1% of a new high and more of its stocks fell to new lows than highs. And those two dates were July 23rd, 1929 and December 21st, 1999. Now, you can see where I'm going with this.

John: I can see the setup. I see the setup.

Andy: Okay? It proves nothing. I'm not asking you to give any sort of market-timing message. I'll be completely clear. We're not predicting a crash or anything like that. But when you hear a statistic like that, what does it make you think about where we are in this cycle today?

John: Well, well, as I said, you're baiting me again. You know, we can't control when things reverse or how the market plays out, broadly speaking, but we can control what we're buying and what we're paying for. And that's where I think that discipline is so important. You know, so that quote obviously is, it's a fun quote. It's a really neat observation, I guess. And you know I think we all don't want to go through another 1929 or dot-com bubble burst per se but these are the things you get in market extremes. Yeah. This dislocation with market hitting new highs most of the constituents comes back to the index concentration we started with that's really driving the phenomenon that you need those conditions to even have this phenomenon occur. That's in the quote there.

Andy: I want to switch gears a little bit and look more closely at the portfolios and perhaps we can even get into some of those interesting names that you alluded to earlier. But when I look at the portfolios today, I think there's a disproportionately large shares in companies whose earnings we do not expect AI to affect at all. You know, either on the kind of positive side or the negative side. They shouldn't be impacted by AI. And when AI-related businesses have become cheap, you know, we have owned them. In memory, semiconductors, you know, being a very good example. So perhaps more broadly, can you sort of set the scene on how we are positioning or not positioning the portfolio in this environment when AI seems to be driving markets so dominantly?

John: Yeah, I think you know we're building our portfolios from the bottom up, right? We're going through and saying what's in the cheapest 20% of the universe. And what's looking interesting and so you're right, we don't have any of the AI winners in the portfolio today. But one of the things that has screened up in the portfolio are perceived AI losers, right? Right? So we have a portfolio with bunch of names that are not really impacted by AI except for the way you'd normally expect a company to be implementing AI as a solution.

But then you have the IT service providers for example like a Cognizant or an Accenture where the market has you know traded off these names saying well wait a minute as AI gets deployed

the market view is that these names are going to be obsolete. We kind of dig in and say, wait a minute, that doesn't make sense to us, right? These are solutions providers. They're the ones who actually going to the companies and helping them implement their AI solutions. And I think, you know, for a while earlier this year, we saw the market seeing kind of a slowdown in growth at these companies as an indicator that they weren't going to be part of the winning team.

The reality is I think IT budgets were under pressure with memory costs doing what they are, trying to figure out how to actually implement AI solutions before hiring the consultant to come in and do it. And you know I think we'll start to see these projects come online and come through revenue over time. We saw some of that with Accenture this past quarter. But you know it's certainly AI is creating opportunities for us but it's kind of on the perceived loser side versus the winners.

Andy: So I guess because of the narrative around AI and as you say perceived losers in some of these names, the market is selling them off in quite an extreme way. And you are able to look through that and see that actually you know they've sold off far too far and that's creating the value opportunity.

John: Exactly.

Andy: Very interesting. Curious to perhaps talk a little bit about the other side because some of these stocks that we have held have been either direct beneficiaries or have become perceived beneficiaries of AI and have rallied you know very very quickly. I think memory is the obvious example here. But it makes me think about a broader question which I think it'd be interesting to explore which is you know how hard is it to sell stocks that clearly have you know strong momentum I might say but also that the fundamentals also seem to be improving a lot as well, right?

John: And I think that really comes down to, you know, our sell discipline and, you know, we sell our stocks when they hit the midpoint of the universe on a price normalized earnings basis and where we saw the most sort of beneficiaries in the portfolio was in our emerging markets portfolio. You alluded to the memory stocks and what I think was interesting there is, you know, as we saw this develop, you know, we didn't have our heads in the sand, we said, well, has something fundamentally changed, and as the stocks appreciated and got towards that midpoint we were evaluating our normal earnings estimate, saying, well, is there something fundamentally different about this cycle versus prior cycles, should we be taking our normal earnings up, and that factors into our discipline as well.

But ultimately at the end of the day, the valuation is the valuation. And when you get to that midpoint of the universe for our portfolios, you're out and we're going back and we're recycling into that cheapest quintile looking for the next new idea.

Andy: So essentially, while it might seem a difficult decision from the outside, the reality is it's not at all because it's the sell discipline and it's why we don't succumb to any style drift.

John: Yeah. I kind of think of it as the no-falling-in-love clause. The question isn't, you know, do I think they're going to beat next quarter. It's okay, why is our long-term normal earnings forecast higher, right? And in the case of some of these memory chips, they do go up a little bit because they are having a cash windfall, but the stocks have gotten ahead of where we actually think the long-term valuations would be.

Andy: Gotcha. I like the no-falling-in-love clause. We'll use that one again. So earlier this year, Dan Babkes joined me on the podcast and we actually spent a very decent chunk of the episode talking about companies the market feared the AI would disrupt, but actually also why the, you know, strong incumbents can often come through periods like this, you know, in far better shape than people expect. You've touched on some of these a little already particularly IT and business services business companies that sold off on those fears of disruption. We have taken some positions there. How, you know, five months later or four or five months later? How is that evolving? And have there been any more kind of opportunities or interesting things in that space?

John: Yeah. So, we touched on Cognizant and Accenture on the IT services side and you know, I think we're starting to see some of that come through like I alluded to. But, you know, another area where we've seen opportunities is in call centers. So, Concentrix, Teleperformance, where, you know, these companies have been very aggressive in rolling out AI solutions to their customers. And you know with that comes a bit of revenue compression initially and then as you penetrate more into the customer base that growth comes back over time. So you know that's another area we've seen some opportunity.

I would say staffing is another place. Temporary staffing where you know the role of temporary staffing is more cyclical today where you've seen hiring be more depressed. Temporary staffing workers have been, volumes have been down. And yet the market kind of treats it as a you know this isn't cyclical. This is permanently changed by AI. And so we get some incredible valuation opportunities there that we can lean into in the portfolio.

Andy: Super interesting. I just like to kind of bring this back together and bring it back to the newsletter. So our portfolios look very different from the index. And you know as a result they'll carry you know meaningful tracking error. You know for a lot of investors tracking error has traditionally been something to manage down. Our observation today is that you know doing so may actually be you know increasing your exposure to a single theme. You know, what does that mean for anybody who's listening to this today who you potentially holds the index or holds, you know, a very kind of core-focused portfolio.

John: Yeah. I mean, I think it's a provocative question, right? Because, you know, the simple just hold the index and that's an easy solution. Look, it's worked very very well for quite some time now. And so I think when you step back, you have to say, well, what am I really owning if I own just a passive index and there are plenty of market environments where it is a broad solution with many different exposures, many different risks. And so it might be the appropriate solution.

Today what's interesting is that as we talked about the concentration of names and the underlying exposures to the drivers of those businesses have gotten so highly correlated that I

think for you know somebody looking at a passive portfolio you have to be asking the question well wait a minute how do I really get the broad exposure? Am I getting the exposure I want in my portfolio? And I think you combine that with the fact that despite kind of all the froth we see in the market, we're finding really attractive pockets of the market to invest in that we're excited about prospectively even in this kind of run-up, frothy market environment. And so I think, you know, we believe that in some ways we can provide the diversification index can't today. And I think that's kind of a very interesting environment.

Andy: Yeah, certainly. And I think something you said there made me think, you know, you've had, if you think about what's happened in the last decade, you've had concentration in the index, but you also have those much, you know, the US market being double its long-term valuation. And the point you made very clearly is, you know, starting point matters. Yes, valuation matters. And irrespective of what's going on on a headline and index valuations as concentration, the opportunity set for us as value investors is actually, you know, as broad as it's ever been and is available at very attractive valuations.

John: Yes.

Andy: With that, I think that's about all we've got time for. So, John, thank you very much for joining me on the podcast. It's been a pleasure. And thank you to everybody listening.

John: Thank you.

Lisa: For more information on the data presented in today's podcast, please see our quarterly commentary for the 3rd quarter of 2026, 'Tracking Error is Not Diversification: How Many Stocks Does Your Index Really Own'. Thanks for listening and as always, if you'd like more information about Pzena Investment Management or value investing, subscribe to this podcast or visit our website at www.pzena.com

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