Reversion to the Mean

This week, I came across a couple of interesting charts from JPMorgan that I wanted to share with you.

This first chart shows some of the concentration risk I have been talking about recently and puts it in a historical context.

As the panel on the right shows, the top 10 stocks by index weight far exceed anything in the last 20 years or so.

Before this AI run, the top 10 stocks were about 18%. Today it's over 40%.

As a result, there's increased risk in the S&P 500 index simply from owning the market-weighted index. When something goes wrong with one of the top stocks (or all of them), it magnifies the damage just like it amplifies the upside when they rally.

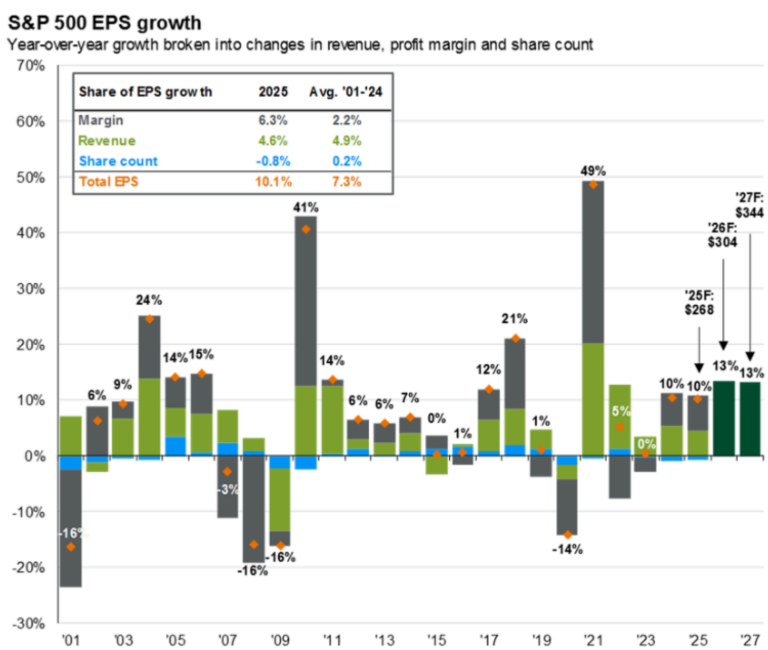
These things *always* revert to the mean. As I have suggested recently, when that happens, the average stock is a much better bet than the biggest stocks in the S&P 500.

As shown on the left side of the panel, all stocks on average exceed the average P/E ratio, but the top 10 stocks are substantially above the mean. I put less weight into the P/E ratio since the "E" is heavily manipulated by practically every company.

You need to know what you're looking at to adjust the "E" to reflect accurate and sustainable sources of earnings better. I wrote the best seller, *What's Behind the Numbers?*, to show you how to do it. Or, I have created the Forensic Accounting Stock Tracker (FAST) to make adjustments easy to see.

FAST is available here from *HS Dent*.

Most concerning to me is the chart below, which shows sources of earnings growth projected for 2025.



Profit margins are a huge driver of growth in 2025—about 60% of the growth rate. Profit margins have surged well outside what might be "normal".

Profit margins have *always* been mean-reverting.

Furthermore, since we know most companies use accounting to manipulate earnings, I'm skeptical of the quality of stated profit margins.

Again, that's why I wrote a book about uncovering skullduggery and created the FAST Model in 2010 to rank stocks by quality.

Since these factors are often of lower quality compared with the past, mean-reverting and exposed to concentration risk, my conviction is even higher that the average stock in the S&P 500 is a better bet than the market-weighted version dominating many investment portfolios.