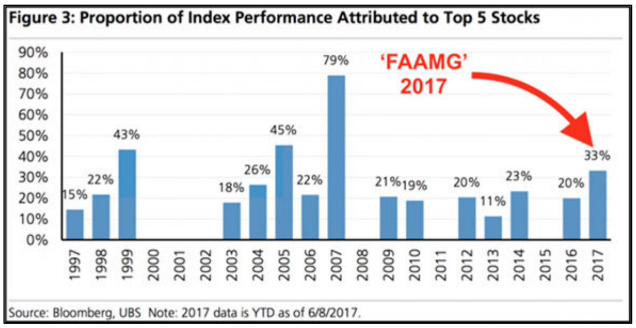
The Long & Short of It

Quarterly Newsletter

Second Quarter 2017

Narrowing Leadership

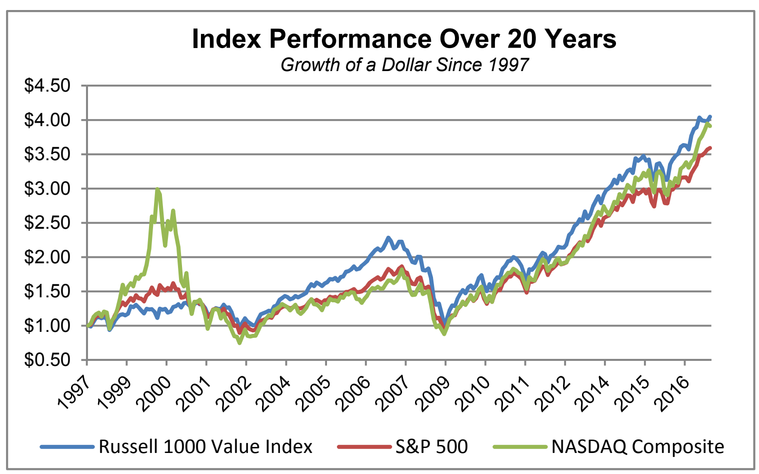
In the months preceding the market peaks of 2000 and 2007, a handful of stocks began to dominate performance. This year, five of the world's biggest stocks represent 13% of the market capitalization of the S&P 500 and have been responsible for roughly a third of its performance. The acronym FAAMG is used to describe these market leaders, standing for Facebook (FB), Apple (AAPL), Amazon (AMZN), Microsoft (MSFT), and Google (GOOGL, now traded as Alphabet). At the end of March 2017, their rankings by market capitalization were: 1) AAPL, 2) GOOG, 3) MSFT, 4) AMZN, and 8) FB.



Why is performance so concentrated in a few large names? Jim Grant, founder of *Grant's Interest Rate Observer*, counts over 21 trillion dollars of assets held by "price-insensitive" buyers like ETFs, indexed mutual funds and global central banks, entities not concerned with valuation or active management of their holdings. Algorithms use specific factors like size, valuation, stock price momentum, and low volatility to automatically make investment decisions. This year the steady rise in these large market capitalization technology stocks means they have become "growth," "size," "momentum," and "low volatility" candidates all at the same time. Buying these names has become so constant that the typically volatile technology sector has been less volatile than both the consumer staples and utility sectors.

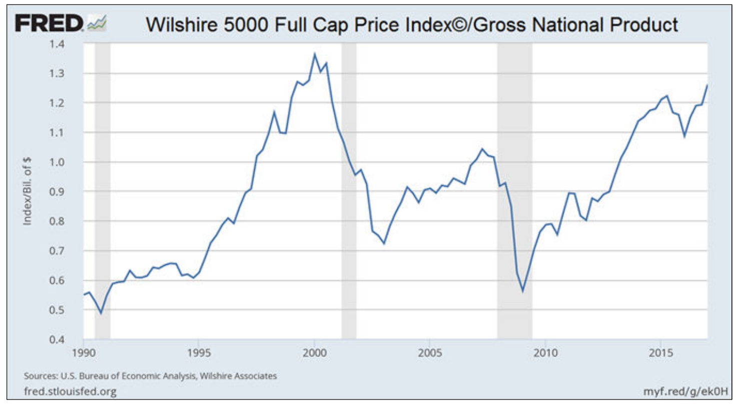
What? Me Worry?

It seems common wisdom today that the FAAMG companies are unassailable and will continue to take over the world. But they have begun to cannibalize each other's lines of business and attract the attention of antitrust regulators who have imposed fines and lawsuits against them. Furthermore, one should be concerned that these behemoths have reached levels of relative market capitalization that make future earnings growth hard to sustain. They only represent 6% of revenues and 10% of earnings of the total S&P 500 Index, so large improvements in the margins and dollar profitability of these firms will only have incremental impact on overall earnings and profitability of the S&P 500.



The variation in the performance of the NASDAQ (heavy in large tech) versus the S&P 500 (significant, but less large tech) and the Russell 1000 Value Index (modest large tech) during 1999 and 2007 is worth remembering. The chart at right shows the "total return" version of each index inclusive of the impact of dividends, beginning on December 31, 1997 with an equal value of $1.00 for each index. By February 29, 2000, the values were $2.99, $1.45, and $1.11, respectively—largely due to investor concentrations in Microsoft, Cisco, Oracle, Intel and Lucent. Value investors were despondent. By June 30, 2002, fortunes had reversed and the values were 93 cents, $1.08, and $1.19, respectively. While each index experienced volatility, the Russell 1000 Value Index had outperformed the other two with much less volatility, holding up very well during the bear market. Although the 2007-2008 bear market saw value strategies suffer due to their excessive concentration in finance, value has remained the superior choice among these groups in both added return and reduced volatility over the long term.

After a solid 2016, value investing is again suffering along with every other style that does not have large exposure to the FAAMG stocks. Year to date, low single-digit returns are prevalent outside of the FAAMG. According to our research, the last two bubbles topped out with the average stock about 20% over fair value. Today, our analysis points to the average stock being about 10% over fair value. That means the bull market may have longer to run and the FAAMG may grow to further dominate the index. But large tech stocks do not have the same growth in front of them as in 2000 and 2007. Other sectors, especially financials and energy, would need to join in. Warren Buffett utilized stock market capitalization-to-gross national product to signal tech's froth in the late '90s (see chart). That indicator has now surpassed 2007 levels and is stretching toward the dot-com highs. Either way, we expect there's not a lot of sustainable meat left on the bone of this bull market.



The Broader Economy

While business levels have slowly improved over the last year, housing starts and lending have slowed. But the stock market remains strong despite sluggish economic growth and considerable political uncertainty, which reflects either significant strength in the market or just wild-eyed optimism. In the end, debt expansion remains the most powerful potential driver of growth in this anemic economy.

With increasing frequency, the media has discussed how lending isn't happening for those in need. On June 22, 2017, the Federal Reserve announced that all large banks passed annual stress tests for the first time since testing began in 2009. There finally is talk of the potential to relax lending standards a bit. In addition, Fannie Mae will allow homeowners to carry higher levels of debt and credit ratings agencies say that they will modify the way liens impact credit scores. In an expected bit of irony, now that the large banks are all in better shape, willingness to lend is beginning to improve anyway. The key hesitancy remaining is about consumer demand for debt that, although growing, has yet to take off in the way it typically does late in an expansionary cycle. The records of bankruptcies and defaults are dropped from an individual's credit rating after 10 and 7 years, respectively, so the many people who had bad experiences 7 and 10 years ago are seeing their credit heal and will be much more able to get loans this year.

To many, the Fed appears set on tightening monetary policy whether or not it is needed. They speak with great confidence that steady improvement is on the horizon, yet back that up with assurances of returning to the extraordinary expansionist policies of the last 10 years if needed. On June 27, 2017, Janet Yellen decreed that *"another financial crisis is unlikely in our lifetimes."* At risk of being labeled Nattering Nabobs of Negativism, we will only say that her conclusion doesn't appear so obvious to us.

The Road Less Travelled

In moments like these, when a few names leave all who do not own them with the gut-wrenching feeling of being left behind, it is our training to more deeply embrace our disciplines and our process—steps that will move us even further away from the sectors and names that are currently popular, and more toward those unappreciated names that the average investor often avoids. It has been moments like these that precede our happiest results relative to the major benchmarks. We remain your loyal and dedicated value-oriented servants. Thank you for the opportunity to serve your family and your portfolios.

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