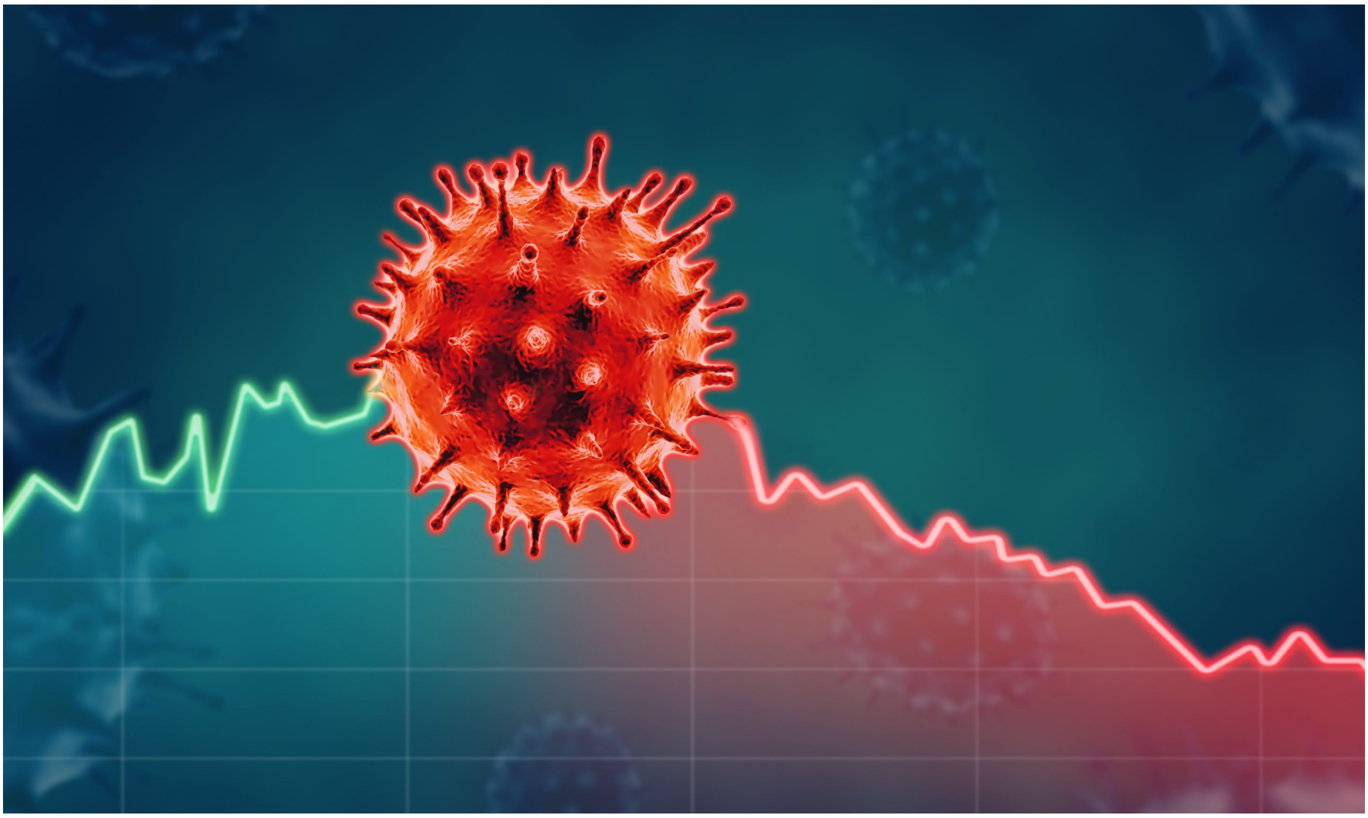
Strange World...and Markets Are Stranger Still



David Andrew
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It is hard to imagine how we got to this strange point where the world order as we knew it, has been upended. Markets are struggling and unemployment sits at 8.9 and 10.2 per cent in Australia and the US respectively, without including those people in receipt of Job Keeper and similar allowances.

There is no doubt the economy is looking grim, and the last time unemployment was this high in Australia was in 1993.

I also know that people are concerned about the seeming disconnect between the real economy and financial markets. It's certainly true that the markets appear impervious to bad news, particularly in the US.

In the US, markets have recovered all their lost ground since March and have actually powered ahead. It feels like US markets think we are still in boom times. Yet there are some interesting and very unusual things going on over there.

At the end of July, the YTD performance of the S&P500 index was being completely dominated by five stocks Amazon, Apple, Facebook, Microsoft and Google – these stocks are up an astonishing 35% for the calendar year to date.

Source: FactSet, Goldman Sachs Global Investment Research

That leaves the rest of the S&P500 index, a basket of 495 stocks, down by a combined 5 percent. This level of dispersion is very unusual and is testament to the reach and power of these tech giants.

Ben Carlson identified that the returns in the S&P500 are very closely correlated with the size of the companies with the largest companies performing best, and the smallest companies struggling the most. In times of uncertainty, this makes sense.

But before you go and sell all your smaller companies, you need to be aware that the larger companies are now *very expensive* by any measure of traditional valuation. Amazon for example is trading at a price earnings multiple of over 120 times.

S&P 500 Median Results Through July 3, 2020

Company Size	Market Cap	P/E	P/S	P/FCF	P/B	YTD Returns
Top 10	$848.5 billion	31.4	6.3	33.2	6.3	9.6%
Top 50	$198.7 billion	28.7	4.6	23.3	5.5	2.4%
51-100	$77.6 billion	26.0	3.8	25.0	5.3	-5.7%
101-150	$49.5 billion	22.9	3.9	23.6	4.1	-1.9%
151-200	$30.5 billion	26.4	3.0	23.5	4.1	-6.7%
201-250	$24.6 billion	24.4	2.6	20.0	3.2	-9.3%
251-300	$20.2 billion	23.2	2.6	21.8	3.3	-5.5%
301-350	$14.9 billion	23.9	2.8	22.8	2.5	-8.5%
351-400	$11.8 billion	22.1	1.8	18.4	3.0	-17.6%
401-450	$8.9 billion	13.3	1.4	12.8	1.9	-22.6%
451-505	$5.1 billion	13.9	0.8	10.0	1.2	-38.5%
S&P 500	$21.8 billion	22.8	2.4	20.4	3.0	-11.0%

Souce: Ycharts

Source: Ben Carlson – A wealth of common sense.

Investors tempted to pile into growth stocks right now would be well placed to remember the tech crash of 2000 where tech stocks, having been pushed to unrealistic valuations, had a well overdue readjustment.

Where some of the tech companies, particularly the 'Big 5', appear expensive, they are also very good sustainable businesses, but that's not the case for all tech companies. Take Tesla for example. The fabled electric vehicle manufacturer has just turned its first monthly profit, yet its market capitalisation is US$263Bn and it trades on a price/earnings ratio of 737 times. (For comparison, you can buy shares in Toyota Motor Corp for 12.87 times earnings).

Let's take a hypothetical. I am going to give you two choices in building your portfolio. The first choice is to build using a portfolio of the *cheapest, yet most profitable* stocks. Option two is to build your portfolio using the *most expensive, least profitable* stocks.

Most rational people would choose option one.

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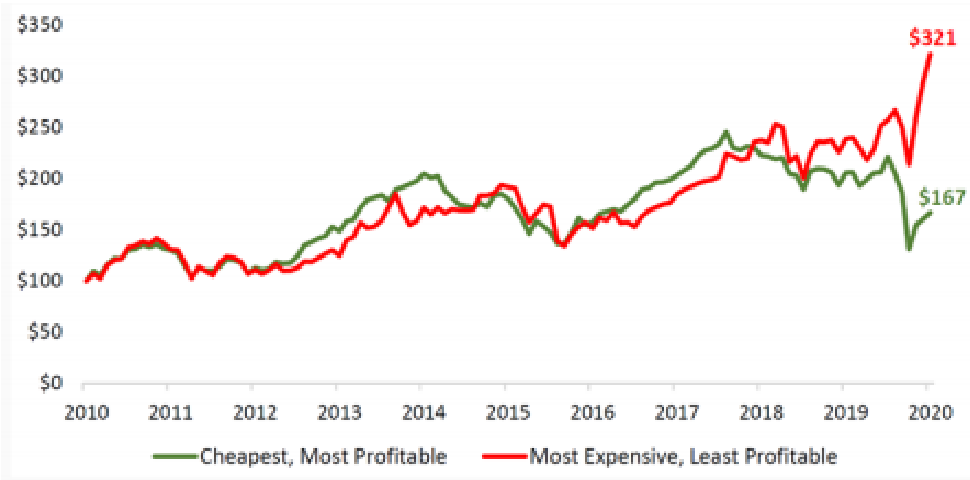

Source: Verdad Research. Data Ken French

Using the graph above we can clearly see that the rational investor has not been rewarded adequately in the past few years – at least in relative terms.

Fortunately, the historical data is firmly in favour of the rational investor. While holding expensive low profit companies may have worked in the past few years, there's ***six decades of evidence*** showing that the portfolio of cheaper, more profitable stocks will outperform the low profit growth stocks, in fact over the past six decades the rational strategy has created 132 times more wealth than the more speculative high growth strategy.

Source: Verdad Research, Data: Ken French

If we take out the performance of the major tech stocks from the S&P500 index, the picture for US market is far more sober than it first appears.

In Australia, the position is similar with the ASX300 index down 8.4 percent since 1 January 2020.

While some investors are finding comfort in chasing the growth stocks, the most compelling evidence lies in the corner of the rational investor whose exposure to value and smaller stocks positions them with an exposure to the highest expected return sectors of the market. Since 1975, value stocks have outperformed growth stocks in 27 out of 44 years, over 60 per cent of the time, and the average annual outperformance of value stocks over growth stocks for the period was 5.93 per cent.

Being patient and sticking to the strategy can be hard, but the evidence keeps pointing us back to a diversified portfolio of quality companies. Brian Chingono of Verdad Research puts the alternative succinctly: *"it's like a game of musical chairs where the speculative logic of buy high, sell higher seems fun until the music stops."*

Some will argue that it is all different now because tech stocks are changing the landscape of how we live, consume and interact. The latter is true, tech is changing our world, however the finance part doesn't change. In Finance 101 we learn that the best estimate of the value of an investment is the present value of its discounted future cashflows, where the discount rate is based on the perceived risks around the certainty of the cashflows. To summarise, profitability and price really matter.

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> *Founder and CEO of Capital Partners, and author of Wealth with Purpose, David firmly believes that sound, objective financial advice can transform peoples' lives and wellbeing. Find out more about how our evidence-based approach to wealth planning, investment management, legacy planning and insurance distinguishes our award-winning team, our results and our clients' lives.*