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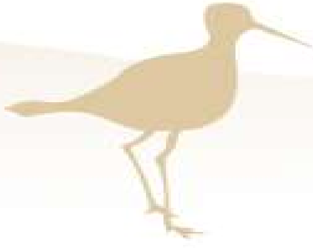
Sandpiper Capital

Gleanings



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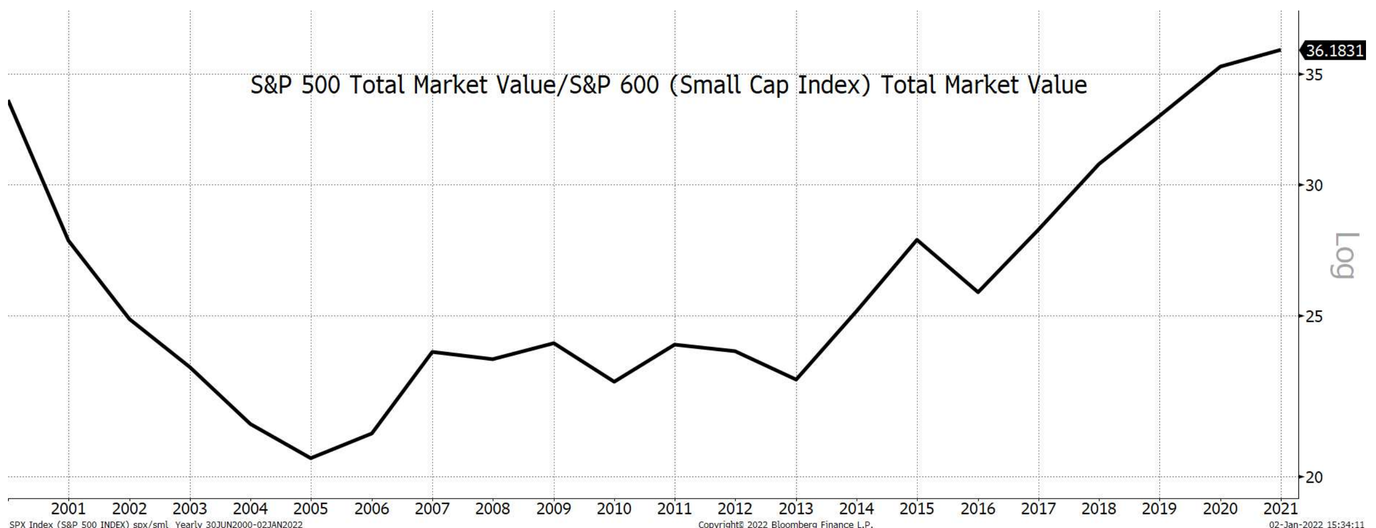
Chasing Winners

Market Returns Annually				
Index	2018	2019	2020	2021
S&P 500	-4.4	31.5	18.4	28.7%
ML 1-5 yr Gov't/Corp	1.2	5.1	4.7	-.9%
EAFE (Dev Fgn Mkts)	-13.8	22.0	7.8	11.3%
Emerging Markets	-14.5	1.0	18.5	-2.5%

The really frustrating thing about markets where the primary driver of stock prices is popularity is that financial analysis, as in what we financial analysts are trained to do, becomes increasingly irrelevant, at least in terms of generating current profits.

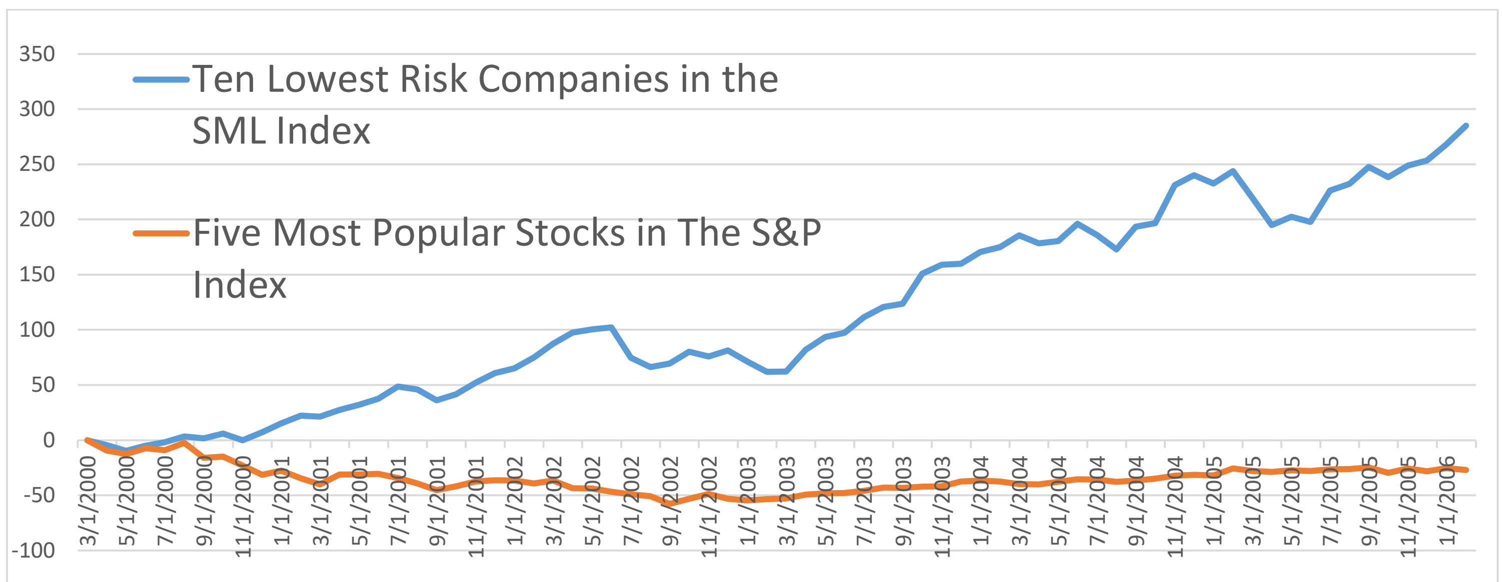
"When, as now, the top five companies in the index make up 24% of its value, the market has clearly become a popularity contest. In March of 2000, the top five companies were just 18% of the S&P's value."

We do know when asset prices are out of line. We can find companies whose stock prices represent good values compared to their future business prospects. We can also clearly identify stocks to avoid where buyers have bid up prices beyond any reasonable explanation. But as hard as we try, we can't say which stocks are going to go up and which are going to go down. That is not the province of investors. That is for stock traders to guess and studies have shown that even with an up market, they guess wrong about twice as often as they guess right. With 25 times more new money coming into the stock market this year than most (about $7.8 billion weekly since February compared to the $258 million average), more people than usual are guessing right and feeling good about it. If, however, you would like to not have to count on an up market to see your account grow, there has rarely been a better time. With more and more money buying fewer and fewer names, the excesses, that is, the differences between price and value, have become increasingly extreme. The S&P 500 index provides a good indication of that. When, as now, the top five companies in the index make up 24% of its value, the market has clearly become a popularity contest. By contrast, in March of 2000, the top five companies were *just* 18% of the S&P's value. In the chart below the I compare the total market value of the companies in the S&P 500 to those in the S&P 600 Small Cap Index. Relative to the last twenty-five years' experience, big companies are very expensive relative to small companies. They may become even more expensive, but with $9.6 billion coming *out* of the market last week, maybe not.



If we use the irrational exuberance of the 2000 tech bubble as a template, we can see that buying the S&P when its top companies are overvalued is a losing proposition. In the graph below, I show the S&P index (black line) and the SML index (red line) at starting values of 100 on March 31, 2000. Six years later the S&P index was still down 14% while the Small Cap index was up 88%. Avoiding the over-priced index and buying the out-of-favor index was the winning strategy.

More practically, avoiding the most over-priced companies in the S&P (at the time; Microsoft, Cisco, GE, Intel & Exxon-Mobil) and buying the lowest risk companies in the Small Cap index (a screen picks the ten with the most stable cash flows) had even more extreme differences. The small cap stocks returned 285% over the next six years. The large cap stocks lost 27%. Certainly the small cap stocks were down in the first few months and I also had the benefit of hindsight to know that March of 2000 was the top of the market for the S&P but whenever the top comes this time, the next five to ten years should prove rewarding for investors buying good companies and pretty bad for traders chasing the current winners.



Tom Lukic