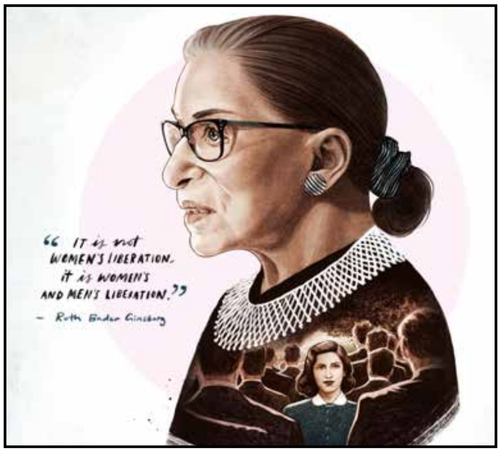
WHITE PINE
INVESTMENT COMPANY

Tony DiGiovanni - October 1, 2020

W.P. Journal

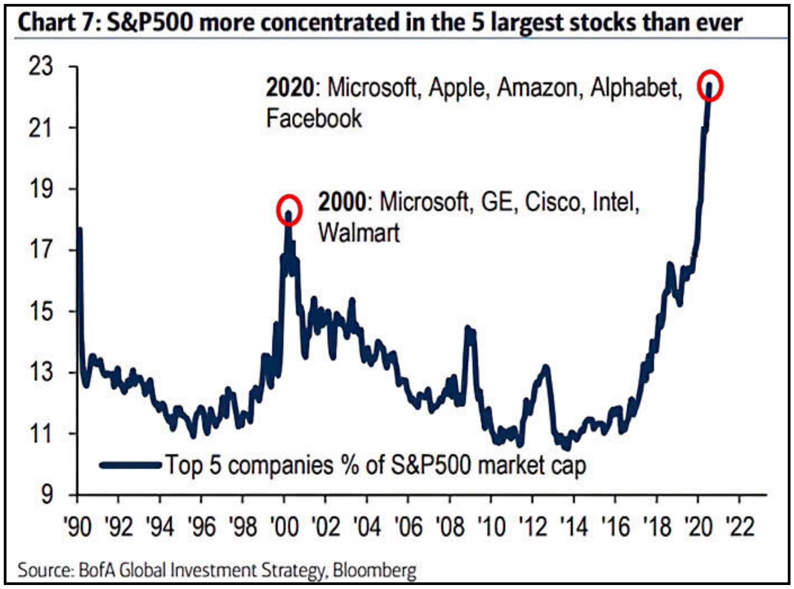
To state the obvious, we are living in very difficult times. At the six-month mark of the pandemic, we are all anxious to get back to some level of normalcy. On top of a disease that has spread throughout the world, other natural and human crises abound. Forest fires rage throughout the West filling the air with so much acrid smoke that we can see it here in Michigan on a clear day. There have been so many named storms this year, the World Meteorological Organization started using Greek letters for the big storms in the Atlantic. The last, and only other time this happened was in 2005 when megastorms Wilma, Katrina, Rita, and Emily struck the US. Protests continue to fester, and while the overwhelming majority of them have been peaceful, the violence that has occurred has been unfortunate and unsettling. The nation also mourns the loss of the trailblazing, universally respected Supreme Court Justice Ginsburg. All this is the backdrop of a particularly acrimonious political environment in which we find ourselves as Election Day approaches.

CLICK HERE FOR
Ruth Bader Ginsburg
(1933-2020)
in art and words
By Washington Post Staff



Despite all this, the major sports leagues were desperate to test the water of our new normal and resume play. To do so, they established numerous safety protocols, even extreme ones such as isolating players at Disney World and competing in empty arenas. During football games, the league now uses artificial intelligence to create crowd noise for television; even fans have been outsourced. Sadly, they might need to tweak their AI program to add more booing to my beloved Lions games. As much as the world has changed, we still have the same old Lions. Fortunately, the financial markets have performed better than the Lions; the broad US indexes returned to where they started the year after posting a strong third quarter.

Averages can be deceiving. You wouldn't jump into a pool if you didn't know how to swim just because the average depth is only four feet deep. Better to understand what's beneath the surface of your point of entry. The deep end of the stock market consists of the top five stocks which are pulling the averages way higher and obscuring what is going on in the rest of the pool. The S&P 500 is a market capitalization weighted index. This means that the performance of larger companies always has a greater influence on movements in the index. However, the weight of the top five stocks right now is unprecedented. The accompanying chart (taken from a Wall Street Journal article and put together by the BofA Global Investment Strategy group) highlights this well. The last time the top five stocks were even close to this level was in the waning days of the tech bubble.



Today, these five stocks are worth nearly $7.0 trillion. To put that number in perspective, our nation's Gross Domestic Product is about $20.0 trillion. During the pandemic, investors have sought safety, and these five stocks represent safety. Their revenues and earnings continue to grow, benefiting from more people working from home, while most of the nation struggles. Their stocks climbed a collective 40% this year. The median return for the other 495 stocks in the S&P 500 is -8%! That's quite a disparity. International stocks did about as poorly as the median S&P 500 stock, and small to mid-cap stocks fell even more.

This sets up an investing dilemma. While we are in pandemic mode, these companies will continue to grow their earnings, and the average company will continue to struggle. However, the pandemic will end. The stock market usually anticipates economic changes six to nine months in advance. We're getting close to the point where the market will start thinking about what happens after the pandemic – though this timing does assume some of the vaccines currently in the late trial stages will be successful. Will the government continue to support a very weak economy after the vaccines come out? How much permanent damage will the pandemic cause? Will working from home continue after we get the all clear sign? Will there be a rotation out of these big growth names into other parts of the market?

A quick review of the top five stocks from the tech bubble may provide some clues. To put it mildly, they did not fare well in the decade after the bubble burst. Only Walmart, the least techie of the bunch, eked out a return during the next decade, growing a total of just 11%. The median stock rose 52%. The S&P 500 fell about 6% brought down by the performance of the other big four which fell between 32% and 66% during that time. There was a massive rotation out of the big growth names and into the other parts of the market.

While the current environment has the same feel as the late 90s, there are some differences that make an exact comparison difficult. First, the valuations are not nearly as stretched as they were back then. The big five today have a Price/Earnings (PE) ratio of 40. That means, for every dollar of current earnings, investors will pay $40 to own the shares of the company. For context, the market usually has a PE ratio in the 15-22 range. So, 40 is high, but not nearly as high as the 45-65 multiples the top five had back in 2000, and Cisco's PE ratio was well over 100. Also, interest rates are materially lower today with the 10-year treasury rate below 1% vs 6% in March, 2000. Low interest rates support higher valuations in stocks because lower rates provide less incentive to hold treasuries.

Another key difference is the experience of these companies. Back then, newer technologies could and did come out to supplant the existing technology. It was tough for a company to hold its market lead while also expanding its base. The giants today have figured out how to maintain their virtual monopolies while also expanding into new markets. Remember, Amazon used to be just a bookstore. Apple just sold computers. Now, they are entire ecosystems unto themselves. The antitrust laws are decades behind where they need to be.

On the other hand, growing a $2.0 trillion company at rates high enough to justify a premium multiple is difficult. When you become a significant part of the economy, as these five companies are, it is difficult to grow much faster than the economy you now represent. Also, politicians on both sides of the aisle are looking into the market power of the top five companies. Some antitrust measures can be expected in the next four years regardless of who wins the presidential and congressional elections.

At this point, it is a bit too early to completely sell off the large growth names that have been the engines of the market. Taking a little off the top seems prudent, and starting the rotation into the rest of the market should reward investors over the long-haul. Maintaining exposure to overseas stocks will help if and when the rotation begins as well. This also diversifies the portfolio away from the dollar which could be vulnerable considering the amount of debt we are taking on as a nation to offset the forced shut-downs. With interest rates as low as they are, gold too has a place in the portfolio. Unfortunately, unlike in the late 90s and early 2000s, fixed income returns are paltry and should only be used to lower the overall volatility of the portfolio. Just as it's important to work to maintain personal equilibrium during these crazy times, your investment portfolio also needs to remain balanced to be healthy. We'll keep looking under the surface with a critical eye on the elephants in the deep end for any signs they are ready to move in a different direction.

Sincerely,

Tony

Anthony J. DiGiovanni, CFA