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THE PER STIRLING CAPITAL OUTLOOK

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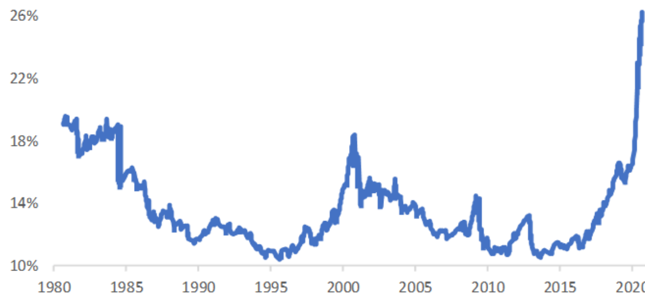
SPECIAL REPORT 2021: The Year That Was

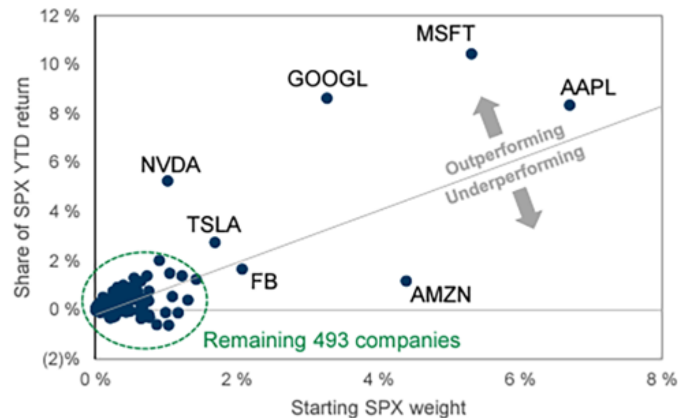
To quote the opening line of Charles Dickens' A Tale of Two Cities, "It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness".



For the two indexes most commonly used as a performance benchmark for equity portfolios, the Standard & Poor's 500 Index and the NASDAQ Composite Index, 2021 has indeed been quite a good year, largely because these two indexes are capitalization-weighted. This proved to be a tremendous advantage, as this has been a year when the "generals" have led, but the "soldiers" did not follow.

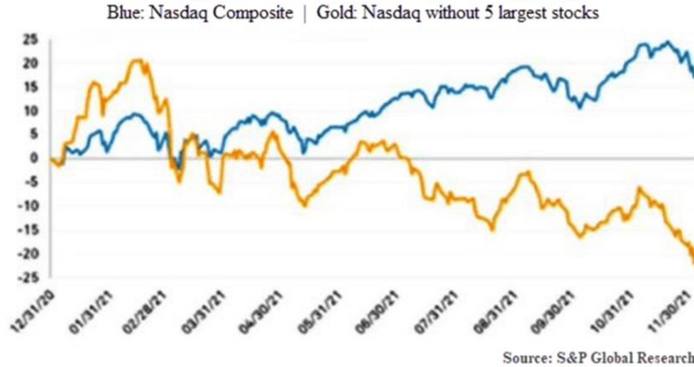
To explain, being capitalization-weighted means that the impact of each stock on the return of the overall index is proportionate to the relative value of each company's total equity. The largest companies have the biggest impact on the index and vice-versa.

While it is true that these indexes have always been capitalization-weighted, the above chart illustrates that the influence of the very largest mega-cap companies has rarely, if ever, been so enormous. Remarkably, while there are 505 stocks included in the S&P 500 Index, the five largest stocks represent approximately one quarter of the index, and therefore approximately one-quarter of the index's performance.



As noted above, these mega-cap companies dramatically outperformed virtually everything else, and the combination of this significant outperformance and the huge weighting of mega-cap stocks in each respective index allowed the overall indexes to advance, despite the relatively poor performance of a significant majority of companies. Indeed, according to Goldman Sachs, five stocks (Microsoft, Alphabet [i.e., Google], Apple, Nvidia and Tesla) accounted for 51% of the S&P 500's return since the end of April and more than one-third of the S&P 500's year-to-date return.

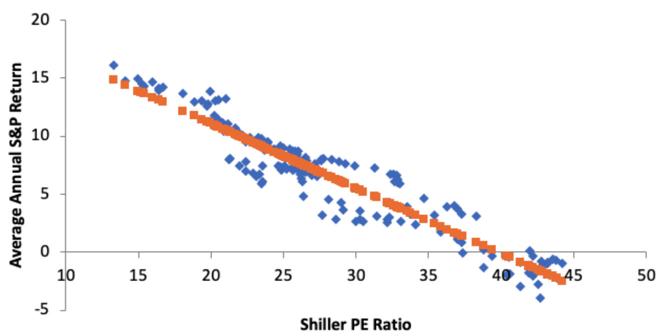
A look at the NASDAQ Composite, which is up by almost 20% this year, provides another great example of this phenomenon. While it is comprised of over 2,500 stocks, it would actually be down by over 20%, as opposed to up almost 20%, if you simply removed this index's five largest stocks (Amazon, Alphabet, Tesla, Facebook and Nvidia), from the index.



On the surface, this dynamic seems like a great argument for putting all of one's money into these mega-cap stocks. After all, what could be better than to dramatically outperform the overall markets while sitting in the perceived safety of America's greatest companies. The problem, of course, is that these mega-cap stocks are arguably among the most egregiously overvalued stocks in the market.

Indeed, by many measures, these mega-cap stocks, as a group, are the second most overvalued that they have ever been (only to be exceeded by the 1999 internet bubble). Obviously, these huge stocks advanced this year, despite these excessive valuations, and there is certainly no guarantee that they won't lead the markets again in 2022.

That said, there has historically been a strong and inverse correlation between the valuations of a stock or index and future returns, with higher valuations historically being associated with low, or even negative, average annual returns over the next decade.

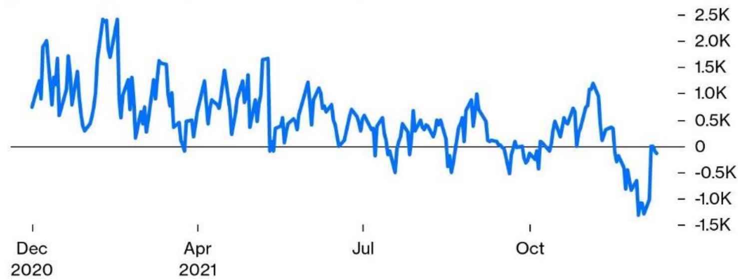


However, in a year of dramatic uncertainty that featured both a pandemic health crisis and the worst domestic inflation in forty years, investors were willing to ignore valuations and pay a significant premium to enjoy the perceived safety of these mega-cap stocks.

Unfortunately, that investor enthusiasm did not extend far beyond the "bluest" of the blue chips, which you can see in the following two charts, which illustrate that approximately 54% of all stocks that trade on the New York Stock Exchange are currently selling below their average price of the past 200 trading days, and that more stocks are hitting new 52-week lows than are hitting new 52-week highs.

Indeed, if you look at the average stock in each of the major domestic stock indices, they are down by between 12% and 39% from their 52-week high prices (see below).

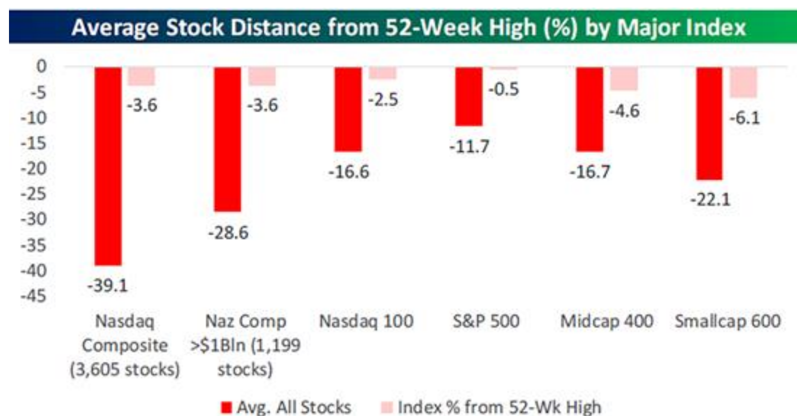
This is more indicative of bear market activity than what you normally see in a bull market, and one could certainly make the argument that we are in the midst of a "stealth bear market" that is being concealed by the massive outperformance by these very heavily-weighted mega-cap stocks.



Further muddying the waters was a complete reversal in leadership, where many of 2020's top-performing sectors went from "heroes" to "zeros" in 2021.

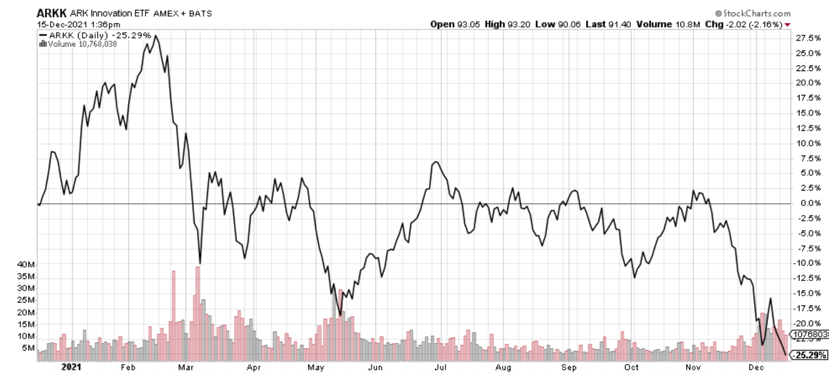
This included many of the cutting-edge, innovation-driven companies, which are sometimes potentially years away from profitability, but which may potentially be the next Amazon, Tesla, or Nvidia. Unfortunately, 2021 has been a brutal year for these types of companies.

For evidence, you need look no further than the following performance chart of the ARK Innovation ETF, which is viewed by many as the prototypical example of this type of strategy. After several years of massive outperformance versus the broad stock market, this ETF has lost almost 53% of its value since mid-February of this year.



While we remain very bullish on these innovative companies over the longer-term, and believe that many investors will ultimately get rich investing in them over the next decade or so, it is historically true that higher interest rates have diminished the value that investors are willing to assign to future earnings (and particularly those earnings that are years into the future).

We are concerned that these more speculative stocks may not return to their leadership role until the markets perceive that the Fed is almost done raising interest rates, and that could easily be another year or two before that happens.



The following chart illustrates just how severe this change in investor preferences has been. It compares call volumes (a measure of investor risk appetite, the blue line) with an index of innovative technology stocks that are not yet profitable (in gold). You can see that there has historically been a very tight correlation between the two, until very recently, when risk appetites soared but, for a change, money did not flow into this more aggressive part of the market.

In the most recent Per Stirling Capital Outlook, we quoted several statistics about how higher interest rates have traditionally motivated investors to shift from high-growth stocks to high-quality stocks (primarily blue-chip, value-oriented and cyclical stocks with strong balance sheets), and we believe that this chart is confirming that this transition is happening again in the current environment.

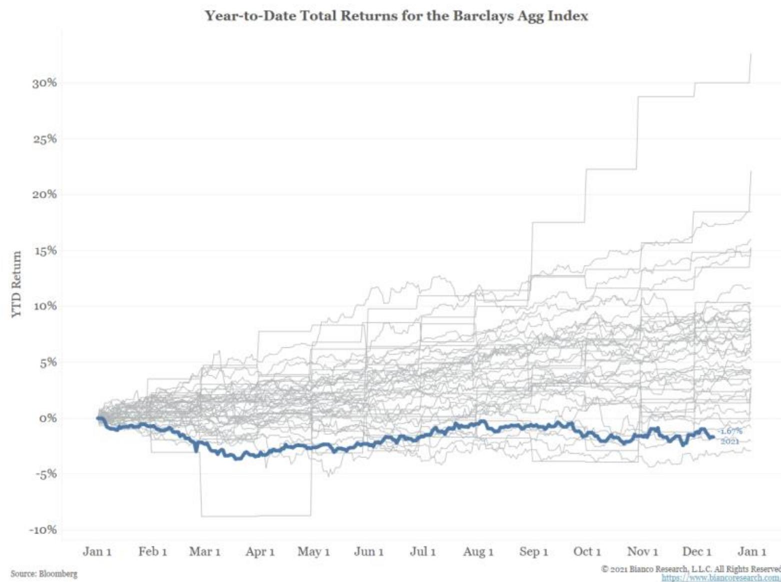
If anything, a shift from growth stocks (stocks that are attractive largely because of current or anticipated earnings growth) to value stocks (stocks that are purchased because they are believed to be underpriced relative to their earnings, book value, etc.) may be more compelling now than it has been in recent history.

According to Credit Suisse (via Barron's Magazine) "the aggregate forward price/earnings multiple for S&P 500 value stocks is currently about 12 points lower than the index's growth multiple, whereas the difference has averaged closer to 5 points in the past 10 years". In other words, value stocks are unusually undervalued compared to their growth stock brethren.

In addition, most investors don't hold portfolios that are 100% invested in equities of any type. Instead, they blend together a mix of non-correlated asset classes, such as bonds, cash, securitized real estate, international stocks and bonds, etc., as a means of creating asset class diversity, dampening overall portfolio volatility, and helping to offset potential losses in the equity markets.

However, very few of these non-equity asset classes provided attractive returns in 2021, particularly when compared to the S&P 500 and NASDAQ benchmarks, which have been so distorted by the performance of these few mega-cap stocks.

The primary asset class used for portfolio diversification is debt (bonds, bills and notes), and 2021 has been one of the worst years in history for the debt markets. Indeed, it looks increasingly like 2021 may end up being the first year in history when Treasury bills actually post a negative total return. The Barclays (Bloomberg) Aggregate Bond Index, which is a very broad index that holds bonds of almost all types and durations is illustrated below. The 2021 year-to-date returns are noted in blue. Prior-year returns are shown in grey.



Obviously, virtually any investor who employed a diversified portfolio strategy also significantly lagged the impressive returns generated by the mega-cap equity indexes in 2021.

Moreover, with money markets yielding approximately 0% and inflation running in the high single digits, holding cash has been anything but an attractive option.

In summary, 2021 has indeed been "the best of times" for the mega-cap equity indexes, and arguably even "the age of foolishness", in light of their egregiously inflated valuations. While it may not have been the "worst of times" for most investors, it was certainly a year that featured one of the largest divergences in recent memory between the returns posted by the benchmark equity indexes, and the returns enjoyed by the vast majority of investors.

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The Standard & Poor's 500 (S&P 500) is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S with each stock's weight in the index proportionate to its market. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

The Nasdaq Composite index tracks the performance of about 3,000 stocks traded on the Nasdaq exchange. It's mainly used as an indicator of how well companies in the tech sector – both large and small – are doing.

The Bloomberg Barclays US Aggregate Bond Index measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, and municipal bonds.

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