Martin Capital Partners

Quarterly Point of View
History Rhymes, #1999

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History doesn't repeat itself, but it does rhyme. That saying is often attributed to Mark Twain, though there is no clear evidence affirming its origin. For the point of our discussion here it doesn't matter who said it, but the fact it carries a substantial element of truth, particularly in the realm of the capital markets.

This has been a year of immense volatility. As the economy shut down in response to the Coronavirus spread this spring, the S&P500 plunged almost 35% in just six weeks, the fastest ever fall to a bear market. What may be more remarkable than the speed of the drop, however, was the pace of the climb back. It took a mere 126 trading days for the S&P500 to reclaim a new record – compared with an average return-to-record time of 1,500 trading sessions, dating back to 1928[1].

How could it take only 8% of the historical average recovery time now, considering we're enduring a pandemic the likes we haven't seen for a century, and the worst economic contraction in essentially eight decades?

Our answer to the above question may seem simplistic, but we believe we are in the midst of a speculative trading frenzy in a subsection of the stock market, creating a bubble that could prove dangerous to those that don't respect its potential impact. Given the massive scale of many of the enterprises involved in the feverish buying, and their perceived immunity from economic hardship, the market indices (which are currently heavily affected by the subset we'll describe) have recovered at a pace not reflecting the impact this contraction has had on the overall economy and vast preponderance of companies. Though asset bubbles by their very nature create outsized risk as they build and then eventually break, they also contain opportunity, which we see in this current environment.

Though history may not repeat itself, it does rhyme, and the current environment 'sounds' a lot like 1999. During that period at the turn of the century, the Technology, Media and Telecom (TMT) darlings garnered so much investor interest they propelled the NASDAQ to an 86% gain that calendar year alone, and fueled a mania in all things having to do with the internet-driven "new economy." The combination of rapidly advancing stock prices, the ascent of cable financial news networks, decreased trading costs and easier on-line trading access, all paired with the legitimate - but massively overhyped - new economy narrative, created a euphoric cocktail in which investors simply overlooked or ignored fundamental economic metrics. Today's climate appears analogous.

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Disruptors

According to analysis by Bank of America Global Investment Strategy, a group they refer to as the "Disruptors" - consisting of stocks in the Dow Jones Internet Commerce and FANG+ Index - has now become the largest bubble of the past 50 years, exceeding even the Technology/Internet bubble of the late '90's. Through February of this year, this group of stocks had produced a return well in excess of 1,000% the past ten-plus years, passing other similar pockets of extreme exuberance, including the U.S. housing market 15 years ago, the aforementioned Technology bonanza, the Japanese Nikkei Index of the 1980's and Gold in the 1970's.

This Disruptor subsection of the market is heavily weighted to companies such as: Tesla, Netflix, Facebook, Amazon, Google, Nvidia, Alibaba and Twitter, amongst a handful of others. The current valuation multiples of the indices that define the Disruptors, on an average basis:

Trailing P/E = 83x   Forward P/E = 60x   Price to Cash Flow = 38x   Price to Sales = 9x

To highlight how much euphoria seems built into expectations for these types of companies, let's drill down and look at one example in particular, Tesla (TSLA). The innovative electric vehicle company, led by a brash celebrity-like CEO, might be the poster child of the current outlook for disruptive companies. Within (and outside of) the stock market the company maintains a cult-like following, and nothing seems to exemplify that more than its current valuation. The stock is up over 800% in the trailing year alone, and trades with a forward price to earnings multiple based on 2020 full-year estimates of over 400x, despite the fact the company has never recorded an annual profit, while losing over $5 billion in the trailing five years. To further illustrate the loftiness of its perceived fortunes, consider this… The following nine auto manufacturers: Toyota, BMW, Daimler/Mercedes, Honda, General Motors, Ford, Fiat Chrysler, Nissan and Renault, produced, in total, over 48,000,000 cars worldwide in 2019. At the end of this August, those nine companies had a combined market capitalization of roughly $460 billion, precisely where Tesla – all by itself – was valued. This is jaw dropping when we consider that Tesla sold just 367,000 cars, or 0.76% the volume of the other nine producers. Clearly, an *extreme* level of excitement over future prospects is being baked into that kind of valuation, when a company that currently maintains less than 1% of a group's market share, is given 100% of its market value.

The Disruptors, generally speaking, are excellent companies, offering products and services many of us likely utilize and enjoy. As their title attests, some have disrupted certain industries so successfully they have become outright dominant, creating businesses that have a high probability of being around (provided antitrust laws aren't given teeth), for decades to come. All of this we acknowledge. Valuation matters, however, and at these levels risk is building for high-flying companies and their investors, as well as for those who get tempted into chasing them.

Valuation Matters, Then & Now

We believe this period is now rhyming with the ebullient days of 1999, but also with an overconfident period in the 1970's illustrated by a group dubbed the Nifty Fifty. Looking at both periods, some clear lessons on potential risk, and future returns, are unmistakable.

Tech Bubble
1990's

Company Name	Symbol	Peak Date	Trailing PE	Trough Date	Peak to Trough Return	10YR Return	10YR Return Annualized
Cisco Systems	CSCO	3/27/2000	308	10/8/2002	-90.1%	-67.7%	-10.7%
Qualcomm	QCOM	1/3/2000	578	8/5/2002	-88.4%	-53.7%	-7.4%
Oracle	ORCL	9/1/2000	172	6/4/2002	-84.4%	-51.3%	-6.9%
Intel	INTC	8/28/2000	64	10/9/2002	-82.9%	-75.8%	-13.2%
Walt Disney	DIS	5/1/2000	87	8/8/2002	-69.3%	-14.9%	-1.6%
Microsoft	MSFT	12/30/1999	79	12/21/2000	-66.4%	-48.4%	-6.4%
Amgen	AMGN	7/24/2000	75	7/15/2002	-62.0%	-34.4%	-4.1%

The data tables above and below, are a sampling of well-known, successful companies that participated in the upside of the previous bubbles analyzed. The valuations at which they peaked in each of those periods are displayed, followed by their performance from peak to trough, as well as over the subsequent decade. In each case, we selected outstanding, durable enterprises to prove our point on valuation - eschewing the easiest and most egregious examples - the many highfliers of both periods that failed the ultimate test, survival.

Nifty Fifty
1970's

Company Name	Symbol	Peak Date	Trailing PE	Trough Date	Peak to Trough Return	10YR Return	10YR Return Annualized
Walt Disney	DIS	1/3/1973	82	12/17/1974	-85.9%	-43.6%	-5.6%
McDonald's	MCD	12/29/1972	86	10/4/1974	-72.8%	15.2%	1.4%
Coca-Cola	KO	3/8/1973	48	10/4/1974	-70.5%	-31.4%	-3.7%
Pepsi	PEP	11/17/1972	29	10/4/1974	-67.7%	25.2%	2.3%
Eli Lilly	LLY	7/26/1973	46	9/21/1977	-64.7%	-32.9%	-3.9%
General Electric	GE	1/11/1973	26	9/16/1974	-60.5%	28.9%	2.6%
IBM	IBM	2/13/1973	37	9/16/1974	-58.8%	5.6%	0.5%

In both periods, you can see that even great companies failed to be good investments over lengthy stretches, once valuation extremes were reached. With the Disruptors of this generation trading at valuations very similar to those of the Tech and Nifty Fifty Bubbles, investors would be wise to heed the warnings of history. This doesn't mean, however, that these stocks are currently done rising. This is not a call on timing as behavioral forces often override reason for extended and unpredictable periods – it is simply a view that valuations already appear extremely stretched. These conditions do, however, increase the probability that future returns of the group may be unproductive, or even poor, over the next cycle.

Index Concentration
Performance for the Disruptors relative to the average stock has been nothing short of dominant the past few years, and particularly this year. The two indices that comprise the group have returned an average of 57% in pandemic-ridden 2020, compared to the equal-weighted average stock *decline* of 17% as represented by the Value Line Composite Index (geometric) through the third quarter[2]. By virtue of this incredible performance disparity, the market capitalizations, and therefore weighting and

influence within the indices has become disconcerting. For widely followed, capitalization weighted indices, the following stats deserve attention:

- The 5 biggest stocks in the S&P500 (three of which we cited earlier in this letter) now account for 25% of its weighting, this is the highest number in roughly four decades.
- The 5 biggest stocks are now equal in value to the bottom 389 companies in the S&P500. This is equivalent to saying that the top 1% of stocks in the index have as much impact as the bottom 78%[3].
- The 5 biggest stocks now account for nearly 40% of the Russell 1000 Growth Index. This is roughly four times the size of the biggest 5 stocks in the commensurate value index.

This kind of concentration is also causing some notable market behavior:

- One Monday this past quarter (July 20th), the S&P500 posted a handsome gain of nearly 1%, yet accomplished that with 8 of the 11 economic sectors declining, and an incredible 70% of all stocks retreating. It was one of only 5 occurrences in the past 58 years where the market gained over 0.75% on a day with more declining stocks than advancing on the New York Stock Exchange[4].
- As of August 28th, barely 3 in 10 stocks were outperforming the S&P500 over the trailing 3 months, yet the index was within 2% of its all-time high. It was the first time fewer than 35% of stocks had outperformed as the Index sat near highs since March of 2000, the final month of the Tech Bubble[5].

> *The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs*. Warren Buffett

In a bubble, market participants (it's difficult to call them investors at these points) cease to invest in companies, but instead start making bets on the collective behavior of other participants. In other words, a greater fool theory materializes whereby conventional valuation metrics cease to matter, only the idea that another participant will come along and pay a higher price at a later date than the price one participant just paid.

In these environments, the biggest risk then becomes behavioral. Investors need to avoid the temptation to:

- Chase certain stocks simply because they are rising, and fueled by the overarching narrative of participants, and the media, that they will continue to rise.
- Compare their performance and their own long-term strategy to market cap weight indices (like the S&P500) that are top heavy with these kinds of stocks. This comparison often throws investors off course, serving to inadvertently induce the acceptance of additional risk.

One of our favorite investment theory commentators, Morgan Housel of Collaborative Fund says, "Bubbles do damage when long-term investors mistakenly take their cues from short-term traders." We emphatically agree.

Despite the dangers that bubbles pose, there are often places to hide and opportunities presented in areas of the market that are not reflecting the same behavioral patterns. Looking again back to the late '90's Tech Bubble we see some interesting parallels. In both periods, the growth indices vastly outperformed their value counterparts as the bubble formed, and though there were many excesses of the '90's that exceed today, the current environment has actually witnessed a wider growth to value spread than two decades ago. In the final four years of the '90's, growth stocks outperformed value stocks by 45%, while currently there has been a spectacular difference of 74%, dating from 2017, through August 31st.

Index Returns Post Tech-Bubble Peak
March 9th, 2000

	Annualized				Cumulative
Index	**1YR Return**	**3YR Return**	**5YR Return**	**7YR Return**	**7YR Return**
Dividend Aristocrats Index	36.18%	7.24%	14.21%	13.13%	137.19%
Russell 1000 Value	16.21%	-4.18%	7.66%	9.20%	85.19%
S&P 500	-10.99%	-14.90%	-1.43%	1.67%	12.29%
Russell 1000 Growth	-35.59%	-25.65%	-10.25%	-5.32%	-31.79%
Nasdaq 100	-60.45%	-40.08%	-19.66%	-12.68%	-61.32%

As can be seen in the table above, after March 9th, 2000, everything flipped. From that peak point of the Tech Bubble, the ensuing seven years was an entirely different story. By March of 2007, the Nasdaq 100 sat 61% below its peak, and the Russell 1000 Growth Index was still 32% lower than its record. Meanwhile, previously unloved value stocks rose 85%, while dividend stocks saw investors once again return to the fundamentals they had previously ignored, producing a 137% increase in value over those seven years[6].

No two periods are identical, and history does not repeat, but it does rhyme. We can learn some things if we're listening.

Please feel free to call or email with questions you may have regarding our strategies or Martin Capital Partners in general. You can also find information on our website at www.martincp.com.

Respectfully,

Cameron K Martin
Chief Investment Officer
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1. Wall Street Journal, September 15, 2020
2. Refinitiv Index data
3. Michael Batnick, Ycharts, August 26, 2020
4. Sundial Capital Research, July 20, 2020
5. Cypress Capital, August 28, 2020
6. Value stocks refers to the Russell 1000 Value Index, Dividend stocks refers to the S&P High Yield Dividend Aristocrats Index

Statistical and analytical data provided by Factset.