Fox-Smith Wealth Management Quarterly Commentary

Fourth Quarter - 2020

"Optics vs. Reality – The Misleading Signals of Cap-Weighted Indexes"

Economic Outlook and Market Commentary – Gustin D. Fox-Smith, AIF®, ChFC®

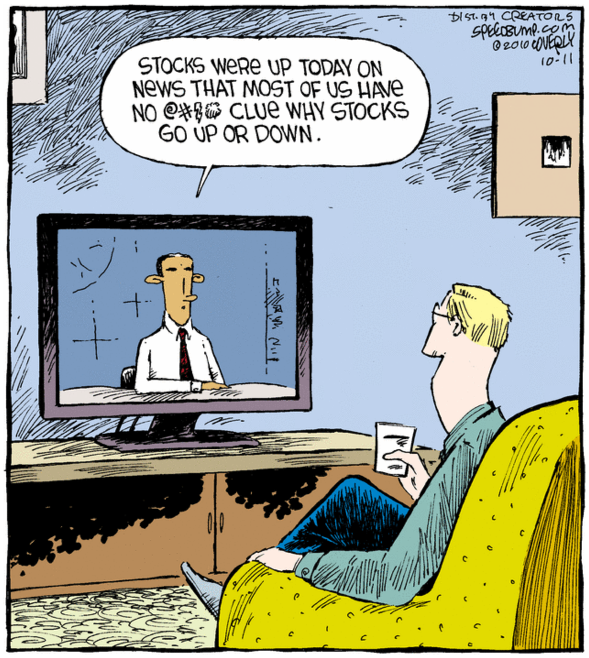
You see it every day on the nightly news or the financial headlines of your favorite web site. A headline telling you what happened in the markets that day. Many are surprised to see very positive headlines while the economy has yet to even fully re-open following the COVID lockdowns. In recent weeks, we have seen headlines like:

"Nasdaq, S&P end week with new records, Dow up 0.7%"
August 22

"S&P 500, Nasdaq close at record highs on trade, vaccine developments"
August 26

"Is it too Late to Buy?"
September 7

"Do You Have FOMO (Fear of Missing Out)? Buying is the Cure."
September 12



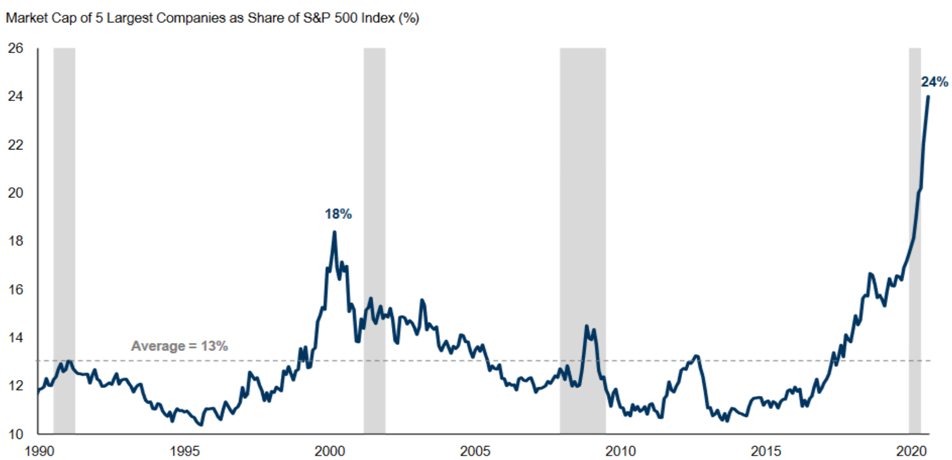
You may be asking yourself, "How can the market be setting new records while the economy is still in recession?", and that is a very valid question. The answer is quite simple, Capitalization weighted Indexes. The S&P 500, Wilshire 5000, and Nasdaq Composite are all cap weighted indexes.

The S&P 500 is touted as a good measure of the total market. With 500 companies, it is believed to be a well-diversified barometer of total market conditions. Sadly, that is not the case. The truth is that most indexes we follow to track the market are Cap Weighted. That means that the stocks contained in the index each have a completely different weighting in the index based upon each company's value. The definition provided by Investopedia does a fair job explaining how they work:

> *A capitalization-weighted index is a type of market index with individual components, or securities, weighted according to their total market capitalization. Market capitalization uses the total market value of a firm's outstanding shares. The components with a higher market cap carry a higher weighting percentage in the index. Conversely, the components with smaller market caps have lower weightings in the index.*

In practice, this means that the price movement of the largest companies in the index are able to completely overshadow the movements in the smaller components, and therein lies the problem.

At any time you choose, the top 5 or 10 stocks carry far more weight in these indexes than most of the others, but there are times that their value becomes so far above the rest of the market that their effect on the index causes a signal that is simply false. This is one of those times.



Source: Compustat, GoldmanSachs Investment Research as of September 8, 2020

Back in 1999, at the peak of the internet bubble, the top 5 S&P stocks reached a record by becoming 18% of the index's value, 18x what you would expect in an equal weighted calculation. Then, the tech correction over the next few years brought them back down to more reasonable levels. We hit a new record at the start of 2020 with the top 5 companies reaching an 18.3% allocation, but corrections tend to correct these imbalances. I expected the COVID correction would rebalance the index as usual. But, not this time. Because the 5 largest names were all tech companies, the FAANG stocks, COVID actually increased their values due to the heavy use of technology that the lockdowns required.

As a result of the outperformance of tech stocks, the top 5 names in the S&P 500 have now reached a dizzying 24% weighting. In fact, some analysts have taken to referring to the S&P as the S&P 5 and the S&P 495. I hear you asking, "Okay, so now I know what cap weighting is, but why is that a problem?". There are several issues that come from this type of index calculation.

Source: Bloomberg and GSAM as of September 8, 2020

First, we use stock indexes as a measure of the health of the markets, to gauge consumer and business sentiment, and as a signal of the growth of the economy. Cap Weighting sends a false signal in this regard because the 5 largest names can go up $2 in a trading day while the other 495 stocks go down $1 and the index value will go up. Logically, when 99% of the companies in an index are going down, that is a signal that the broad economy is under pressure, yet the performance of a few stocks hides their decline. Additionally, all 5 are technology companies so we cannot see the movement of any of the other market sectors that make up the US economy. Look at the chart and you can see that the general market is actually down YTD, which is much less than I would have anticipated following a complete economic shutdown, but down, nonetheless. That fact is obfuscated by the growth of just 5 stocks that have kept the S&P in positive territory.

Second, after several solid years of consecutive market gains, index funds become more attractive as they begin to outperform everything else. This is what we saw in 1997-1999 and we are seeing it again in the last few years with record inflows into S&P 500 tracking investments, beginning in 2018. They outperform in this environment because they cease to be index funds and become momentum plays, buying more and more of the companies that are climbing the fastest. Once this occurs, it adds to the upward trend in these names as all the index-based investments must continue buying more and more shares of the top companies to stay in synch with the index. This is a direct violation of the first rule of investing, “Buy Low, Sell High”. By investing in index funds, your money is being used to buy higher and higher as a stock climbs with the largest purchases occurring at the top.

This buying activity is all well and good as long as the momentum continues. But what happens as the top stocks finally reach their peak as the economy inevitably shifts and they begin to roll over and decline in favor of other companies in other industries? Unlike actively managed investments, the manager does not have the discretion to harvest your gains by selling before the stocks drop. They are required to only sell shares of the top companies as their capitalization declines. That means index investors are forced to hold a massive number of shares of depreciating stock, only being able to sell as the index formula dictates. And as the whole market drops, the selling is much slower than the buying was on the way up, thereby making index investments some of the worst performers in the market exactly when you need protection the most.

The final concern about the way indexes are calculated lies in the over reliance on index investing. Stock selection is a science requiring research and due diligence to find the individual stocks that may outperform the market. However, as more and more people rely on indexing, their trading volume is removed from all the other companies in the market that aren’t in the indexes. It could reach a point that it simply doesn’t matter how well a company performs in terms of sales and profit growth because if they aren’t in an index, there won’t be enough buyers to push the stock up. We may become a market of only the 500 companies in the S&P and all purchases into that small group are limited to just 5 or 10 stocks. This is the recipe for a monumentally narrow market with stock valuations that are astronomically high. I see the beginning of this in the markets right now. The Price Earnings Ratio (P/E) has been one of the most

Financial Trivia

Second Quarter’s trivia question was:

“In what year did the Dow Jones Industrial Average first cross 100? When did it first cross 1,000? And in what year did it first cross 10,000?”

Answer:
The Answer may surprise you. The Dow first crossed 100 points on January 12, 1906. Following that, it took almost 67 years to reach 1,000 points for the first time on November 14, 1972. And while it took two-thirds of a century to climb 10x from 100 to 1,000, the next 10x leap to 10,000 took just 26 years and 4 months. The 10,000 mark was reached for the first time on March 29, 1999. So the answer is 1906, 1972, and 1999.

With the index setting a new record high of 29,398 just 8 months ago, how long do you think it will take to complete another 10x climb? It has already been 21 years since the last 10x milestone. Absent the total economic collapse of the United States, I believe we will reach 100,000 before the end of this decade.

We did not get a correct answer for the second quarter. Better luck this quarter.

This quarter’s question:

Why do we call shares of ownership of a company a “Stock”?

E-mail your answers to Erin at erin@fswealth.biz and we will award a prize to the first correct answer *(Be honest, no “googling” it!)*

commonly used stock evaluation tools for the last century. Historically, the P/E of the general market hovered in the range of 14 to 18 and anytime you saw a company's P/E getting to 40-50 it was definitely time to sell because they were getting too expensive. Today, so many companies have been pushed to P/E's of 200, 250, 300 and continue to climb that P/E is meaningless.

I will close with a bit of advice. We do not use indexes except in very thinly traded sectors for the reasons I just mentioned. I do not know how the next 10-20 years will shake out or if we will change our methodologies. But I do know that the overweighting of capital into such a small group of stocks always ends the same way eventually, with significant pain. If you or anyone you know has been happily pouring money into S&P index funds or ETF's, there has rarely been a better time to harvest your gains and walk away before the bleeding begins

~ Disclosures and Definitions ~

The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip stocks that trade on the New York Stock Exchange which are selected by editor of The Wall Street Journal.

The S&P 500 Index is a capitalization-weighted index made up of 5000 widely held large-cap U.S. stocks in the Industrials, Transportation, Utilities and Financial sectors.

The Wilshire 5000 Total Market Index (TMWX) is a broad-based market capitalization-weighted index composed of 3,451 publicly traded companies that meet the following criteria

Nasdaq Composite is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange.

FAANS Stocks - In finance, "FAANG" is an acronym that refers to the stocks of five prominent American technology companies: Facebook (FB), Amazon (AMZN), Apple (AAPL), Netflix (NFLX); and Alphabet (GOOG) (formerly known as Google)

2000 The Price Earnings Ratio (P/E) is the ratio for valuing a company that measures its current share price relative to its per-share earnings (EPS). The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

Get To Know Your Fox-Smith Wealth Management Team

In order for you to better know your team that are here to serve you at Fox-Smith Wealth Management, we will highlight one of our team members each quarter. This quarter, we start with our most senior member (other that Gus):

Brian Bush, CFP

Financial Advisor

Brian Bush was born and raised in Manitou Springs, Colorado, outside of Colorado Springs. As a youth, Brian filled his time by playing soccer, getting and prepping firewood (since he lived at the foot of Pikes Peak), fishing, and playing with dogs; that is, when he wasn't engaged in his true passion, riding dirt bikes. Brian, like so many of us in the 80's, sported an awesome mullet that may have even carried over into the early 90's.

After college, Brian worked as an engineer. Once he enrolled in his company's 401(k) Plan, he started to get interested in reading about finance, and here, many years later, he still loves reading about finance. He switched careers in 1998 and obtained multiple licenses and designations, including his Series 7, Series 63 and his CFP designation.

Brian still loves much of the same things he did as a kid; fishing, being in the mountains, playing with his dogs and riding dirt bikes. Does this mean he is resisting growing up? Perhaps, but who cares.

Anyone who knows Brian knows that he goes his own way, as he puts it "I like to zig when the crowd zags!" His most cherished piece of wisdom he has to share is to "Really listen to the wisdom of your elders."

Brian is a truly valued part of our team and we are very grateful to have him as one of our Financial Advisors.