MADISON PARK
CAPITAL ADVISORS

WEEKLY MARKET UPDATE

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Concentration Risk, or When Size Matters Too Much

As a firm, we have a longstanding objection to using the S&P 500 as a performance benchmark for most investors. The reasons are too numerous to mention here, but we will enumerate just two for the purpose of brevity. First, while we all love upside "volatility", the S&P buy and hold investor must be willing to live with the sometimes vicious downside volatility inherent in market cycles. One need only think back to the 58% peak-to-trough S&P drawdown during the 2008 financial crisis to recall the queasy doomsday feeling that haunted the retirement plans of many investors. **We know of precious few that are willing to benchmark downside volatility of such magnitude.**

At MPCA, we are well aware that risk and volatility are not the same thing, but they are closely related. If risk is the permanent impairment of capital, then downside volatility is the catalyst that leads to bad decision-making that leads to permanent portfolio damage, which is the essence of risk. The last sentence sounds obvious, but it stills needs to be pointed out on a regular basis, and we will from time to time.

The second reason that we object to the S&P 500 as a benchmark lies in its composition as a "market cap-weighted" index. **Simply put, the bigger the valuation of the company as a whole (market cap), the greater the influence on the movement of the index.** We would argue that size should not be the only thing that matters when it comes to deciding which companies to own. Projected earnings growth, valuation, return on equity, free cash flow and a host of other metrics matter much more than pure size when it comes to the desirability of owning any ongoing enterprise. Those inputs may overlap, but they do not always go hand in hand. The wise investor digs deeper into the income statement and balance sheet to discern exploitable value.

Consider the following, courtesy of the number crunchers at Evergreen/GaveKal. In 2015, seven high profile tech companies - the "FAANGs" (Facebook, Amazon, Apple, Netflix, and Google) plus Microsoft and Tesla – appreciated an average of 25%. If you remove those seven companies from the S&P, your returns were negative 4%! **This in spite of the fact that Tesla would go on to lose $674 million in 2016, and Netflix and Amazon currently trade at close to 200 times earnings.**

This year is shaping up in much the same way.

The "FAANGs + 2" (there has to be a better name!) are up 27.6% so far in 2017, while the rest of the "S&P 493" is up a more modest 4.95%. Little wonder that the U.S. market trades at a P/E (Price/Earnings) ratio 3 digits higher than the rest of the world, at 18.57 times versus 15.54. When you consider that the U.S. share of global GDP has been falling since the 1960s, from 70% then to 24% today, it makes little sense that the value of U.S. stocks has been growing relative to the rest of the world for the last decade.

Our purpose here is not to denigrate the domestic equity market. Far from it – the United States remains an entrepreneurial powerhouse driving innovation from the east coast to the west, and there is a reason that Silicon Valley is synonymous with wealth creation. But if an investor chooses to benchmark or chase the performance of seven stocks, we feel that it is our duty to point out the risks. We remember 2000-2002 and 2008-2009 very well, and will continue to apply the lessons learned as we seek the proper balance of risk and return in client portfolios.

With that, we will climb down from our soapbox and wish all of our readers a great first week of summer and a belated Happy Father's Day to all the dads in the audience.

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