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Year-End Market Comments

A Turn for Value
In 2021

Several developments are emerging in the stock market which, coming together, may finally result in a swing back to value in 2021. History shows that after a long, extended up-market, a point is reached at the end of the cycle when speculative behavior becomes extreme with everyone piling into the same popular stocks.

Just how extreme the behavior has become can be seen in the table below: **the highest P/E multiple stocks, averaging 49x earnings, were +21% while the lowest P/E multiples selling at 10x earnings were -37%.** The huge **58%** gap between growth and value is by far the widest differential on record. Even the highest dividend yielding stocks were down **-27%.**

Performance of S&P 500 by P/E - As of 9/30/2020*

Growth:	**+21%**
Value:	**-37%**
Gap	***-58%***

The performance brings 1999 to mind, when value was also extremely oversold. Growth was up +24% and value was down -5%. The difference of **-29%** was the biggest up to that point in market history. **The next year, as you can see, the MARKET FLIPPED and value was up +24% and growth was -17% -- a whopping +41% gap. Value then went on to outperform for most of the next ten years** (see the chart on the next page).

Market Flip Period – 1999-2000*

1999*:

Growth:	**+24%**
Value:	**-5%**
Difference	***-29%***

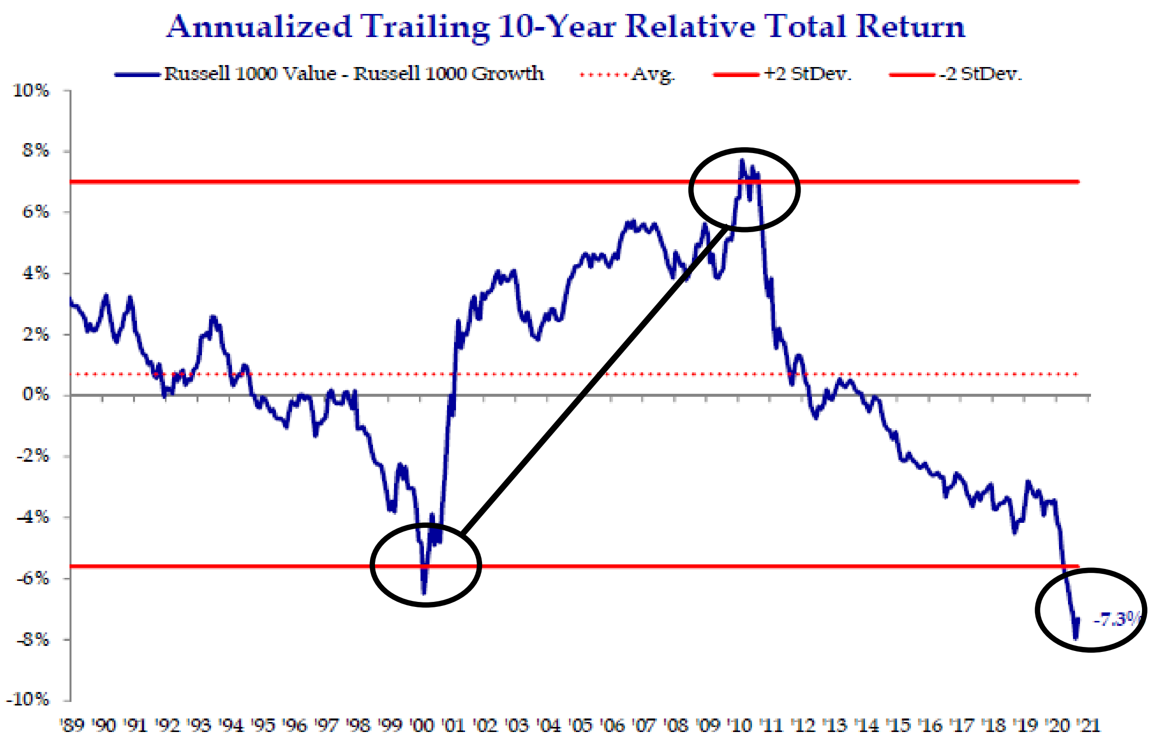
The Flip Year 2000*

Growth:	**-17%**
Value:	+24%
Difference	***+41%***

*Growth= Highest 20% by P/E / Value= Lowest 20% by P/E
***Past performance does not guarantee future results**. Investors cannot invest directly in an index.

A Long Term Update

The chart below, one we have referenced before, shows how exaggerated the sell-off for value has become. **It is the most oversold level relative to growth that we have ever seen.** We have also circled the **FLIP YEAR** of 2000 to make clear how dramatic the value recovery was, one that lasted for a decade.



Source: Bloomberg & Strategas Research, November 2020

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The Danger Zone

Before looking at prospects for value in 2021, we need of course to get there first – to get through the fourth quarter of 2020. **In our experience, the fourth quarter represents the DANGER ZONE, when most major portfolio mistakes are made**. What we saw at the end of 1999 was that mutual funds were shutting down their value funds and there was a general belief that value was dead forever. The result was that tons of investors were bailing out of value in the beginning of 2000, even though by that time the market had already swung back in favor of value.

More Warning Signs

While markets can become extreme, they also can stay extreme for longer than one would think or imagine. Here are some more signs that show how hugely overbought the present market has become.

1) Over-Concentration

   In recent letters, we showed how a concentration in a few stocks has occurred during all past market peaks. Currently, the top five holdings that dominate the S&P 500 are -- Alphabet, Apple, Amazon, Facebook, Netflix. Right now, this concentration exceeds the concentration of the Nifty Fifty and Tech Bubble market peaks.

2) The Public is Back in the Market

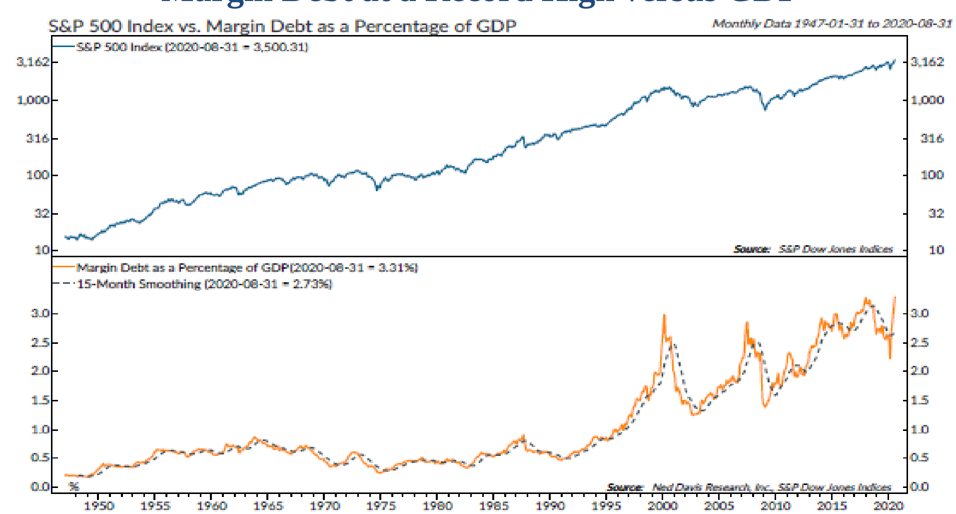
   Four years ago, the public showed virtually no interest in the stock market, but they have gradually been coming back into equities. **Currently, holdings for the average household are now at record highs.** Much of this new enthusiasm for stocks has come from the use of free trading firms like Robinhood that are seeing record inflows[1].

   [1]CNBC, August 21, 2020

3) Margin Debt

   Out of nowhere, margin debt has now reached all-time highs, much higher than in the early 1970s and the late 1990s. **This combination of new market speculation and extensive margin debt is a dangerous combination**.

Margin Debt at a Record High versus GDP



Source: Ned Davis Research, October 7, 2020

4) A Red Hot New Issue Market

   The public's new interest in stocks has opened the gates for a hot new issue market where companies with no earnings have people clamoring for shares. **The market for new issues is now hotter than it was during the "Go-Go Period" of the 1960s.**

5) Mutual Funds

   A recent article by Fred Hickey in the *High Tech Strategist* pointed out that all the mutual funds that have had the best performance and attracted most of the money all have positions in the same five stocks -- Alphabet, Apple, Amazon, Facebook, Netflix -- regardless of the stated investment philosophy of the fund.

6) ETFs

   While there are valid uses for ETFs, they are relatively new. **They have seen phenomenal inflows especially in passive investing, which has just added to the concentration in the most popular stocks.** In addition, aggressive strategies have been developed, where investors are using two or three times the leverage of the underlying ETFs in order to chase performance.

7) Algorithms

   Algorithms are back and part of the ETF market. The mathematical constructs are used to make investors feel comfortable about the extra risk they are taking. A recent example in the press[2] of failure of algorithms is the experience of the New York Subway Worker's Pension Fund whose main objective was to protect the workers' nest eggs. The fund was sold something called the Structured Alpha 1000 Fund, which was marketed as an "All Weather Fund." In it, options were used to presumably protect downside risk. **But in the last quarter, the $330 million Subway Worker's Pension Fund was down 97% to $9 million**. Obviously the options didn't work.

   [2]Reuters, September 28, 2020 / New York Post, September 28, 2020

Presidential Election Cycle

Besides the possibility of a flip year for value in 2021, history is another factor that favors value next year.

History shows that the year after the presidential election has typically been the most challenging for the market, but best for value. In fact, of the 14 recessions we had in the last 70 years, more than half started in the year after a presidential election. Also, in the 14 recessions, value outperformed growth in all 14 periods[3].

[3]Business Insider, June 2, 2020

Is it Different This Time?

After such a long period of underperformance by value, many believe that the world has changed and the popular growth stocks are bullet proof even in a downturn, thanks to how fast they are growing. **And in every cycle, you get the same question: Is this time different**? **History shows that it is not, as similar extreme markets like the 1920s, the 1970s, or the Tech Bubble of the year 2000 demonstrated.**

The Tech Bubble

Most investors remember the Tech Bubble, which was fueled by investors finally coming back into the market after the Nifty Fifty collapse of the 1970s. **During the bubble, there was talk of a new paradigm created by new tech companies that would reshape the world far into the future. Another theme was that value investing was dead forever.** Technology had become a huge factor in the world, but abandoning an investment discipline and chasing technology stocks during the bubble was a mistake. When the market finally rolled over, the tech stocks in the NASDAQ dropped about 80% over the next ten years. The chart below shows what happened to a few of the tech leaders.

The Tech Bubble

Major Expansion	Top Stock	P/E Multiple at Peak	Return 5 Years Later (2005)	Return 10 Years Later (2010)
Tech Bubble				
	Cisco	230x	-78%	-67%
	Intel	50x	-66%	-76%
	Microsoft	79x	-55%	-48%
	Oracle	60x	-71%	-41%

Source: SCCM, 2020. For illustrative purposes only. This is not a recommendation to buy or sell the stocks shown.

Actually, what we see is free market capitalism at work. The growth story starts with an exciting new industry or technology, followed by rapid growth in the US and globally. To keep the growth rate going, companies tend to make acquisitions that may or may not work out. **And finally, to push growth further, the leading companies start to get into each other's businesses.** Just this week we read in the *Financial Times* that Apple is starting to edge into Google's search business. Also, another article in the same newspaper reported that in China, where Tesla has had phenomenal success, local Chinese companies have developed small electric cars that are outselling and are less expensive than the Tesla Model 3. These and other similar examples will be putting pressure on the technology companies' growth rates.

The reason value stocks start to outperform is not because growth stocks begin to do badly, but because their valuations have become so extreme and extended that they are vulnerable to any disappointments, resulting in P/E multiple contractions. **Also, any gradual liquidation by investors tends to feed on itself, and once the selling starts, it tends to last.**

What can happen after a five and ten year correction is that these stocks can become attractive to value investors. In fact, we wound up buying all four of these tech leaders for our value accounts after 2010.

Summary

The best way to avoid the extreme volatility of the stock market is to take a long term view (that is, five years) and invest with a price discipline. Also we believe we could be entering a period where earnings and dividends become more important, following a five year period when they were considered irrelevant.

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