A Market of Stocks

Not a day goes by without investors referencing "the stock market." On a recent webinar, we were reminded by JP Morgan's Global Market Strategist, Gabriela Santos, of a simple, subtle, and often forgotten truth of investing. Rather than a stock market, we should more precisely focus on a market of stocks.

Isn't this splitting hairs? Aren't these two sides of the same coin?

First, there are literally dozens of stock markets around the world and the S&P 500 represents only one of them. Secondly, a stock market indicates a single cohesive unit moving as if it is a single entity. For the last decade, the S&P 500 has seemed to many investors to be the only stock market that mattered. Its returns outpaced nearly all of its peers and it bested historical averages by a wide margin. During this stretch, to most the S&P 500 was the stock market!

But why was the S&P 500 so dominant and why change what has worked?

Allow us a moment to start at the beginning. A single stock represents a business and all its risks, opportunities, frustrations, challenges, and such. When electing to own that stock, one is embracing that business at a specific price with the anticipation that ownership will be rewarded through a combination of dividends and appreciation over time. Without much doubt, there will be ups and downs, but a case can be made that the wins will outweigh the losses. As the father of value investing, Benjamin Graham, termed it, ***'In the short run, the market is a voting machine but in the long run, it is a weighing machine.'***

A stock market is a weighted collection of stocks. Some are weighted by company size, others by price or equally weighted, and still others by alternative methods. Most adjust weightings a couple of times per year and have certain standards to remain eligible to stay included. ***Being a well-run market leader, an innovator in one's space, reasonably priced or having strong leadership is most often NOT a requirement to be included in an index.*** Debt and leverage ratios rarely exclude a company.

When one buys a stock market, they get the good with the bad, the cheap with the expensive, the old-world with the new innovators. Owning an index may or may not provide an investor what he expects. Below are a few quick facts about the S&P 500 that may be surprising:

- 10 stocks represent 25.6% of the S&P 500 index; 50 stocks represent 52% of the S&P 500 index
- The largest weighting (APL at 6.44%) is over 600 times larger than the 4 smallest (.01% each)
- If the bottom 200 stocks each doubled, it would contribute only 8.3% to the index
- ***AAPL (6.44%) is 1.7% more heavily weighted than the combined weighting of the 23 Energy stocks in the index***

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So what was Mrs. Santos saying when she referred to a market of stocks?

Our takeaway is that there are meaningful advantages to being selective about whick stocks one elects to own, at what percentages, and for what reasons. We believe there are times when an index can serve as a useful tool (i.e. as the uinderlying for a buffered ETF or Striuctured product). The names at the top of the weightings list provided investors the greatest opportunity for return BEFORE they took over the leadership of the index. Furthermore, the law of large numbers has consistently shown that businesses at the top of the market-cap pyramid often find staying there difficult.

When the Technology Bubble hit, names like GE, Cisco, Intel, NTT, Lucent and Nokia were among the top 10 largest companies in the S&P 500. At the beginning of 2009, PetroChina, ICBC, China Mobile, and China Communication were among the top 10. Just 4 years ago Alibaba and Tencent had joined the Top 10. The leadership is almost certain to change again in the coming years. Companies among the bottom half of the index (all weighted 0.09% or less) will likely climb the ladder meaningfully. With only a market weighting to such names, it's difficult to benefit meaningfully from such a move.

Quick Math Example:

- Top 25 names collectively fall 20%
- Next 125 names collectively trade flat
- The remaining 350 names would have to be up 33% each for the index to trade flat
- In this example, 95% of the names were flat or positive!

Many argue that today's stock market is fairly valued or expensive. Within the index, however, are stocks that trade with single-digit P/E ratios and stocks without earnings at all. Not all stocks are created equally and not all types of stocks are in favor during various points of the economic cycle. We would argue that owning more than 4.7% in energy right now makes sense for investors. Owning nearly 26% exposure to 10 names that trade at multiples well above that of the index makes less sense in our eyes. In fact, of the top ten in the index, only XOM trades with a multiple below 20.

Finally, not all "markets" are the same. The S&P 500 is but one of dozens of markets. Overseas, some markets trade at dramatic discounts to that of the S&P 500. We believe there are tremendous opportunities to identify mispriced assets and underappreciated companies outside of the US markets. The US doesn't have a monopoly on great companies, and after a decade of outperformance, it seems more plausible than ever that some of the best opportunities are currently in non-US equities.

History has shown active management and in-depth company-specific research are valuable tools that can help identify opportunity during challenging times and add value to one's portfolio during turbulent times. While some may argue that many active managers failed to add value over the past decade, we believe the next era of the markets likely looks dissimilar to the last decade. We believe there is value in disciplined security selection and that venturing well beyond the S&P 500 is likely to reward investors in the years ahead.

Stay disciplined, stay focused, and remember that stock markets STILL are made up of individual stocks!

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