

WHITE PAPER



Dominance

I have written many times about the difficulty that investors face in evaluating a situation in which relationships between different types of securities are way out of line with historical metrics. This always raises the question of whether there has been what is known as a “paradigm shift” or simply a temporary aberration that is likely to reverse. Of course, we really don’t know the answer in most cases, but our general bias is that markets are self-correcting meaning that regression to the mean is the more likely outcome. I am writing about this topic again because we have a number of extraordinary deviations from historical experience in the equity markets, and they are extreme in terms of both magnitude and duration. The most recent trends are likely associated with the significant impact on the capital markets of Covid-19, but even longer-term disparities are of a magnitude that raises fundamental questions about the future of markets.



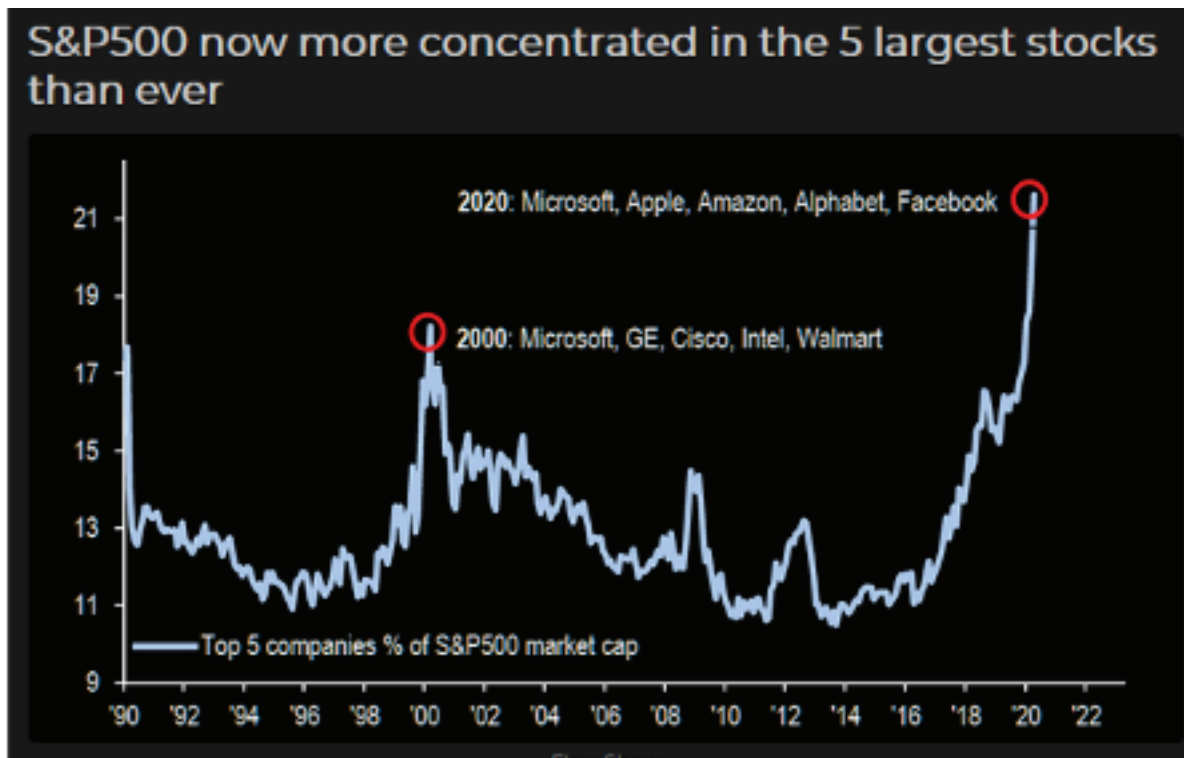
WILLIAM T. SPITZ, CFA
FOUNDER & PRINCIPAL

**DIVERSIFIED
TRUST**

diversifiedtrust.com

The Big Five-Extraordinary Concentration

As depicted in the graph below, five stocks now represent more than 21% of the S&P 500 (which is weighted by market capitalization), exceeding the prior peak weighting of 18%.



Including these stocks, the Technology Sector represents 26% of the S&P 500 and one bit of perspective is that there have only been three prior occasions when a single industry, much less just five stocks, represented more than 20% of the S&P Index. They were energy stocks in the early 1980's, technology stocks in the late 1990's, and financials in 2007. For whatever it is worth, the stocks of all three sectors performed poorly for several years thereafter. Let's dig a little deeper.

Over the past five years, these five stocks (Microsoft, Apple, Amazon, Alphabet, and Facebook) have generated a weighted average annual return of 30.2% versus the 9.9% return on the S&P 500 Index. A little quick math indicates that the other four hundred and ninety five stocks earned an average return of 4.5%, so slightly more than one-half of the return earned by the entire index is attributable to these superstars! Perhaps even more striking is the fact that the five stocks have enjoyed average price appreciation for calendar 2020 to date of 26.8% versus the -3.5% change in the price of the S&P 500! (As of 6/22) The incredible relative performance in 2020 is explained in part by the fact that these companies are to varying extent beneficiaries of social distancing.

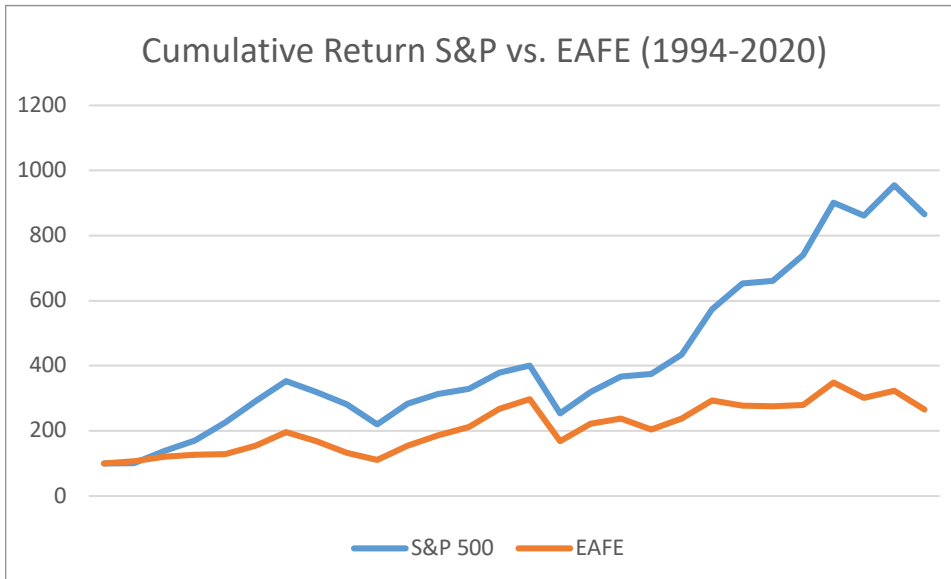
What about valuation? These five stocks sell at an average P/E of 44.7 versus 19.5 for the S&P 500, a 125% premium. The overall P/E of the group is distorted by Amazon's extraordinary valuation as measured by a P/E of 112.6, but the average of the remaining four companies is still 27.7 which represents a 40% premium. These data points raise the obvious question as to whether the superb performance and high valuations of these stocks are justified by their corporate performance. Over the past five years, their earnings growth has averaged 34% per annum as compared to 6.4% for the S&P 500. Once again, the figures are distorted by Amazon which has experienced triple digit growth, but the average growth rate of the remaining four has been approximately 19%. As a result of Covid-19, S&P 500 earnings are expected to decline 21% for 2020 whereas these five companies are forecasted by Wall Street analysts to increase earnings by about 1%. Over the next five years, analysts forecast average earnings growth among the group of about 15%. Given the current turbulence in the economy, it is very difficult to forecast a growth rate for companies in general, but the 6.4% rate over the past five years is probably a reasonable starting point.

One important factor in the outperformance of these stocks has been the trend toward passive, indexed products such as S&P 500 ETFs. Because the S&P is capitalization weighted, every investment in the index funnels 21% of the incremental dollars into these five stocks whereas the remaining stocks receive a smaller allocation. In other words, the trend is self-reinforcing.

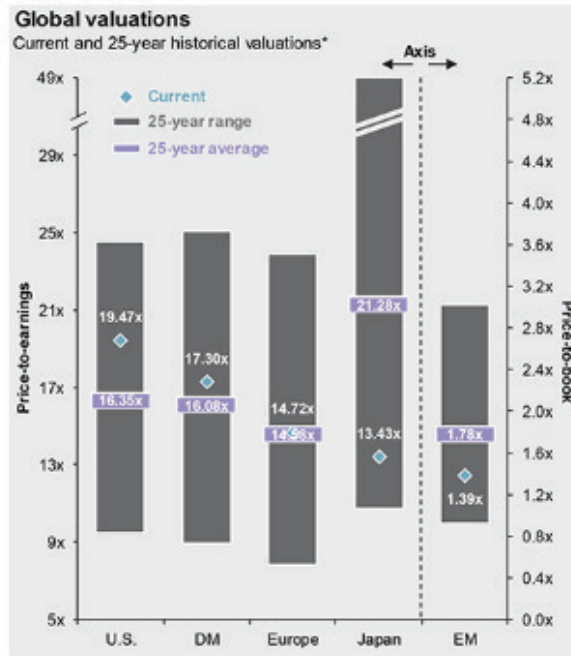
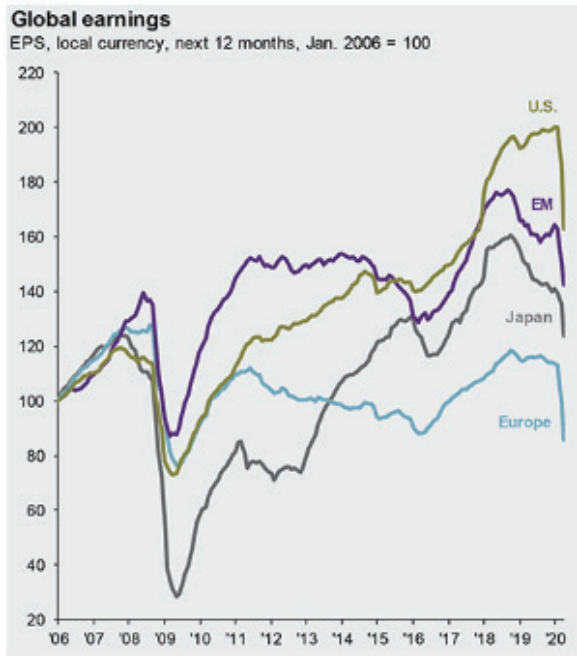
The Bigger Picture

In part, the extraordinary dominance of these stocks has been responsible for another discrepancy which is the performance of U.S. stocks versus the rest of the world. From 1970 to 2007, U.S. and Non-US stocks delivered identical returns of 11.2% per year. But, the entire period can actually be broken into three sub periods. From 1970 until 1982, both groups generated an annual return of about 8%. Then, from 1982 to 1994, international stocks outperformed with an annual return of 15.7% as compared to 13.1% for the S&P 500. This was followed by the period 1994 to 2007 in which U.S. stocks delivered 11.2% as compared to 8.1% for the rest of the world. So, investors came to expect cycles in which one or the other group would outperform for a period of years only to be followed by a reversal resulting in fairly similar returns over time. Well, from 2007 through today, U.S. stocks have generated an annual return of 6.4% versus -.9% for Non-U.S. stocks as measured by the Europe, Australia, and Far East Index. (EAFE) Actually, the picture is even more extreme because the last two periods (1994-2007 and 2007-2020) were both characterized by significant outperformance on the part of the S&P.

By combining these two periods, we find that for the twenty-six year period, the annualized return for the S&P was 8.5% versus 3.8% for the EAFE Index, and one hundred dollars invested in the S&P grew to \$866 while the same amount invested in the EAFE grew to \$266. Here is what it looks like graphically:



Due to this divergent performance, the U.S. market sells at valuation metrics considerably above those of the rest of the world. JP Morgan produced the following chart illustrating relative valuation and earnings growth for several regions of the world. As of April 30th, the U.S. was selling at a P/E of 19.5 as compared to its twenty-five year average of 16.4, a premium of 19%. In contrast, Europe's current P/E of 14.7 is in line with its long term average. Most notably, Japan currently sells at 13.4 times earnings as compared to the long term average of 21.3.



An entire paper could be devoted to a discussion of possible explanations for this valuation disparity but the chart on the left provides one clue. It shows cumulative earnings per share growth for each region and it is clear that the U.S. has trounced the rest of the world, most notably Europe.

Growth versus Value and Large versus Small

Over the years, there have been innumerable academic studies pointing to “value” and “small capitalization” factors in stock performance. Specifically, these analyses find that cheap or value stocks tend to outperform growth stocks, and small companies tend to outperform their larger cousins. Well, both of these expectations have been tossed on their ear for a sustained period. As was the case with the U.S. versus International phenomenon, this is at least partially a function of the performance of the Superstar U.S. companies. Let’s look at the data. Over the past ten years, the Russell 1000 Growth Index has earned an annual return of 14.4% versus 8.5% for its value counterpart. And, the overall Russell 1000 Index (large capitalization stocks) has compounded at 11.6% versus 7.7% for the Russell 2000 Index. (Small capitalization stocks) Over a ten year period, performance disparities of this magnitude result in considerable differences in cumulative wealth.

The Key Question

Stock selection is all about evaluating prospects versus price. In other words, does the fundamental outlook for growth in revenues and earnings justify the current valuation of a given sector or company? In this paper, we have provided considerable detail on the lofty valuations and excellent relative performance of U.S. stocks in general and large capitalization growth stocks in particular. And much of this is a function of a handful of stocks with exceptional performance. Clearly, the market has expressed the view that the U.S. is a superior place in which to invest, and further, that these are extraordinary companies with very bright prospects. And, in all likelihood, the Covid-19 crisis has simply accelerated the trend that was already in place in which technology dominates virtually every business as well as every other facet of our lives. More value-oriented investors would likely accept these points, but assert that the difference in relative valuation more than takes these factors into account. Moreover, some market observers suggest that markets led by a small group of stocks lack “breadth”, which can be a sign of significant downside risk. So, where does that leave us?

Let’s divide that question into two parts. First, what is the outlook for the U.S. economy and the underlying businesses of the Superstar growth companies? Second, what about the prospects for the stock market in general, and the performance of these stocks in particular?

While the U.S. economy certainly faces challenges, it is far stronger than the remainder of the industrialized world and likely to remain so. Therefore, we think it will continue to be the investment market of choice and are maintaining the overweight to U.S. stocks that has been in place for some time. Similarly, the five companies enjoy incredibly strong business franchises, consumer brands, and financial strength which makes them unassailable over the short term although there is always the prospect for disruptors in the longer term.

IMPORTANT NOTES AND DISCLOSURES

This White Paper is being made available for educational purposes only and should not be used for any other purpose. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Diversified Trust Company, Inc. believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based. Opinions expressed in these materials are current only as of the date appearing herein and are subject to change without notice. The information herein is presented for illustration and discussion purposes only and is not intended to be, nor should it be construed as, investment advice or an offer to sell, or a solicitation of an offer to buy securities of any type of description. Nothing in these materials is intended to be tax or legal advice, and clients are urged to consult with their own legal advisors in this regard.

Through both passive and active management, our portfolios have benefited significantly from exposure to these Superstars as well as targeted exposure to other growth oriented stocks. One potentially dark cloud is that their size and strength has attracted anti-trust scrutiny in both the U.S. and elsewhere, so it could be that the governments pose a much greater threat than competitors.

With respect to stock prices, the U.S. market and these Superstars enjoy tremendous momentum and the continued trend toward passive investing will only support that trend. Moreover, investors tend to extrapolate recent experience so the strong historical outperformance of these stocks is very seductive. As a result, many investors have chosen to abandon international investments and further concentrate on this small number of U.S. stocks. We believe that is a mistake because there eventually comes a point when valuations are so distorted that relative performance shifts in favor of the cheaper stocks. However, as we have seen, the cycles can be quite long in duration. Ideally, we could recognize the turn and change portfolios accordingly, but there are frequent false starts and head-fakes. So, in the absence of a crystal ball, we maintain significant exposure to large capitalization U.S. growth oriented stocks but with healthy positions in U.S. value stocks and international markets as well. Further, we expect to shift the relative exposures when there is evidence of a reversal in the tidal flow. This approach is consistent with our long held belief that success at investing results from consistently earning attractive returns while avoiding major mishaps.

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333



GREENSBORO

701 Green Valley Road, Suite 300
Greensboro, NC 27408
Phone: 336.217.0151



MEMPHIS

6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979



NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302