INVESTING INSIGHTS

The Elephants in the Room

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In the past few years, equity market returns have shown a marked impact from a handful of enormously capitalized companies.[1] These companies are often collectively referred to as "the FANMAG group", taken from the first letter of each company's name: Facebook, Apple, Netflix, Microsoft, Amazon and Google. The companies each have strong consumer franchises with dominant market shares. They have shown consistent growth and, for the most part, good profitability over the past decade. As a result, it is no surprise that their stock prices have appreciated significantly, and the majority are now the highest capitalized publicly traded companies in the world.

Investors who bought and held these shares in significant concentration over the recent past have enjoyed excellent returns…better than the average stock and considerably better than smaller and/or relatively cheaper (value) stocks.

What about the future: will the superior returns remain in place going forward? Should we simply buy and hold this group and forget about the laggards of the recent past? Let's look to history for precedents that might provide some insight.

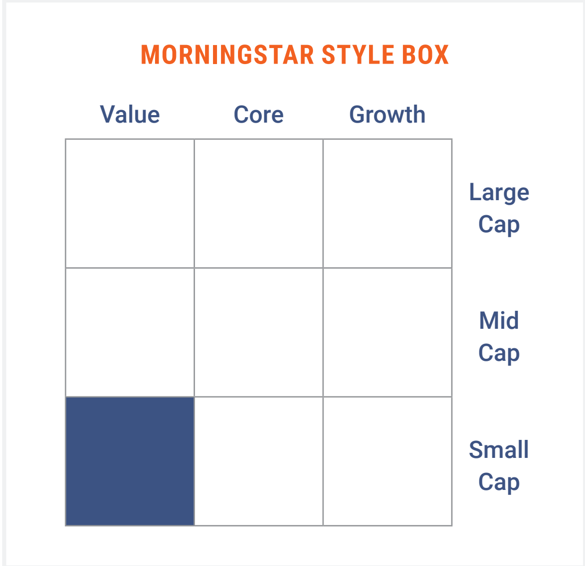
HOW BIG ARE THEY?

The largest stock market capitalization currently belongs to Microsoft; the total value of its shares now stands at $1.36 trillion, down from the peak of $1.43 trillion. At present, both Apple ($1.24 trillion) and Amazon ($1.18 trillion) join Microsoft with capitalizations above $1 trillion. Google comes in at $882 billion and Facebook is at $511 billion. Netflix is a comparative runt with a $186 billion capitalization, only 24th on the list of largest companies. I think it is included on the list by many because it shares some business characteristic and growth elements with the others on the list. It is also quite expensive in valuation at 96x earnings.

Together, these six stocks comprise ~21% of the total capitalization of the S & P 500 Index. In comparison, the bottom 100 of the S & P 500 capitalizations comprise only ~2%. Without question, this group has a significant disproportionate impact on Index returns. For example, in the three years ending January 31, 2020, the S & P 500 Index gained 49.8%; without the FANMAG stocks, it would have gained 34.9%. Just six stocks boosted the whole Index by almost 15%! In this same period, the Large Cap Growth Index, propelled significantly by the FANMAG stocks, gained 72%. This eye-popping return compares to a disappointing 0.8% total return for the Small Cap Value Index for the three years- a remarkable disparity!

WHAT DOES IT MEAN FOR FACTOR INVESTORS?

Size (small cap vs. large cap) and Value (cheap stocks vs. expensive stocks) are among the earliest discovered and most researched stock market factors. The seminal research of Eugene Fama and Kenneth French published in 1992, “The Cross Section of Expected Stock Returns”[2] identified that smaller capitalization stocks displayed superior returns to larger capitalization stocks and cheaper stocks displayed superior returns to more expensive stocks over long time period. The excess returns for Size and Value are called factor premiums. Over long-term periods, the combination of both factors represented by Small Cap Value category has offered significant premiums compared to all the other “style box” categories.



As described in my paper, “Probability”, while long term factor trends may be powerful, they are not always observed in shorter time frames. While uncommon, both Value and Size have displayed occasional negative premiums over time frames as long as 10 years. The Size factor is the least persistent (observable consistently over time) among the factors, yet still provides significant excess long-term returns. The Value factor is more persistent, yet also has recorded periodic shortfalls.

Currently, both factors are in an extended drought, evident in the previously noted 71% shortfall of Small Value versus Large Growth over the three-year trailing period ending January 31, 2020. Since these periods have happened before, a review of those circumstances may be helpful.

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Two previous periods offer interesting comparisons to the recent shortfall in Value and Size factors. Like today, both periods are also examples of the bias of “Herding” from Behavioral Finance research, in which investors concentrate their portfolios around a narrow group of stocks so as to not “miss out” on the performance others have experienced in those stocks. The first was 1969 through 1972, a period often associated with the terms, “Nifty Fifty” or “One Decision Stocks”. The second was 1997 through 1999, a period often referred to as the Tech & Internet Bubble. We used Professor Kenneth French’s historical data website[3] to create Tables to show the performance of Small Value and Large Growth portfolios in these time frames.

TABLE 1 — LARGE GROWTH DOMINANCE PERIODS:

	1969–1972	1997–1999	Feb 2017–Jan 2020
Small Value	-2%	48%	1%
Large Growth	46%	135%	72%
Difference	***48%***	***87%***	***71%***

Large Growth portfolios provided significant excess returns in each of these periods. As the four-year period from 1969 to 1972 progressed, it became increasingly fashionable to invest in the large growth stock group designated the “Nifty Fifty”. Eastman Kodak, Xerox, IBM and Proctor & Gamble were typical stalwarts of the group. The popular investment strategy of the day was to buy these stocks and put them away- never sell. Thus, the term “One Decision Stocks” (buy!). These stocks became increasingly expensive in valuation, but the One Decision rationale seemed fool proof. After all, weren’t these the best companies you could own?

During the Tech & Internet Bubble period, growth stocks were led by Tech favorites who were riding the spending boom triggered by necessary preparations for the possible computer crash associated with the calendar turn on January 1, 2000. Also capturing investor’s attention was the rapid growth of businesses accessing a new distribution channel- the internet. As we approached the end of the century, investor enthusiasm for technology driven growth stocks reached a crescendo. Valuations among these stocks were so expensive on traditional methods that investment analysts created new valuation metrics to justify purchase!

Like the other periods, the current FANMAG-driven large cap growth stock dominance arose in the later stages of an extended period of economic growth and generally rising stock market valuations. As noted in a recent Research Affiliates paper- *Reports of Value’s Death May Be Greatly Exaggerated,* the current underperformance of value investing relative to growth investing has been extraordinary; only the Tech & Internet Bubble shows a comparable differential. They further point out that growth stocks have gotten significantly more expensive than value stocks…a condition also seen in the prior periods discussed.

- Over the period studied (July 1963-September 2019), value is one of the most attractive factors in terms of market-adjusted return when compared to the other factors of size, operating profitability, investment, momentum, and low beta.
- Even with the handful of large drawdowns over the 56-year sample period that coincided with the Nifty Fifty, Iran oil crisis, tech bubble, and global financial crisis, a value investor is still 6.1 times wealthier than a growth investor.
- The Fama–French value factor, and value investing in general, has suffered an extraordinarily long 12 years of underperformance relative to the growth investing style.
- With today’s value vs. growth valuation gap at an extreme (the 97th percentile of historical relative valuations), the stage is set for potentially historic outperformance of value relative to growth over the coming decade.

Reports of Value’s Death May Be Greatly Exaggerated,
Research Affiliates (2019)

AFTER THE GOLD RUSH: THE NEXT CHAPTER

Each of these periods of large growth dominance came to an end as economic conditions and investor preferences changed. Not surprisingly, the stretched valuation differences between the groups resulted in notable periods of excess performance for Small Value portfolios as return premiums reverted to the long-term trends.

Following the Nifty Fifty and Tech Bubble periods, large growth portfolios provided negative returns for long periods of time. It is important to note that not all large growth stocks crashed and burned following these periods. For example, IBM, GE and McDonalds continued to prosper as businesses for decades following the end of the Nifty Fifty era although their stocks experienced a drift toward lower valuations. Microsoft was the largest capitalized stock in 1999 and is also the largest capitalized stock today. Even so, Microsoft's stock price traded below it's early 2000 peak for 16 years before climbing to new highs in recent years. However, many of yesterday's large cap favorites- Kodak, Xerox, AOL, Cisco and Dell Computers come to mind- never regained their footing.

TABLE 2 — REVERSION TO THE MEAN:

	1973 - 1979	2000 - 2006	2020+
Small Value	213%	274%	???
Large Growth	-2%	-10%	???
Difference	***215%***	***284%***	***???***

Will the current period of Large Growth dominance resolve in a similar fashion? The Research Affiliates study concluded "With today's value vs. growth valuation gap at an extreme (the 97th percentile of historical relative valuations), the stage is set for potentially historic outperformance of value relative to growth over the coming decade".[4] Time will tell.

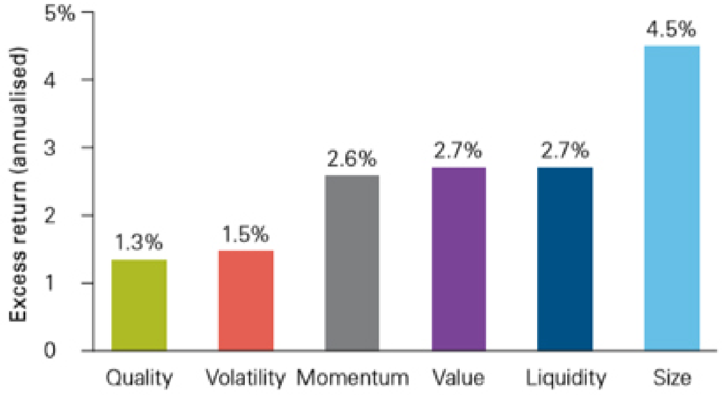
PLAYING THE PROBABILITIES

For diversified factor investors like HPA, our holdings in Profitability, Momentum and Low Volatility factor vehicles shielded the full portfolio from most of the damage from the Value and Size factors' poor comparative performance. Both Profitability and Momentum factors have exposure to the FANMAG stocks. We are confident that the Size and Value factors will be large contributors to positive comparative performance in the future. Table 3 shows the long-term premium returns from each factor as calculated by Vanguard. As you can see, the Value and Size factors have been amply rewarded historically.

TABLE 3 — LONG TERM FACTOR PREMIUMS

Chart #1 (Vanguard)[5]

Figure 1. Different equity factor tilts have outperformed historically



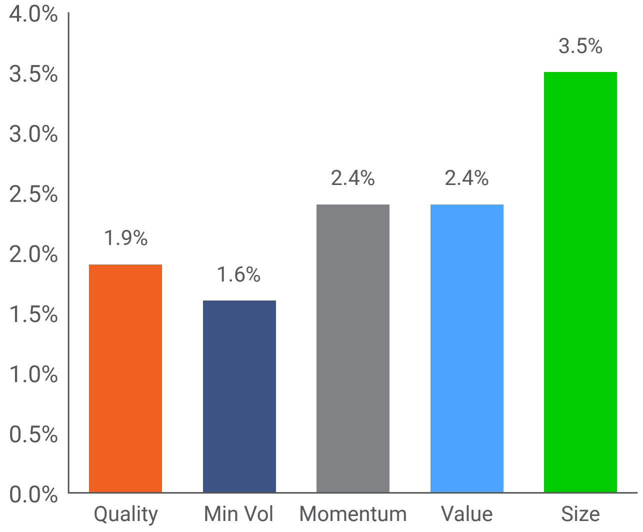
Past performance is not a reliable indicator of future results.

For a look at more recent times, we include Table 4 from MSCI, a leading provider of global index and analytics for investment markets. For the last two decades, Value and Size continued to provide excellent premiums despite the shortfalls of the past decade.

Considering their long dry spell, it is tempting to assume that the Small Cap and Value factors are poised for another long period in which reversion to those long-term trends generates an excellent return premium in the future. Should we make a bigger bet and increase our allocation to the Small Cap Value category?

The difficulty lies in figuring out when the mean reversion will get started. If we made the same judgement two years ago, following a decade of lagging performance for value and size, our portfolios would have suffered significant additional shortfalls. In the first quarter of 2020 alone, our preferred Small Cap Value ETF (symbol SLYV) declined -37% as compared to the Russell 3000 decline of -21%. Trying to "time" factor exposures is just as difficult as trying to "time" the stock market. It would be fabulous if an investor could move in and out of exposures in anticipation of future changes- but no one has been able to do it. Adopting an investment strategy based on timing factor exposure or stock market exposure is ***highly unlikely*** to lead to success.

TABLE 4 — RECENT FACTOR PREMIUMS[6]
2001–2019



HPA'S APPROACH

Our approach incorporates balanced exposure to all five factors with the understanding that not all will work in short-to-medium term time frames. Thus, we occasionally "re-balance" our factor exposures to provide a less volatile path to long term superior results. We fully expect that the Value and Size factors will lead portfolio performance again in the future, so rebalancing ensures that we maintain adequate portfolio exposures for their eventual return to prominence.

[1] "Market capitalization refers to the total dollar market value of a company's outstanding shares of stock." -Investopedia.com

[2] Fama, E. F., & French, K. R. (1992). The Cross-Section of Expected Stock Returns. *The Journal of Finance,* 47(2), 427–465. doi: 10.2307/2329112

[3] https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

[4] Arnott, Harvey, Kalesnik, & Linnainmaa. (2020, January) Research Affiliates, LLC. Reports of Value's Death May Be Greatly Exaggerated. Retrieved from https://www.researchaffiliates.com/en_us/publications/articles/reports-of-values-death-may-be-greatly-exaggerated.html

[5] Douglas Grim, Scott Pappas, Ravi Tolani, and Savas Kesidis, Equity factor-based investing: A practitioner's guide (June 2016), Notes: Excess returns are calculated relative 10 the MSCI World Total Re1urn Index (USO). All results are as at 30 September 2016. MSCI World Momentum Index (USO) history begins 31 May 1973: MSCI World Value Index {USO) is from 31 December 1974 10 30 November 1997 and MSCI World Enhanced Value Index thereafter. MSCI World Quality Index (USO) begins 30 November 1975: MSCI World Minimum Volatility Index {USO) begins 31 May 1988: MSCI World Small Cap Index IUSDI begins 31 December 2000: and FTSE Developed liquidity Factor Index {USO) begins 30 September 2001. Sources: Vanguard calculations, using data from Thomson Reuters Datastream. MSCI. Bloomberg, and FTSE.

[6] Notes: Excess returns are calculated relative to the MSCI World NR Index. The following Indices represent the stated factors - Quality (MSCI World Quality NR), Min Vol (MSCI World Minimum Vol USD NR), Momentum (MSCI World Momentum NR), Value (MSCI World Enhanced Value NR), Size (MSCI World Small Cap NR).