INVESTING INSIGHTS

High Probability ADVISORS

The Elephant Boneyard

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In the April 2020 paper "Elephants in the Room," I reviewed the extreme impact that the handful of large digital companies (FANMAG) are exerting on stock market performance. This short list of stocks has provided significant gains to investors this year, while most of the stock market has lagged. These circumstances have plenty of historical precedent; a review of this history can help with perspective.

The FANMAG giants are very successful, enormous businesses. Riding the wave of mass computerization and the arrival of a new, efficient distribution channel (internet), these businesses brought valuable new products and services to the world. They reached their dominance by growing revenues and profits rapidly and consistently--often trampling or acquiring the competition along the way. With hindsight, it is quite reasonable that these stocks have performed well. But the issue for investors is what will happen in the future? Perhaps we can learn from the experience of previous "Elephants."

FANMAG STOCKS:

- Facebook
- Apple
- Netflix
- Microsoft
- Amazon
- Google

ANCIENT HISTORY: THE TECH BUBBLE OF THE LATE 1990s

As we approached the year 2000, an ominous threat hung over the computerized world. From the beginnings of computer software programming in the middle of the century, it was customary for programmers to use a "19xx" convention when programming internal date sensitive software. This was fine until the end of the century approached. What would happen when January 1, 2000 appeared? Would software default to 1900 and stop working? It seems silly now, but it was a real concern. Doomsday predictions abounded, warning of catastrophes such as failure of electrical grid, nuclear power plants melting down, banks unable to account for transactions and airplanes falling from the sky.

As the topic gathered momentum in the mid-1990s, businesses began to address the problem by spending on new technology, replacing older systems where the 1999 problem was embedded. From 1995 through 1999, business spending on computer technology surged. Along with that momentum, a new communication channel emerged: the internet. The ability to have computers communicate with each other through a publicly available system spawned new opportunities in both business and consumer domains. Suddenly, email was a required function. Companies could create web sites. "Browsers" could comb the digital world to deliver useful information with a few clicks. You could buy and sell items without leaving your home. "Social media" arrived on the scene. The dynamic changes and new opportunities provided by the internet spurred a tech spending boom by itself. As the internet driven demand wave added to the Y2K driven tech spending wave, technology stocks boomed.

At the same time, the rest of the world faced challenging times. The Asian boom of 1993-96 ended with a crippling financial crisis in 1997. Russia had its own financial crisis and defaulted on its sovereign debt in 1998. The result was a significant decrease in the demand for raw materials in these formerly growing parts of the world. Minerals and basic commodities plunged in price. Oil prices fell to $10 per barrel. The demands of technology spending crowded out traditional capital spending. Many traditional businesses suffered.

Unsurprisingly, the difference in earnings growth between tech and non-tech business resulted in the major divergence in stock market results seen in Table 1.

TABLE 1

	1998	1999
S&P 500	28.58%	21.04%
Russell 1000 Growth	38.71%	33.16%
Russell 2000 Value	-6.45%	-1.49%

The amazing performance of the broad market index and the Growth index were driven by the Elephants of the day. Like the Elephants of 2020, several were successful technology businesses. The tech heavy NASDAQ Index rose 85.6%. Qualcomm was the best performing stock for the year, up an amazing 2,619%! Investors piled in and valuations went to unimaginable heights. Speculation among the internet related stocks was rampant. And then, the circumstances changed once again.

What happened? The clock struck 12:01 on New Year's Day 2000. The computers continued to work. None of the doomsday prophecies arrived. The power was on, TV broadcasts continued, and planes did not fall from the sky. Good news, right? While the world breathed a sigh of relief and we all went back to work on January 2, a subtle change in the economy sparked a significant change in the stock market.

In retrospect, that change seems predictable; yet few saw the significance. As business and governments blew out their tech spending budgets in the late 1990s to prepare for Y2K, they eventually got the job done. Not only did they avert a Y2K disaster, they also brought in new systems with leading edge technology. And then they could cut back on this expensive spending which had put a significant drag on their earnings. They could address more traditional areas of spending such as plant and equipment. Non-tech companies' profit margins improved. The developing global economies began to work through their financial crises. Supply and demand for raw materials rebalanced, resulting in a bounce in commodity prices. The decline in tech spending growth put pressure on technology company earnings. As tech companies fell short of overly optimistic earnings forecasts, the high valuation stocks crumbled.

Technology spending didn't go away, and the internet continued to blossom. But the excessive expectations for growth and profitability could not be met. Speculation wilted. The divergent performance of the Growth and Value Index was dramatically reversed, as seen in Table 2.

TABLE 2

	2000	2001	2002
S&P 500	-9.11%	-11.88%	-22.10%
Russell 1000 Growth	-22.42%	-20.42%	-27.88%
Russell 2000 Value	22.83%	14.02%	-11.43%

Value stocks beat investors' low expectations for profits while Growth stocks fell short of the high growth rates that had been extrapolated from the late 1990s. The new circumstances arrived as the tech spending boom driven by Y2K subsided.

THE PANDEMIC PUSH

Unexpected events often bring unexpected outcomes. The COVID pandemic had a marked impact on the economy this year. Most businesses have been dealt a huge blow by the pandemic. Consumer and business spending declined significantly. Many retailers, restaurants, salons, and other service businesses were shuttered. When looking at the earnings reports among banks, energy companies, real estate companies and other sectors of the non-digital economy, it is not surprising that these stocks have performed poorly.

At the same time, we see that the global pandemic provided a tailwind to most of the digital economy. Consumer and business spending were redirected into digital channels as the world responded to the medical threat. With people at home for extended periods, Facebook's new subscriber growth accelerated from an 8% rate to 15% in the months following the onset of the pandemic.[1] Amazon internet retail sales flourished as physical retail outlets were shuttered. Walmart's online sales jumped 97% in the second quarter of 2020.[2] Demand for cloud computing capacity skyrocketed as both work and play activities were channeled to the internet. These trends were in place before the pandemic, but they accelerated in the first half of 2020. Digital businesses boomed and their stock prices followed suit.

IS THE PAST PROLOGUE?

The Tech boom of the late 1990s and the current environment share some similarities: divergent earnings growth leading to dramatically different stock market outcomes between the digital economy stocks and all the rest. The artificial boost to tech spending from the Y2K era led to an extrapolation of growth expectations that could not be met in the early 2000s. The tech businesses didn't disappear; many continued to grow, but at a slower pace. Former stalwarts such as Qualcomm, Cisco, Intel and Oracle are still with us, but their shareholders have not fared well (Table 3).

TABLE 3

January 2000 - July 2020	Annualized Return
Cisco Systems Inc	0.69%
Qualcomm Inc	2.67%
Intel Corp	2.97%
Oracle Corp	4.13%

At some point, the COVID pandemic will subside. Like every pandemic before it, a combination of medical technology and biological evolution will cause it to recede. Will a return to normalcy spawn a similar turnaround in the divergent trends going forward from 2020? It is conceivable that the reopening of the traditional economy could cause a rebound in non-digital company earnings, while at the same time lessening the pandemic inspired spike in on-line demand for goods and services. The elevated stock valuations found in many of the digital economy leaders could make any shortfall in growth a painful experience for their shareholders. Time will tell if the reversal of fortune plays out in 2021 and beyond.

BLINDED BY THE "NOW"

While we know that change is a constant; the human condition leads us to underestimate change. The well-documented behavioral tendency called **Extrapolation Bias** (also called Recency Bias) blinds us to change. We tend to think the recent past and current conditions will continue far into the future. We project that companies whose earnings have grown at elevated rates in the past few years will continue to experience the same growth going forward for many years. However, as we've seen in the past, growth trends are notoriously difficult to maintain.

The digital economy Elephants aren't going away, but they face significant challenges to deliver growth at the current rate. Louis Gave provided a great example pointing out that total worldwide advertising spending in 2019 was $560 billion (US). Google commands the leading position with $113.3 billion or 20.2% of the market. Facebook is a strong second with $73.4 billion or 13.1% market share. The global advertising market only grows at a 3% rate. For Google and Facebook to continue growth at 20%, by 2027 their revenues would exceed the entire market (not possible!).[3] All the FANMAG companies need large NEW markets to sustain their growth.

PORTFOLIO POSITIONING

In the factor world, **Momentum** and **High Relative Profitability** are the two factors moderately exposed to the digital leaders. They have delivered excellent returns for our clients' portfolios in the past few years. The **Value** and **Size** factors are heavily exposed to the traditional economy; both have struggled significantly in recent years. If the post-COVID economy shifts, it is possible that those trends would reverse…just as they did in the post Y2K environment.

We carefully avoid basing investment strategies on future forecasts for market movements. Shifting back and forth between factor exposures is not a sustainable route to success. Long-term success requires a diversified exposure to all factor portfolios, with regular rebalancing--just like we rebalance between stocks and bonds. This is our bedrock philosophy and rebalancing drives most of our trading activity. Keeping our portfolios positioned to succeed in an environment of constant change is our mission.

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[1]PR Newswire. (2020, July 30). Facebook Reports Second Quarter 2020 Results. Retrieved from https://seekingalpha.com/pr/17953411-facebook-reports-second-quarter-2020-results

[2]Perez, S. (2020, August 18). Pandemic helped drive Walmart e-commerce sales up 97% in second quarter. Retrieved from https://techcrunch.com/2020/08/18/pandemic-helped-drive-walmart-e-commerce-sales-up-97-in-second-quarter/

[3]Gave, L. (2020, July 24). Have Equities Become a Bubble? Retrieved from https://blog.evergreengavekal.com/have-equities-become-a-bubble/

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