QUARTER 2 • 2018

# Investing INSIGHTS
*from Evanston Advisors*


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July 2018

If you've ever been in my personal office, you've seen the array of monitors on my desk. They look impressive, but they aren't there simply to impress people. I'm a data junkie, and the more of it, the better. To the right of the displays, I have a television mounted on which CNBC is constantly streaming live commentary. Though I often accuse the "talking heads" of making noise simply to keep anxious investors tuned in, from time to time I glean interesting bits of information from the broadcast.

## Just six stocks are credited for all of 2018 returns

In a segment earlier this week, one of the guests pointed out that the entirety of the stock market's returns so far in 2018 can be attributed to a mere six stocks. I was curious about this, so I did a little investigating on my own. As it turns out, he was correct, but he was referencing a date in July – I wanted to know how concentrated the returns were in the first half. Turns out it's even worse when we stop the clock at June 30th.

In the first half of the year, the S&P 500 returned 1.67%, not including dividends. A mere four companies (technically it's five stocks, as Alphabet aka Google has two share classes that trade) account for 137% of that return. In other words, without those four companies (Microsoft, Facebook, Amazon, and Alphabet), the market would have had negative returns for the first half.

## It's all in the "weighting"

I've discussed it before, but I'll bring it up once again: The manner in which indexes are calculated contributes significantly to the perception of how the market is performing. The S&P 500 is a market-cap weighted index. The largest companies get much higher weighting in the calculation of the index than smaller ones. These four companies account for a mere 1% of the stocks in the index, but receive 11.5% of the weighting. As a reference point, Walmart, McDonald's, IBM, Texas Instruments, Union Pacific, Costco, Nike, Caterpillar, UPS, and Goldman Sachs combined only receive 4.3% of the weighting. These two groups of companies have similar combined net annual income, yet the group of four is weighted more than twice what the group of ten is. This is why I often say that

> *"...the entirety of the stock market's returns so far in 2018 can be attributed to a mere six stocks"*

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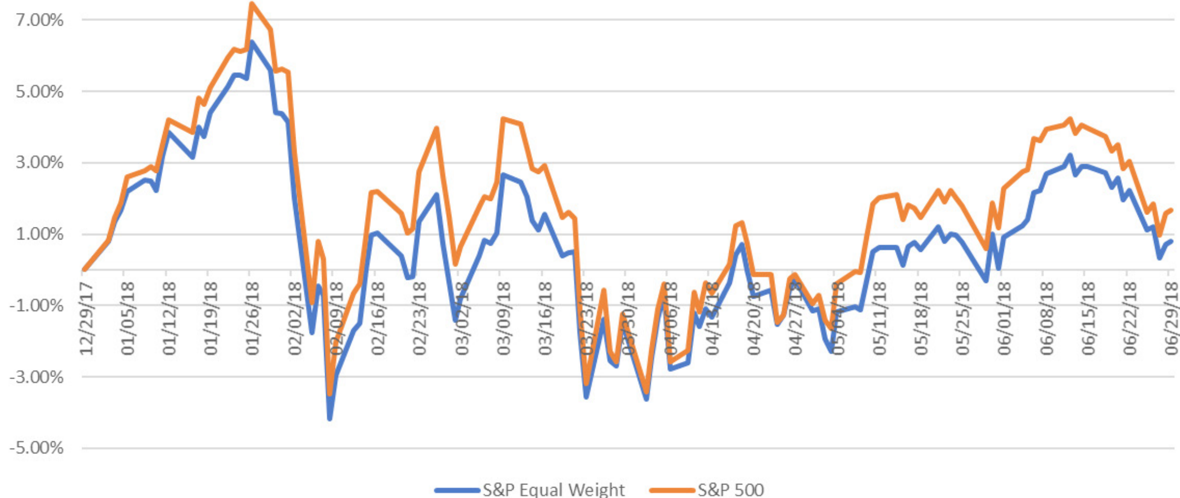
**S&P 500 vs S&P 500 Equal Weighted**




indexes are a far from perfect scorecard against which to compare one's investments. The following chart shows the S&P 500 against itself, only with the effects of the market-cap weighting removed. Note that without the weightings, the index is lower.

*"…below the surface the market is not doing nearly as well as one might think… there may be some unrecognized risks…"*

The lack of market breadth at the security level is disturbing, but that does not tell the complete story. If we look at the sector level, we see that seven of the eleven sectors are in the red for the first half of the year. Only Technology, Consumer Discretionary, Energy, and Healthcare are positive for the year. And for the first two of those sectors, again we have to point out the dominant weightings of Microsoft, Facebook, Alphabet, and Amazon are what's driving the returns. The first three are tech companies, and make up 30% of that sector's weighting; Amazon accounts for 23% of the weighting of the Consumer Discretionary sector.

### Looking below the surface

I'm bringing all this up to highlight the fact that below the surface the market is not doing nearly as well as one might think. Moreover, I believe there may be some unrecognized risks at the broad market level that could have negative consequences.

For example, the Technology sector now makes up over ¼ of the weighting of the S&P 500. The only time in history it has been this dominant was just prior to the bursting of the dot-com bubble. And though technology is most definitely a driving force in our economy, the President's tariff talk could have significant effects on tech companies. According to an article published by NASDAQ, the tech sector gets more than 50% of its revenue from overseas sources. Should the trade war deepen, domestic tech companies could see an earnings impact from retaliatory tariffs.

Stock valuations are relatively high compared to historical levels. This suggests that if the economy slows, or even if it grows at a rate slower than projected, stock prices would fall. The more optimistic the valuations, the greater the fall.

### Index investing and the herd mentality

There has been a dramatic shift in the investing marketplace in the past few years toward passive management, also known as index investing. While index investing is very cost efficient, and guarantees results similar to whatever index one is attempting to mirror, there are many in the investment industry that are concerned that risks are concentrating.

Passive investing can induce herd mentality that can snowball rapidly. If an active investor is concerned about the economy, we sell those companies that we believe to be vulnerable, and perhaps invest the proceeds in companies that may be able to take advantage of the perceived issues the economy may be facing. If a passive investor is concerned about the economy, she sells her fund, which sells all 500 stocks (assuming an S&P 500 fund), liquidating the good with the bad. Assuming the investment is a mutual fund, if enough investors sell, the fund manager has to sell shares of the underlying holdings. Guess which get sold off in the greatest quantity? Those that have a higher weighting in the index.

## Are investors really diversified?

Compounding the problem is the fact that many passive investors have created what they ***think*** is a diversified portfolio by buying multiple funds, but because of the way indexes are created, they've bought the same thing over and over in different wrappers, creating a very concentrated risk profile. For example, many people will buy a tech sector fund, a NASDAQ QQQ fund, and an S&P 500 fund, among others. While it seems they have diversification, let's look at what they really hold:

| | S&P 500 | Tech Sector | QQQ |
|---|---|---|---|
| Apple | 3.91% | 13.94% | 11.55% |
| Microsoft | 3.31% | 11.83% | 9.30% |
| Face Book | 2.05% | 7.33% | 5.66% |
| Amazon | 2.99% | 0.00% | 10.02% |
| Alphabet* | 2.96% | 10.57% | 9.03% |

**both classes*

The funds are heavily weighted in the same holdings, magnifying the risk, most likely unbeknownst to the investor. If (when) one of these stocks sells off, inducing investor panic, they end up selling a fund, which means more shares of each of those stocks gets sold – it's likely to be a compounding effect.

## And now for the good news…

Now that I've given you plenty to worry about in this letter, let's talk about the good stuff that's going on.

1. The economy is positively humming. Nearly every measure of economic activity is positive.
2. Consumer Confidence is at the highest rate in over 15 years.
3. Unemployment is at the lowest level since 1953 (though the labor participation rate is still below its pre-recession highs).Housing starts are at their highest level since the recession, as are building permits, and existing and new home sales.
4. The Leading Indicators Index, a measure that is used to forecast the direction of the economy in the near term, is at its highest level since at least 2000 (my data set only goes back to 2000, but the current level is significantly higher than it was then).
5. Corporate profits are again at all-time highs.
6. Inflation remains in check so far.

So, given all these great things going on in the economy, why have equity returns been so anemic this year?

My belief is that there are a few things holding the market back:

1. Trade war/tariffs. The market is afraid that a trade war, especially a prolonged one, will put a damper on profits. Tariff increases are just beginning to go into effect, so we'll see how that plays out.
2. The Fed has stated that they will continue to raise interest rates. This is a delicate dance that they must perform – if rates increase too quickly, the brakes get slammed on economic growth, but if they aren't raised quickly enough, inflation will ensue.
3. Valuations remain high. The market may have gotten ahead of itself a bit last year, and the fundamentals need a little time to catch up. As a result, prices may languish a bit.

*"The economy is positively humming. Nearly every measure of economic activity is positive."*

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*"Volatility induced by geopolitical and trade-war saber-rattling aside, there are a lot of positives in the economy to point to."*

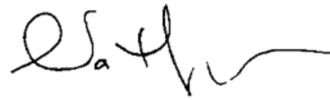
## More money back in the economy

Volatility induced by geopolitical and trade-war saber-rattling aside, there are a lot of positives in the economy to point to. The tax cuts have resulted in increased take-home pay for most employees, and several companies have given bonuses or raises as a result of the reduced tax rates on corporations. In addition, repatriation of overseas profits should result in a large influx of cash coming back into the United States. More money in consumers' pockets and more cash in circulation both bode well for the economy and the stock market. Unemployment is now at 4.1%, the lowest level since 2000. Average weekly hours worked have been slowly increasing, as has average pay. So far, inflation is remaining relatively benign.

In summary, my earlier contention that in the absence of any economic or geopolitical crisis, the Fed will continue to raise rates this year in an effort to stay ahead of inflation. I expect at least two more rate increases this year. This obviously could change as the effects of the tax law changes and economic growth play out in the coming months and quarters.

If you have any questions, please feel free to contact us.

Very truly yours,



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