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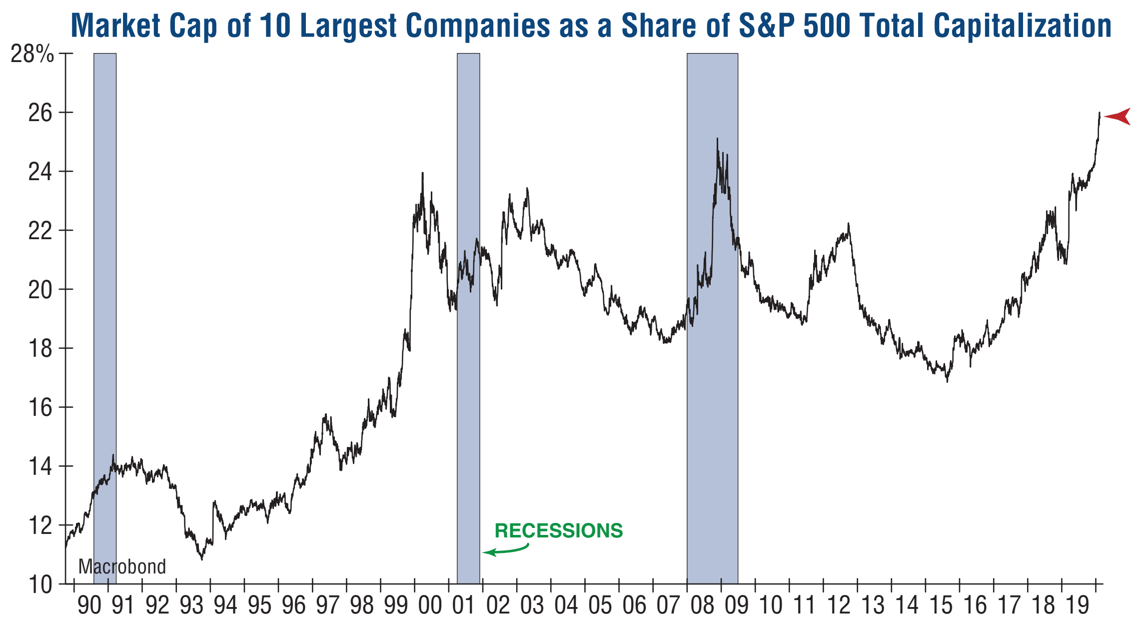
Stack Financial Management Special Report:

IN PURSUIT OF VALUE

The first six weeks of 2020 have seen a continuation of the strong market returns experienced during 2019. In fact, the +4.5% return would equate to an annualized increase of over +38% if the frenzied pace continues. While investors cheer higher values in their portfolios, we take a deeper look behind the scenes to discover that speculation is becoming more apparent and a cautious stance at this stage in the cycle is warranted.

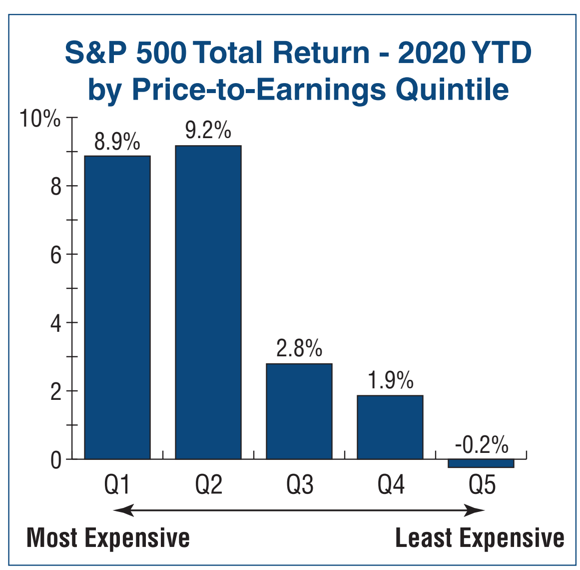
Historically speaking, the internal quality of a market advance is critical, and analysis of market leadership can help investors draw conclusions about the likelihood of future market gains. The chart below is a good measure of leadership depth, as it shows the market capitalization (i.e., stock price times number of shares outstanding) of the 10 largest companies as a percentage of the total capitalization of the S&P 500. A low reading means that changes in the S&P 500 Index are being driven by price changes in a large number of stocks, while a high reading indicates that a much smaller group of stocks are accounting for a substantial amount of market action.



This indicator recently reached an all-time high as mega-cap stocks are dominating the investment landscape. As more people hold fewer stocks, we question the viability of the current market rally and, more importantly, how narrow the door might become if everyone decides to exit at the same time.

In addition to market leadership, valuation metrics are typically utilized to help guide investment decisions. Thus, we took our analysis a step further and uncovered an interesting phenomenon that is taking place during the first part of this year. The chart at right sorts the constituents of the S&P 500 Index into five different buckets (quintiles) based on Price-to-Earnings (P/E) Ratios. Year-to-date returns were then calculated for each quintile.

We discovered that for the first six weeks of this year, the top two quintiles (highest P/E stocks) have outperformed the rest of the overall market by a historically large margin. Stated differently, the most expensive segments of an ***already expensive*** market are leading the way. Conversely, the relatively "inexpensive" segments (P/E quintiles four & five) of the market are lagging by a significant amount.



Source: FactSet

(Over, please)

Historical S&P 500 Total Return by Price-to-Earnings Quintile

	P/E Quintiles Total Return					Q1/Q2 Avg. minus
Year	Q1	Q2	Q3	Q4	Q5	Q4/Q5 Avg.
2020 YTD*	9%	9%	3%	2%	0%	**8.2%**
2019	29	31	29	32	37	-4.8
2018	5	-7	-4	-7	-8	6.3
2017	21	21	23	21	25	-2.1
2016	7	5	12	19	17	-12.0
2015	5	8	0	-2	-3	**8.6**
2014	13	14	14	15	13	-0.8
2013	27	37	32	29	38	-1.1
2012	20	14	17	18	12	2.1
2011	-1	-2	9	3	-1	-2.6
2010	20	21	11	15	12	7.1
2009	30	21	27	22	35	-2.4
2008	-45	-36	-34	-28	-43	-4.6
2007	5	13	8	3	1	**7.2**
2006	8	11	16	19	24	-12.0
2005	4	1	5	3	12	-4.5
2004	6	7	15	7	20	-7.3
2003	45	17	25	33	36	-3.7
2002	-27	-18	-24	-17	-14	-6.9
2001	-25	-11	1	-2	10	-21.8
2000	-28	-2	15	25	19	-36.9
1999	41	32	3	4	8	**30.6**
1998	52	28	23	27	25	**13.9**

*Jan. 1 - Feb. 14 Source: FactSet

For comparison purposes, we ran this same analysis on a yearly basis going back to 1998 to see how prevalent this relationship has been. The table at left shows a year-by-year break down of P/E quintile returns from 1998 until 2020. This data is utilized to calculate the final column which reflects the difference between the average of quintile one and two (most expensive) and the average of quintile four and five (least expensive). As you can see, there have only been a handful of times when the highest P/E stocks have outperformed by such a substantial margin, the majority of which (1998, 1999, and 2007) have been at the tail end of a bull market.

While each market cycle is unique, investor behavior eventually transitions from sound fundamental analysis to outright speculation. The conclusions we draw from the data highlighted above are twofold. First, while actions by the Federal Reserve have no doubt elongated the current cycle, we still believe this is a late-stage bull market and an emphasis on risk management is imperative. Second, our disciplined approach to portfolio construction at Stack Financial Management –which combines macroeconomic views with bottom-up stock selection using our proprietary SFM Scoring process– becomes even more important going forward.

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