PORTFOLIO NOTES **February 2020**

To our Business Partners:

- ***KNOW THY INDEX.*** Investing (speculating?) in index funds is all the rage these days. Unbelievably, there are now more index funds in the form of Exchange Traded Funds (ETFs) than there are stocks on the New York Stock Exchange. Exchange Traded Funds and index mutual funds are created to replicate and track a group of stocks like the S&P 500, NASDAQ 100, Wilshire 5000 Total Market, or the Europe Australia Far East (EAFE) Index, or a sector of the market. Despite their popularity and wide ownership, we're certain that most investors have no idea at all, and perhaps would be quite surprised at, what makes up the index underlying their ETF or mutual fund.

  Take, for instance, the S&P 500, which is the most recognizable and widely used group of stocks by index funds. The S&P 500 (and most other indexes for that matter) is based on the total market value of each stock in the index. In other words, the largest companies by market value have the most weight or impact on the index. No other criterion is used. As a stock goes up in price, its impact on the index rises. As a result, indexes become "top-heavy." A few heavyweights in the index drive the fund price higher, which attracts more money flowing into the fund, which money is allocated more to the heavyweights to stay true to the index, which drives the fund price even higher, and so on. This self-reinforcing loop pushes index fund prices to unsustainable highs.

  Today, the largest five companies in the S&P 500, all technology-related, make up over 18% of the entire index. *One percent of the stocks make up nearly one-fifth of the index*! And, the five stocks have a higher weighting than *four entire S&P Sectors* (Energy, Utilities, Real Estate, and Materials)! This degree of concentration hasn't existed since late 1999/early 2000. Maybe we should rename it the "S&P '5' Index," consisting of Microsoft, Apple, Amazon, Facebook, and Alphabet (Google).

  In the past it has always been considered a red flag when a sector (much less five stocks!) got to be 20% of the index. It's been a sign of over-popularity, over-ownership, and over-valuation. Significant market selloffs have always occurred in following years. While we can't say if/when/how much the current situation will play out, we believe buying "the market" these days carries considerably more risk than investors believe they are undertaking. Would a prudent, rational value investor structure a portfolio in this way?

- ***VALUATION.*** In general, rising stock prices and flat-to-declining profitability have thrown valuations further out of whack. Price-to-value relationships remain high. Bargain stocks remain scarce.

- ***RECENT RESULTS.*** Stocks started 2020 with declines. Indexes in January were down as much as 4%. The exception once again was the NASDAQ Composite which rose 2% -- a perfect example of a top-heavy basket of mostly tech stocks described above. For the same reason, the large company indexes (Dow and S&P) suffered smaller declines. Over the latest twelve months, only the large company indexes produced double-digit returns in a range of 13-25%, while smaller-sized company indexes have risen 5-9%. The "average" stock traded on the New York Stock Exchange was up just over 6%. Meantime, because our group of widely held stocks* are weighted more equally in portfolios, it's beaten the small-cap indexes but trailed the big guys over the past year.

Steve Nichols, CFA *Bill Warnke, CFA*

The group of "portfolio stocks" -- our Equity Composite for the purpose of evaluating investment performance -- consists of 17 stocks that are held in our clients' accounts. Portfolios might hold some or all of these stocks, depending on investment guidelines unique to each client, the timing of purchases and sales, and start dates of accounts. The performance of this group of stocks is a good proxy for our equity performance but might vary widely among accounts. Of course, past performance is not necessarily indicative of future results.