Strategy Thoughts

April 2015

What everyone already knows doesn't help!

The Wonder of Apple?

Introduction

Over the last couple of weeks two news items have dominated the business pages, the first was the Fed's removal of the word 'patient' from their latest policy statement. This resulted in a surge in the Dow and a plunge in the dollar over the short term. I read very little into this, whilst the media and market machinations and gyrations before and after each Fed utterance is entertaining, and to some extent understandable, I don't believe it is in anyway helpful to investors. My concern continues to be that a deflationary disappointment, for both the Fed and investors, lies ahead and therefore believe that a cautious outlook continues to be warranted. The second news item that so captured the media recently was the inclusion of Apple in the elite of the Dow Jones Industrial Average. In and of itself I don't think that this story tells one anything about where markets may go, however, the history of changes in the Dow does tell an investor about what really drives markets. In this month's Strategy Thoughts I will explore the history of the Dow, look for some surprises and then share some longer term perspectives, particularly for Australian readers.

The wonder of Apple and the wisdom of DOW!

The stock price of Apple was a wonder to behold up until late 2012 when it suffered a 45% bear market in just seven months, since then it has once again become a wonder for investors as its share price has rocketed higher by more than 140% to its most recent peak on 24th February this year. That peak came just ten days ahead of the announcement by McGraw Hill that Apple was going to replace AT&T as one of the thirty Dow components.

USA Today reported the inclusion of Apple in the Dow Jones Industrial Average with the headline;

iDow: Apple to join iconic Dow stock index

And quoted David Blitzer, managing director and chairman of the Index Committee at S&P Dow Jones Indices as follows:;

> *"As the largest corporation in the world and a leader in technology, Apple is the clear choice for the Dow Jones industrial average"*

The question this raises is why did it take so long, and so much appreciation in the price of Apple, for the Index Committee at Dow Jones to notice? Apple first became the largest company in the world by market capitalisation six months prior to its previous peak, in April 2012, and it became the largest corporation in history in August of that year. Perhaps those achievements were noticed by the committee but by the time they came to make the next change in the Dow, in late 2013, Apple had been falling and Goldman Sachs, Nike and Visa, though none were anything like as large as Apple, had been rising. Those three were added at the expense of Alcoa, Bank America and Hewlett Packard. Nothing was said of Apple.

Dow Jones describes why a particular company gets included in the DJII:

> "While stock selection is not governed by quantitative rules, a stock typically is added to the index only if the company has an excellent reputation, **demonstrates sustained growth** and is **of interest to a large number of investors**. Maintaining adequate sector representation within the indices is also a consideration in the selection process." (Emphasis added)

At first blush this seems a sensible approach; however, given that a technology laggard in HWP was being removed in 2013 it could be argued that the inclusion of Apple would have maintained the sector representation. Nonetheless, we had to wait until March 18th of this year for Apple to have convinced the 'Index Committee' that it was large enough, growing and of interest to a large number of investors.

These comments about the work of 'Index Committee' may sound a little facetious, but my primary aim is to highlight that no fanfares should be sounded for Apple's inclusion, if anything the reverse is more likely to be true.

I have been following the Dow Jones Industrial Average for almost thirty five years and consistently those stocks that have been added to the Dow have, understandably been great performers over the prior few years or longer, and those that have been removed have been laggards that have not performed anything like as well. This makes sense given the 'Committee's stated objective which could be paraphrased along these lines;

> *"A stock is only added to the index once everyone in the whole world knows what a great company, and stock, it **has** been."*

Again this may sound a little disrespectful but I do vividly remember when the 'Index Committee' broke with tradition and selected two companies for inclusion in the Dow that were not listed on the New York Stock Exchange, they traded over the counter on the NASDAQ. Those two companies were Intel (INTC) and Microsoft (MSFT) and the date of their inclusion was 1st November 1999.

By that time Microsoft had already become the largest company in the world and Intel was the sixth largest company. Both their stock prices had enjoyed phenomenal booms through the tech explosion of the nineties having risen more than ten times in value over the preceding five years. By the time they were both included in the Dow it is fair to say that anyone who was ever going to be remotely interested in them had by then become aware of their stories and their success. This is where the problem lies and it can clearly be seen in the aftermath of those two company's late 1999 admission to the Dow. Immediately after their inclusion both stocks rose, MSFT for a month and INTC for about four, but then they plunged. Three years after their inclusion INTC was down 70% and MSFT 50% and in early 2009 both stocks were still 70% below where they had been when the 'Index Committee' voted for their inclusion. Even today MSFT remains 10% below its inclusion price and INTC 25%.

In investing it is absolutely the case that by the time everyone knows something, even if that knowledge is correct (which is certainly not always the case with what becomes conventional wisdom) it is absolutely useless to an investor. Whatever that knowledge is has already been reflected in the market, possibly many times over!

I have reviewed only one of the many changes that have been made to the Dow over the years, however, in 2008 Anita Arora, Lauren Capp and Gary Smith, published an academic paper, **"Do Stocks Added to the Dow Outperform the Stocks They Replace?"** in which they analysed the performance of the additions and deletions to the DJII since the index became a 30 stock index in 1928. Their results are quite conclusive.

One year after a change in the Dow, on average a portfolio of those stocks taken out has risen by more than 19%, whereas those stocks added have risen by just 3%. Two years after the change the trend continues with the deletions rising by an average of 56% compared to just 15% for the two year old additions. Three years later the story continues with the discarded stocks up an average of 59% while the additions still up just 15%. Even five years after a change in the membership of the Dow has taken place the removed stocks continue to dramatically outstrip the new entrants, rising on average more than 170%, more than two and a half times the rise experienced by those stocks that were added to the index. The paper's conclusions were;

> A portfolio consisting of stocks removed from the Dow Jones Industrial Average has outperformed a portfolio containing the stocks that replaced them. This finding contradicts the efficient market hypothesis since changes in the composition of the Dow are widely reported and well known. Our explanation for this anomaly is the market's insufficient appreciation of the statistical principle of regression to the mean, an error that has previously surfaced in a variety of contexts.

This raises the question, which stock should be bought now, Apple or AT&T?

The chart on the right shows the last five years of performance by Apple, up about 300%, and AT&T, up about 25%. Their recent histories, at least when measured by stock price, could hardly have been more different, and over a longer time period the difference is almost mind blowing. A little over seventeen years ago AT&T was trading at the same price as it is now, over that same period Apple's share piece has risen more than 16,000%.

Given this history it is not surprising that analysts hold quite different opinions on the former and new Dow stocks. AT&T is followed by thirty two analysts and twenty four of them (75%) have either a hold, underperform or sell opinion. Apple, on the other hand, is followed by forty nine analysts and only ten of these (20.4%) have a hold or underperform opinion. None have a sell opinion.

The history of the Dow 'Index Committee' clearly demonstrates that their decisions, when they are finally made, reflect what everyone already knows. Given this, plus the totally different price histories and the relative optimism or pessimism that are currently reflected in AAPL and AT&T the question does arise; where is there scope for the biggest surprise and where is the biggest disappointment most likely?

Where are the surprises?

As I have described above, it is always important to look out for surprises, and disappointments, it is these, not the expected, which ultimately drive markets. A couple of recent Bloomberg headlines highlight two surprises. The first supports my concern regarding a deflationary slowdown that I described in greater depth last month. Despite the growing evidence that deflationary forces are present, and not just in Europe, it is still far from the consensus fear. This provides the backdrop and set up for the possibility of what would be a shocking, and potentially devastating, deflationary disappointment;

Wholesale Prices in U.S. Unexpectedly Fall for Fourth Month

Bloomberg 13th March 2015

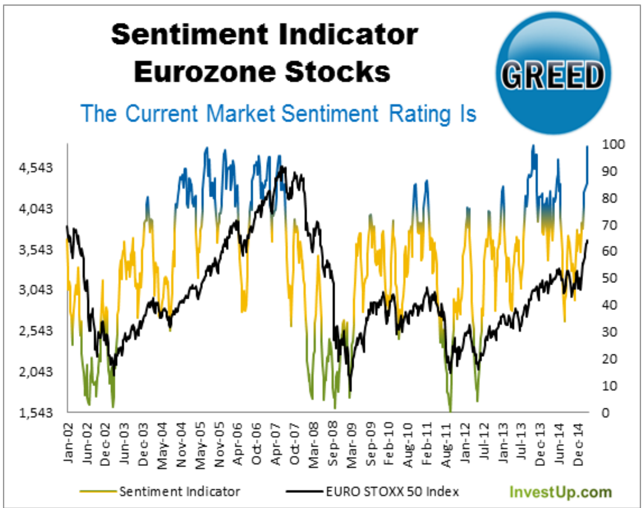
The second headline should be of concern for all those investors looking at the US and seeing an economy, and stock market, in recovery mode. Again this sets up for disappointment.

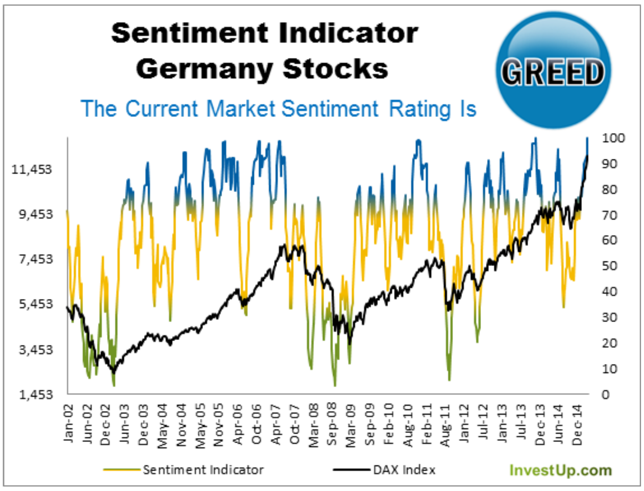
Surprise: U.S. Economic Data Have Been the World's Most Disappointing

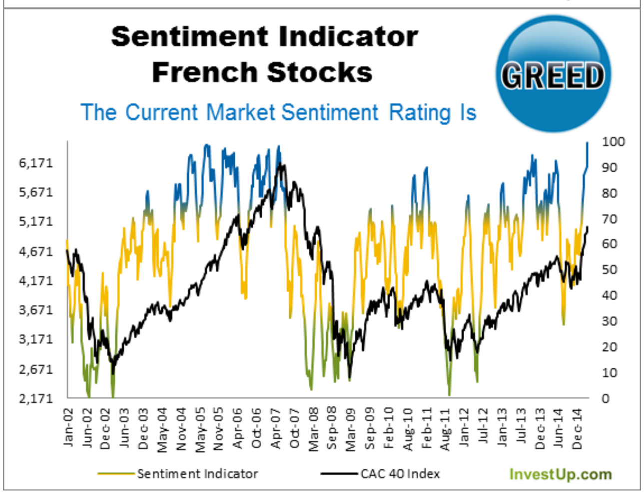
Bloomberg 13th March 2015

Europe

Currently the greatest scope for disappointment appears to be in Europe as the chart to the right shows. Investup's sentiment indicator for the Eurozone market as a whole shows that expectations have become about as elevated as they ever do. All this despite numerous signs of deflation in the region.







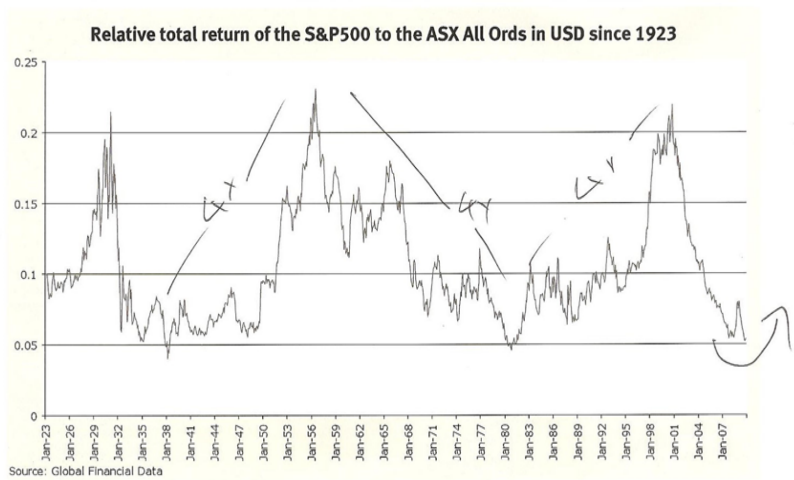
Undoubtedly a substantial driver of these elevated expectations in Europe has been the rapidly rising levels of optimism in France and Germany, both of which have seen surges in bullishness accompanying markets that have risen steeply over the last few weeks.

Some longer term reflections

Back in early 2010, the economic backdrop was beginning to measurably brighten. This was particularly the case of Australia and selected Asian economies, as was reported by the Australian Treasurer Wayne Swann on the 21st April 2010;

> "The IMF in its latest World Economic Outlook confirmed that Australia continues to outperform the major advanced economies and is a leader in the global economic recovery… The IMF notes that in the context of an uneven global recovery, Australia and the newly industrialised Asian economies are off to a strong start and will likely stay in the lead."

At that time the Australian market was recovering from the GFC, as was the Australian dollar that had fallen sharply against the US dollar. It seemed that the trend of Australian stock market outperformance against the US market, which had been evident throughout most of the 2000's, was reasserting itself. (However, Finance Minister's comments tend to be as useful to investors as central Banker's comments, frequently reflecting what markets already know)

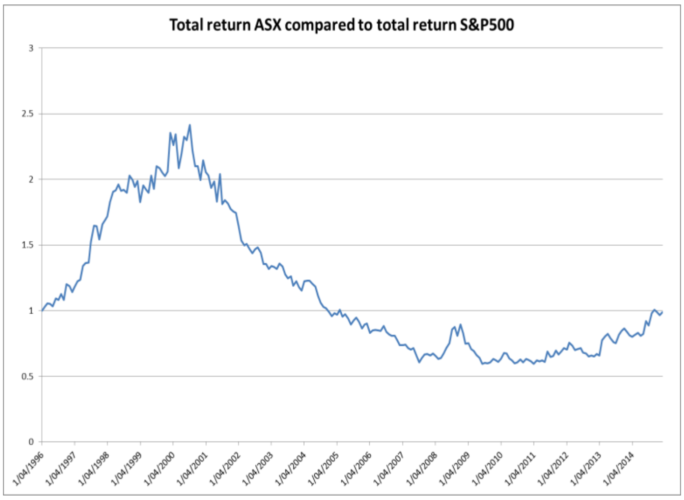


In presentations at that time I included the chart I have reproduced to the right to try and provide some longer term perspective and also to temper some of the enthusiasm for their home market that was obvious in many Australians. The chart showed the relative total return, adjusted for currency movements, that investors in Australia and America had received over many decades.

Perhaps most importantly it showed that over the very long term it hadn't mattered which market one had invested in, they had both done equally well. However, over shorter time periods of ten or twenty years where one was invested had made a huge difference. In the period through the Great Depression to the start of WWII the Australian investor received about four times the total return of the US investor. But then through the forties and fifties this Australian advantage was totally unwound as the US investor did four times better than his Australian counterpart. Then through the sixties and seventies the results were once again reversed in favour of the Australian before this advantage reversed once again through the eighties and nineties in favour of the American investor.

The main point I was attempting to make with this chart five years ago was not that anyone should expect an immediate reversal, rather I was trying to highlight the danger of expecting a neat extrapolation or resumption of what had been enjoyed prior to the GFC. I was also making the point that some international diversification was probably warranted for Australians.

The chart to the right is an update of the one shown above. What is clear is that the relationship has indeed once again reversed and swung in favour of the American investor, however, the longer term perspective that needs to be taken now is that the relative move against Australia, and in favour of America, has been small and brief compared to the longer term swings that have been seen over the last eighty years. The situation is not as extreme as it was five years ago but would still argue in favour of the US investor over the longer, secular, term.



Is this a secular bull market?

A recent Seeking Alpha post by Dr Andrew Wood posed this question about the current bull market in the US. I have reproduced some of his observations below:

> **Growing consensus that this is the early stages of a secular bull market**
>
> This has been a very strong bull market. From the trough in March 2009 to the end of 2014, the S&P 500 increased 171%. The magnitude, and the duration of this strength, has led some investment commentators to conclude that the U.S market is in the early stages of a secular bull market. For example, Kevin Mahn (the President and Chief Investment Officer of Hennion & Walsh Asset Management), asserts that the current bull cycle is a secular trend.
>
> **Characteristics of secular bull markets**
>
> What do we mean by a secular bull market? Secular bull markets are characterised by very long periods of asset price growth. The average length of secular bull markets has been 13.5 years (1921-1999). Bear markets do occur within these periods, but price pullbacks are limited and the upward path very quickly resumes. In all secular bull markets since 1921, the percentage of positive years has been at least 75%.
>
> Given the strength of the current up cycle, it is perhaps not surprising that many commentators think that we are in a secular bull market. However, while strong market conditions are a necessary condition for a secular bull market, they are not a sufficient condition. It takes more for a secular bull trend than merely a strong market.
>
> An examination of the history of secular bull markets shows that there are a number of different conditions necessary for a secular bull market including:
>
> 1. Price instability: Very strong inflation or deflation at the start of the secular bull/end of the secular bear.
> 2. Very low p/e ratios: At the end of the previous secular bear, p/e ratios have historically reached very low levels over an extended period of time. This is because during secular bull markets p/e ratios typically double or triple.

3. A catalyst which fundamentally alters the investment landscape and drives prices higher for an extended period of time.
4. Very strong market conditions: This includes significant asset appreciation, shallow pullbacks and most years producing positive returns.

Dr Wood concludes that this has been an unusually strong cyclical bull market, but, importantly, it has not been the first six years of a secular bull market. This is a point I have been making for several years and continue to believe that the long term valuations seen at the lows in early 2009, at least in the US, were not consistent with the level of valuations seen at previous important secular inflection points. It should also be of some concern that so many commentators are now comfortable with the term secular bull market.

A source of concern

A recent story on Bloomberg should raise at least some warning flags amongst investors who witnessed and survived the tech wreck of the early 2000's;

> **The Fuzzy, Insane Math That's Creating So Many Billion-Dollar Tech Companies** Bloomberg 17 March
>
> Snapchat, the photo-messaging app raising cash at a $15 billion valuation, probably isn't actually *worth* more than Clorox or Campbell Soup. So where did investors come up with that enormous headline number?
>
> Here's the secret to how Silicon Valley calculates the value of its hottest companies: The numbers are sort of made-up.

These concerns echo some of the comments made earlier in the month by billionaire investor Mark Cuban;

> **Billionaire Mark Cuban Warns On Tech Bubble** 3/6/2015 RTT News
>
> One of America's most famous tech investors sees private investors getting crushed in a race to make money on apps.
>
> "Small individual investors are putting their money into apps with no chance of getting their money back," billionaire Mark Cuban told CNBC as the tech-heavy Nasdaq hit 5,000 for the first time since 2003.
>
> Investors in publicly traded companies are not in danger yet, but Cuban warns that a tech bubble is forming in private investment, where backers of a company cannot easily trim their losses in a failing firm, as there is no stock to sell.

Such irrational enthusiasm has usually been followed by damaging disappointment.

Tribute

I have been writing Strategy Thoughts in one form or another since the early 2000's and it was in the early 2000's that I first met John Austin. I initially knew John as a valued client, but over the years a real friendship grew. It was a friendship based upon mutual respect and a number of common interests, particularly investment markets and golf. He was an avid reader on markets and I could always expect a stimulating and challenging discussion after most editions of Strategy Thoughts were sent out. I really valued this aspect of our relationship.

John would be known to many readers of Strategy Thoughts, particularly those in the South Island of New Zealand, as he regularly attended the seminars and presentations I was involved with. He was also a founding member of my previous employer's first advisory board and his contributions there will undoubtedly have greatly contributed to an enhanced experience for all clients.

Three weeks ago we visited John, who had been battling cancer, at his home in Christchurch and whilst frail he was still as interested in discussion as ever and his mind was as challenging and probing as it always was. It was therefore with great sadness that we received the call last Sunday to tell us John had passed away. I am grateful to have known John for as long as I did, he was a wonderful friend, a mentor, a sounding board and a gentleman. I will greatly miss him as I know everyone who knew him will

Conclusions

I have written many times over the last year that nothing has changed to make me give up on my view that caution and discipline will still be the most valuable attributes for investors over the coming months. This continues to be the case. I do not believe that Central Banks will facilitate the great deleveraging that still needs to take place just as I didn't believe they would prevent the GFC, even though it had not yet been given that name, in 2007.

Monitoring the fortunes of Apple and AT&T over the coming months will be entertaining, but I think that is where it should remain, AT&T may outperform the wondrous Apple now that Apple is in the Dow, but perhaps it will be by not falling as much. The important lesson that needs to be taken out of my discussion on this subject, apart from whatever limited entertainment it may offer, is not that one should buy AT&T and short Apple, rather it is that successful investors need to be able to identify what has become 'conventional wisdom' and treat it differently than the vast majority of investors do.

As the great Yogi Berra said;

"You can observe a lot by just watching."

Update on the STA Portfolio

This product continues to be worked on and the actual structure and set of rules continue to be refined. I'd again like to thank all those readers who have expressed interest in the product for their patience and I hope to be able to provide more details next month.

Kevin Armstrong

25th March 2015