COMMENTARY

August 21, 2020

Dear Clients and Colleagues:

What a year it has been so far. The COVID-19 pandemic brought the global economy to a complete stop, interest rates are edging lower and lower, and we are seeing unprecedented monetary and fiscal stimulus. Companies have turned upside down as work from home (WFH) becomes the new normal. Social unrest is growing across the world, and all eyes are fixed on the upcoming United States (US) presidential election. All we're missing is a plague of locusts to make this year truly biblical.

Despite the upheaval, financial markets are shrugging off the uncertainty. Equities continue to swing back and forth on a minute-by-minute basis. While market performance on the surface appears to be strong, it is polarized with a handful of companies outperforming the rest of the indices, a trend which has only accelerated since COVID. Unfortunately, we are not out of the woods yet, and it's even more important to be diligent and take precautions in managing risk.

What is driving the optimistic market sentiment?

If you look closely, you'll notice that a small cluster of companies are driving the strong market performance. The combined market cap of Apple, Microsoft, Amazon, Google and Facebook is over 22% of the entire S&P 500 market cap. These companies also have a greater percentage of earnings, compared to the dot com days when the top five were just 18% of the index.

The Sweet 16

Over the last few years, popular media have frequently highlighted the strong performance of FANG stocks (Facebook, Amazon, Netflix and Alphabet). Eventually, this group evolved into FAANG (adding Apple) and now FAANGM (adding Microsoft). These stocks are long recognized as powerful market movers.

However, there has now emerged a new group of power players, which is so large, they could be considered an asset class unto themselves. Unable to find an acronym for such a large number of companies, the equity strategist at Jefferies cleverly coined them the "Sweet 16".

The stars of our Sweet 16 production are Adobe, Alphabet, Amazon, AMD, Apple, Broadcom, Facebook, Fiserv, Intel, Microsoft, Netflix, NVIDIA, PayPal, QUALCOMM, Tesla, and Texas Instruments. Collectively, these 16 stocks represent over 30% of the entire US equity market with a combined market cap of almost $9 trillion. Yes, you read that right. These 16 stocks are almost one third of the value of the entire US equity market.

What is driving this strong performance? Bulls say they deliver faster growth than the rest of the market and have a clean balance sheet. It is true that the Sweet 16, with their strong innovations and global expansion, have been growing quickly. However, there are many other companies that have been growing two to three times faster than the Sweet 16 combined. The difference is this: the Sweet 16 have been handsomely rewarded by investors for their current and expected growth when you compare the strong performance (~500%+) vs. the S&P 500 in the last five years.

Surprisingly, their balance sheet is not as clean as you might think. In fact, the Sweet 16 debt to capital ratio is almost identical to the S&P 500 index.

Are the Sweet 16 really cheap to buy?

The Sweet 16 trade almost three times higher than the entire S&P 500. Bulls may point out that we are far from the dot com craze – but according to portfolio strategists at Canaccord Genuity, growth rates today are much lower than during the dot com bubble, when we had hyper growth expectations. Today's forward growth estimates are half of what they were during the boom. However, the current PEG ratio, which takes into account future growth, is similar to what it was during the dot com bubble based on research from Canaccord Genuity. Today's growth expectations are more about recurring revenue and stability as penetration rates of many technologies are already high.

How crazy are Sweet 16 valuations?

Let's take two simple examples. Apple, Microsoft, Amazon, and Google combined have a market cap of over $6 trillion. With the current combined market cap of Apple and Microsoft, one can buy all the United Kingdom-listed shares, including those listed on the AIM exchange, and still have over $600 billion in change.

Tesla, with a market cap of over $350 billion, is bigger than companies like P&G, MasterCard, and Home Depot. It is yet to be added to the S&P 500 index, but is already in about 312 ETFs. If Tesla does get added to the S&P 500 index, even more ETFs will own the stock (Microsoft is in over 700 ETFs) and Tesla could be valued even higher than companies like Walmart, Visa, Johnson & Johnson, and Berkshire. Yet, all these brands generate more revenue and profits than Tesla may ever be able to deliver.

What is fuelling this rally? Robinhood or WFH boredom?

There is growing evidence that WFH boredom has been driving many unsophisticated investors to start playing the market.

Historically, retail investors have not played a major role in individual stocks. According to recent research from Pipe Sandler, this has changed. Since the onset of COVID, we are seeing a high correlation between retail user accounts and stock price changes. Based on the last available data from Robinhood, 10 of the top 100 stocks owned on the Robinhood platform are from Sweet 16 stocks.

A CNBC report on July 13 showed 40,000 Robinhood accounts purchased Tesla Stock and its impact on the performance for that day, as shown in the chart below.

Source: Bloomberg

The Trillion dollar question

History shows us that at some point, valuations do matter, just like trees don't grow to the sky. A 10% correction in the Sweet 16 stocks would require all the other Nasdaq names to rally more than 18% just to break even in terms of performance.

The good news? If investors would remove just 10% out of the Sweet 16 stocks, and allocate those funds somewhere else, we would have almost a trillion dollars to improve overall market health and performance.

Portfolio impact

Our portfolio has much faster growth than the index, and trades at a discount to the index. Our companies delivered strong top-line and bottom-line growth in their latest reported earnings. Our portfolio holdings have a strong balance sheet with over a third of our companies having no debt. As money begins to move out of the Sweet 16 stocks, we believe our names are ideally positioned to benefit from the reallocation.

Have a good weekend!

The Global Alpha Team