January 12, 2021

Quarter Ending December 31, 2020

Year-to-Date Performance	YTD Index	Close
Dow Jones Industrial Average	9.7%	30,604.64
NASDAQ Composite Price	45.0%	12,890.03
Standard & Poor's Averages	18.4%	3,756.31

2020 has been a year that none of us will ever forget. We experienced the worst global pandemic in 100 years; we witnessed the worst economic downturn since the Great Depression of the 1930s; the Federal Reserve sent trillions of dollars directly into the pockets of Americans, civil unrest erupted in major cities all over America, sparking protests globally; and we had one of the wildest presidential elections in our history. Ironically, the negative impact of these events, on the broad investment markets, only lasted about 5 months. Broad-based stock indices experienced some significant volatility during the first six months of 2020; however, almost every stock index finished the year at record levels. The biggest outlier was the NASDAQ finishing the year up a staggering 45%.

The biggest theme investors can take away from 2020 is that, unless you were a mega-cap tech company (or investor), nothing was easy. We have commented on this phenomenon in previous letters, but the design and makeup of broad-based indices (like the S&P 500) heavily influence the performance of a small group of stocks. In 2020, three stocks (Apple, Amazon and Microsoft) accounted for more than 53% of the S&P 500's total return. **Take out the top 30 stocks by market cap and the index fell .03%.**

Famed economist, author, and investor Benjamin Graham is widely known as the "father of value investing". In describing the stock market, Graham explains that in the short run, "the market is like a voting machine, tallying up which firms are popular and unpopular". Many of today's investors are continuing to invest (cast their votes) in the mega-cap companies whose weightings have been the main driver in the outperformance of most indices. At QAM, we continue to believe most of these investors are chasing performance and not paying attention to valuations or fundamentals. As an example, we will look at the performance and fundamentals of one of these mega-cap names, Apple.

Undoubtedly, Apple is a great company and has changed the landscape of daily life and how we communicate. However, over the last 5 years, Apple's revenues are up approximately 5% annually. During that same timeframe, Apple's stock price has rallied a staggering 428% to a valuation of 2.1 trillion dollars. It will be extremely difficult for a company of that size to continue to grow at that rate. We do admit that this is very simplistic analysis. That said, does it make sense to pay 40 times earnings for a company whose revenues are growing at low single digits? We do not believe these valuations are sustainable over the long term.

One of the questions we often get asked is how did we get here? There is not one simple answer. It is a combination of factors that led us to these lofty levels. First, and probably most impactful, has been the massive injection of capital by the Federal Reserve. As mentioned above, the Fed has attempted to stimulate the economy by cutting interest rates close to zero and issuing stimulus checks to businesses and individuals through the Cares Act. The enormous rise in central bank assets has perfectly matched the strong rebound in the mega-cap growth stocks in the last eight months. Second, investors have been looking for investments that can offer a good return. Unfortunately, in most cases, investors look at what has been working and use past investment returns as a guidepost. To compound this issue, savings, treasury, and fixed income rates do not offer very attractive returns. According to Deutsche Bank, only 15% of all global bonds have a yield above 2%, and only 10% above 3%. The repeated rounds of liquidity, interventions, and accommodative policies have trained (or forced) investors to take on more “risk”.

There are talks of additional stimulus coming from the government, which should allow the markets to stay at these lofty levels for a period of time; however, there has been some considerable damage done to the economy that is not being reflected in today’s markets. The total number of Americans on government unemployment benefits ended 2020 just below 20 million (2019 ended with just 2 million on jobless claims). Nearly 12 million renters will owe an average of $5,850 in rent and utilities by January. Last month, 9 million renters said they were behind on rent, according to a Census Bureau. The numbers do not get any better on the corporate side of the spectrum. Bloomberg notes that more large US companies filed for bankruptcy in 2020 than in any year since the 2009 global financial crisis. More importantly, these numbers do not include the numerous small businesses and restaurants that have closed or are struggling to make ends meet.

Moving forward, we do see a silver lining. In the fourth quarter of 2020, stock momentum started to shift from growth to value. Many of the defensive sectors and names that have lagged over the last year started to make some great headway. We don’t believe broad-based investor sentiment will change that quickly; however, a subset of investors are starting to realize there are great investment opportunities if you are willing to put in the work.

Here is wishing you and your families a very safe and prosperous New Year!

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