

July 22, 2016

*Second Quarter 2016 Commentary*

On his podcast “Revisionist History,” Malcolm Gladwell says: “...We’re bad historians. Something happens, we see it, remember it, file it away....If you look back at what you filed away—closely—you discover it’s all wrong.” He reviews and critically examines “an event, a person, an idea...for something we all missed, something we all remember, but misunderstood.” What he discovers is that seemingly unrelated events or ideas do, in fact, help to explain why what we know, our long-held, cherished beliefs, the ideas we erroneously embrace, are wrong.

When we look at the stock market, we remember but misunderstand, misinterpret. Gladwell’s research indicates that we do things one way when there is evidence that there is another proven, more effective way to accomplish the same thing. Rick Barry, an NBA Basketball Hall of Fame player, was one of the best free throw shooters ever. He made 93% of his free throws, missing as few as 10-15 in an entire season. A contemporary super star, LeBron James, might miss 150. What differentiated Barry from other outstanding players and most notably, Barry’s contemporary, Wilt Chamberlain? Barry shot free throws under hand, using the technique derisively called the “granny shot.” Chamberlain, who once scored 100 points in a game in 1962, making 28 of 32 free throws (87%). But Chamberlain, one of the most dominant players ever, wasn’t always good at shooting free throws. Before he started shooting under hand, he was notoriously bad, shooting 40%. When he switched to the under hand shot, he got much better. Then, inexplicably, Chamberlain returned to shooting over hand with disastrous results, “a choice he knew would diminish his stature.” Opponents fouled Wilt expecting he would miss the preponderance of his free throws. This strategy was later described as “hack-a-Shaq,” for Shaquille O’Neal, another outstanding big man. Before erroneously concluding that this is a big man’s problem, remember that Rick Barry is 6’ 8”.

When we look at the stock market, what we remember is often misunderstood. While the market operates with its own rhythms, reasons and rationales, it confuses most investors much of the time. It is very easy to get the market wrong, to be out of step with what’s actually happening, but as Gladwell says, “The past deserves a second chance. We’re fine with the future; the future is in our imagination....The truth is in the past.” Gladwell could have been talking about the stock market. I read recently that securities analysts routinely low-ball quarterly earnings estimates because if they aim high and the company misses, the analysts fear that the subject company will refuse to speak with him or her again...

The second quarter of 2016, after nearly a year of volatile markets, exhibited some unusual action, particularly at the end of the period. The market ended 2015 in an uptrend, but abruptly reversed course on the first session of 2016. An uptrend that reverses course in after a single session is unusual in the extreme. Historically, it takes six months for the market to recover from the type of aggressive correction that took place in January & February. At each low, naysayers, not wishing to look foolish, predicted worse to come. But January 20 marked the first low (1812.29 on the S&P 500) and as is frequently the case, made a second and final lower low on February 11 (1810.10). The market rallied from there until the April 20 high of 2111.05. After a month-long pullback, the S&P 500 marked a high for the quarter at 2113.52 and seemed to be overcoming the recent challenges a little before the six-month time frame. Investors, confident that the quarter would end favorably, were in for an unexpected, negative surprise. The change in psychology, from complacency to fear, was spawned by Britain’s vote to leave the European Union. Caught totally off guard by Brexit, the market sold off hard for two sessions knocking 5.6% from the Dow and 6.8% from the NASDAQ. Select growth stocks were hit much harder. Priceline, for example, dropped 17.6%, or just a little more than 2.58 times, historically consistent with individual stock correction as a multiple of an index’s correction. Believing that the Brexit-induced turmoil would present obstacles to economic growth worldwide, made safe haven plays seem the absolutely right choice. When these types of stocks lead, not growth companies, the trouble is likely to end soon. Value investors dusted off their playbooks predicting that after “melt-up markets,” value was back and would outperform for a long time. But back to what was, not what market observers predicted.

What happened next, on the June 30 trading session, was equally unpredictable and without precedent. Historically, the time required for a market turnaround, for a rally to be confirmed, is a minimum of four sessions. It can happen after as many as ten days. June 30 was unique. The high volume (+18%) advance on the third day of a rally attempt was unprecedented. There was real urgency to the buying on the follow-through day. The leaders, the best performers on and after the follow-through days—growth stocks, among them the much-maligned Amazon and others like Transdigm Under Armour, Google and even former growth leaders like Microsoft. One well-known value investor even criticized Bill Miller for purchasing Amazon a year ago because it was “100 times earnings.” I recently heard another well-known value investor opine that “Stocks don’t deserve to be at this level,” even after indexes have rallied, followed through and ended the quarter only 1.67% below the all-time high on the S&P of 2134.72.. A careful study of market history reveals that no sustained advance has ever launched without a follow-through day. In each cycle the names of leaders are different. However, the metrics that define them are all the same decade after decade. If you study and understand Cisco or Walmart presented as they began their long, very profitable advances, you will know what to look for when the next leader emerges. As Gladwell says that “good ideas have difficulty spreading.” Somehow we are more comfortable with what we know that just isn’t so. To repeat, “the past is where the truth lies.” Gladwell isn’t talking about the stocks or the market, but he certainly could be. If, as an investor, you are a bad historian, you may not lose, but you will never know how much better you could have done. Mark Granovetter, a leading thinker in the area of behavioral economics, asks rhetorically, “Why don’t people try, or don’t try, difficult or problematic or strange things.” Although admittedly not much of an athlete, but a basketball fan, Granovetter taught himself to shoot free throws under hand. When Gladwell asked him why, Granovetter replied, “Because I saw that it worked.” It is not yet clear what stocks will lead in the recently-established new uptrend, but historically they appear by breaking out in the first few weeks of the uptrend and that’s where we were at quarter-end.

The Dow Jones Industrial Average of thirty stocks was only 2.3% below its all-time highs at the quarter end. New highs on the major averages are good because the market backdrop is the condition that sets the stage, creates the necessary pre-conditions for stocks to move higher. Otherwise put, it’s difficult to sail when there is no wind. There seems to be a flavor for many tastes in this market. For instance, with ten-year Treasury around 1.60% and the dividend on many Dow stocks in the 2-3% range, these dividend-payers are attracting yield investors. Curiously, the Dow dividend yield reached a five-year high on February 11. I was surprised to discover the following: the price to book value on the Dow is currently 5.8 times, a five-year high. In the case of this metric, high is bad. The five-year low—low is good-- was 3.97 times and was established two days after the disastrous August 24, 2015 session. Value investors are attracted to stocks that trade at 3 times book value. Also the current price-to-earnings ratio on the Dow is 19.9 times and that is also a five-year high. The five-year low was made on the day after the August 24 debacle and was 12.3 times earnings. Again, value investors typically look to buy when p/e’s are close to ten times. There are many potential explanations for this one of which might be that investment managers recognizing that the market is in an uptrend know the easiest way to get market exposure is by buying indexes. That may be a first step before finding individual equities that offer above average potential returns. This may be one of those years when indexes out pace investment advisors or that both managed funds and indexes do well, but with the market just a few sessions into a new rally, it’s too soon to tell. With the safe havens historically expensive and many growth stocks on the verge of breaking out, it is too early to say whether the value approach or growth strategy will lead. At quarter end what is known is that a favorable wind is blowing. Consistent with past market recoveries this one demonstrated remarkable symmetry and historical consistency by turning around on June 30, exactly six months after the difficulty began, reminding us that “the truth is in the past.”

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