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April 18, 2017
First Quarter 2017: What the Robots Knew

For the quarter, the NASDAQ led, up 9.8%. The S&P 500 rose 5.5%; the Dow lagged, rising 4.6%.

I noted at the end of 2016 that "We may be on the cusp of a new bull run." So far the evidence suggests that that is the case. Strong uptrends favor growth stocks, i.e. they lead. Against the backdrop of a "decade of indifference" toward equities and "hostility by Washington" toward business, it is not surprising that growth companies struggled. Change is in the wind. There is mounting evidence that the "joyless bull market" is behind us. Heightened "animal spirits" are extant; confidence in the economy and the prospects for business are very positive. With the first quarter earnings right around the corner, investors have good reason to be sanguine. Quarter-to-quarter earnings can be variable leading to short-term disappointment as happened in October when Amazon disappointed. The stock dropped 16% over a few weeks, but was trading at a new all-time high at quarter end. Like other portfolio companies, Amazon's earnings expectations-- +48% in '17 and +72% in 18—are well above the hurdle rate of 25% for inclusion in portfolios. In part, prospects look bright because there is a vocal chorus of market prognosticators who are negative—bull markets climb walls of worry.

Portfolio stocks ended 2016 basing, but they took their clues from the NASDAQ's rising trend and started motoring higher early in the quarter. The leading Dow stock was Apple which rose 24% during the quarter. It broke out on January 6 and went on to hit a succession of all-time highs as investors became convinced that the iPhone 8 would be a "super-cycle" for the smart phone pioneer as investors began to embrace risk. Netflix broke out on January 4. It rose 19.4% through March 31. Cloud-play Adobe joined the uptrend when it broke out on January 23; for the quarter, it was up 26.4%. Facebook broke out on January 24 and rose 23.5% by quarter-end. Seagate rose 30.4% to a high of $49.79 before correcting modestly—a normal occurrence. The stock had broken out and gapped up on a strong earnings report on January 25. Then Priceline broke out on February 8, eclipsing $1600 for the first time ever. It rose 21.4% for the quarter. Amazon took its time breaking out in 2017; it accomplished that on February 16. The stock rose 18.2% for the quarter, making a series of all-time new highs in the process. Alibaba broke out on February 22, rising 22% for the quarter. This stock strength was in stark contrast to the 2016 first quarter. As I mentioned in my fourth quarter letter, "Breakouts are key precursors for future outperformance."

Robots, artificial intelligence and the efficacy of passive investments have been in the news lately. Money manager, BlackRock, announced last week that it would layoff analysts and would increase reliance on "robots"—a media term—to improve outcomes. The expectation is that passive investment performance might be enhanced by the use of artificial intelligence. BlackRock also noted that, by relying on robots, it would be able to reduce management fees. What a winning proposition: better performance at a lower cost. It should be noted that in the last ten years, hedge funds have grown their ETFs to nearly $50 billion passive investments, better than two times they held ten years ago. Why? ETFs are easy to redeem. Also, firms like Bridgewater has up to 70% in

ETFs, according to media reports, to make its macro bets apparently eschewing stock picking. There are undoubtedly benefits that large fund managers could realize from the sagacious use of artificial intelligence. After all, sorting through the reams of data and fundamental research is a daunting and expensive job when funds own one hundred or more stocks. However, there have been many times in the past when indexing or using passive vehicles has outperformed the average mutual fund, only to have active managers outperform passives in subsequent periods. Perhaps the greatest potential benefit would be to identify—in advance—when best to pivot to active management or vice-versa. A recent Forbes cover story proclaimed the demise of active management. In the past, when a national magazine has declared a bull market dead, the subsequent experience proved this view wrong. In 2009, many thought equities—and by extension, active management—dead. The period between March 2009 and July 2015 saw the NASDAQ rise 313%. Wall Street has been very good at embracing a particular strategy or approach at precisely the wrong time, perhaps swayed by short term considerations. Merrill Lynch sold its asset management business to BlackRock in March 2006 to free more funds to redeploy in its sizzling mortgage business. The decision nearly bankrupted the firm and drove it into the arms of Bank of America to secure its survival. In the late 1990's, near the end of a ten-year bull market, one large investment bank decided to shutter its commodities business. The contrarian investor and sometimes Columbia professor, Jim Rogers, went long commodities and profited handsomely. He wrote a book, "Hot Commodities," about his experience.

As suggested in last quarter's letter, the significant change in market condition, a nascent condition which likely has legs, marks a significant change in tone and attitude, particularly toward growth equities. Historically, "animal spirits" unleashed has set the stage for the outperformance of individual equities and active management. I doubt it will be different this time.

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