The Polaris Perspective

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Don't Judge a Book by its Cover

A day doesn't go by without a client of Polaris Wealth Advisory Group trying to make a comparison of what we do managing their portfolio to an index like the S&P 500. Several questions should come up. What is an index? What are they used for? Is this an appropriate way for me to assess if my portfolio manager is doing a good job or not for me?

Indexes like the S&P 500 and the Dow Jones Industrial Average (DJIA) were originally created to give investors a barometer to gauge the health of the overall markets. The creators of these indexes picked a diverse group of stocks that they felt represented the market as a whole. They were built to give investors an overall health of the markets. Were they moving up or moving down? They had no other intentions.

Nowadays, there's an index for just about everything. There are indexes for each of the 11 sectors in the S&P 500. There are indexes for large companies, indexes for small companies, indexes for international stocks, indexes for growth companies, indexes for dividend paying companies, bond indexes, commodity indexes, and currency indexes, to name a few.

In the 1960s & 1970s, large institutions started looking to indexes to understand if the portfolio managers managing their endowments and pensions were doing a good job. The idea of benchmarking didn't really take hold in "Main Street" investing until the creation of Morningstar in 1984. Morningstar started out as a tool to rank mutual funds. In 1992, Morningstar created the nine-square Morningstar Style Box™. This created a way to see if mutual funds and money managers were varying from their stated strategy to try to pick up additional performance in other areas of the market that might be in favor at that moment (now known as "style drifting"). Until this time, a mutual fund manager could tell you they would only invest in large dividend paying companies, and the portfolio manager could invest elsewhere for an entire quarter, and then buy dividend paying stocks at the end of the quarter, when they had to report their holdings to the general public. Morningstar's ability to track fund holdings throughout the quarter kept portfolio managers from "window dressing" their portfolios (to make them look like they should, but only at quarter end).

The term benchmark originates from the history of guns and ammunition. In the mid-1800s, guns and ammunition were becoming industrialized. With rifling of a barrel (cutting small, clockwise grooving the length of the barrel), the rifle was born. Production of ammunition as a self-contained cartridge replaced the manual loading of black-powder and bullet. To understand the precision of a rifle, they would fix a rifle to a heavy work "bench," making it possible to fire several identical shots at a target. The bullets left a "mark" in the target. The manufacturer would measure the spread in the marks to understand the accuracy of the rifle, leading to the phrase "benchmark."

The concept of benchmarking your investment advisor to an index or a combination of indexes makes complete sense on the surface. The biggest issue has come down to the constitution and makeup of the indexes themselves.

As we stated earlier, indexes were created to give investors a general idea about how a particular area of the market was performing, or in the case of the Dow Jones Industrial Average or the S&P 500, the overall market as a whole. Did you know that both indexes have weighted averages of their holdings? This means that all stocks in the indexes are not treated equally.

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The DJIA is made up of 30 companies, but each company doesn't represent 3.33% of the index. As of August 14, 2020, Apple is 11.29% of the index. The other top five are: United Health (7.95%), Home Depot (6.89%), Microsoft (5.13%), and Goldman Sachs (5.11%).

All indexes have their flaws. For example, Microsoft is five times bigger than United Health, yet United Health has a much greater weighting in this index. Goldman Sachs, which is more than 15 times smaller than Microsoft has about the same weighting. Pfizer, the smallest weighted company in the DJIA (0.93%), is almost three times bigger than Goldman Sachs, yet it weighs more than five times less in the index. These comments should raise several questions. Should you look at an index of 30 companies as a proper representation of the broad-based market which has thousands of companies? Is the method in which the DJIA weighted flawed? If you want to have a diversified portfolio, should over 11% of your portfolio be in one stock? I'd say that the DJIA is no longer a relevant way of benchmarking your portfolio.

No.	Stock	% Weight in the index
1	Apple	11.29
2	UnitedHealth Group	7.95
3	Home Depot	6.89
4	Microsoft	5.13
5	Goldman Sachs	5.11
6	McDonalds	5.08
7	Visa A	4.83
8	Boeing	4.37
9	3M	4.08
10	Johnson & Johnson	3.64
11	Caterpillar	3.44
12	Procter & Gamble	3.32
13	Walmart	3.26
14	Disney	3.21
15	IBM	3.08
16	Travelers	2.91
17	Nike B	2.61
18	JPMorgan Chase	2.51
19	American Express	2.47
20	Chevron	2.22
21	Merck	2.05
22	Raytheon Technologies	1.56
23	Verizon Communications	1.44
24	Intel	1.20
25	Coca-Cola	1.19
26	Dow	1.10
27	ExxonMobil	1.06
28	Cisco Systems	1.04
29	Walgreens Boots Alliance	1.03
30	Pfizer	0.93

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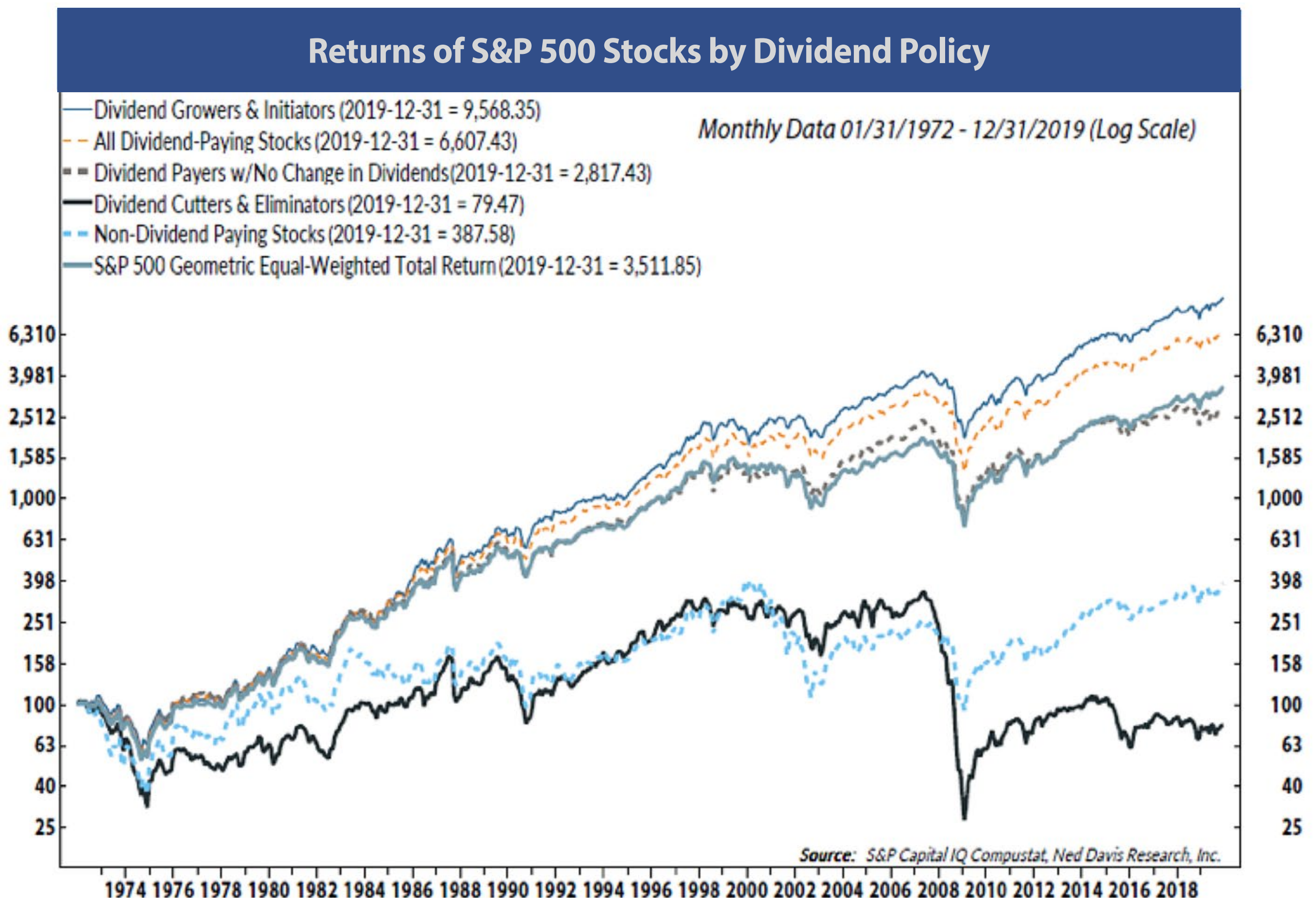
Let's move to the most broadly used benchmark, the S&P 500 (SPX). You can't argue that it has a much larger sample size than the DJIA: 500 companies vs. 30. That's a compelling argument that the S&P 500 as an index should make a better benchmark. Here's the issue. The top five companies in the S&P 500 represent 21.65% of the total index, and the top 10 companies measure approximately 29% of the index. The top five companies as of August 14, 2020 are Microsoft (6%), Apple (5.78%), Amazon (4.49%), Google (3.26%), and Facebook (2.12%). Our Polaris investment committee is calling these companies the "Fab Five." We have not seen mega-cap stocks dominate the weighting of the S&P 500 to this magnitude in 40 years. Is this a good barometer to measure what is going on in the broad-based markets? I'd argue no.

There is an equal weight S&P 500 index (RSP). Since its creation in 2002, it has slightly outperformed the weighted S&P 500 by about 20%. Over the last year, SPX has outperformed RSP by over 10% and over 23 ½% over the last five years. This is due to a few things. First, large companies have doubled the performance of small companies over the past five years (61.26% vs. 30.11%). The other reason is growth companies have dominated value companies over the past five years. Historically, dividend paying companies (commonly referred to as value companies) significantly outperform growth companies (see below).



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As you can see, companies that pay a dividend have done better than companies that don't pay dividends. Those raising their dividend do better than those who leave their dividend alone. It's been that way for the past 50 years, but it does go in waves. We are seeing a historic divergence. Since the beginning of 2018, the Russell 1000 Value price return is -5.36%. The Russell 1000 Growth appreciated more than 50% during the same time period. We have not seen this kind of return disparity since just before the Dot Com Bubble in 1999.

Many indexes have become skewed and are no longer representative of the markets for which they were supposed to provide insight to the broad-based health of the market. I would argue that the Dow Jones Industrial Average and the S&P 500 (weighted average) are no longer representative of the health and performance of the markets as a whole. When the top ten holdings in the S&P 500 represent almost 30% of the market, there are flaws in the system. Just remember, you are running your own race. You need to compare your investments to a proper index that is representative of what you are trying to accomplish with your overall portfolio.

Where do things go from here? The only way that the stock market goes higher is if there is a change in leadership. As I mentioned, the Russell 1000 Growth has dominated the Russell 1000 Value. Historically, value outperforms growth about 60% of the time and with less risk. The Russell 1000 Growth index is dominated by our "Fab Five," which represents 35.62% of that index, with Apple at 11.63%, Microsoft at 9.68%, Amazon at 8.26%, Facebook at 3.88%, and Google Cl A at 2.17% of the index.

This index, as well as the DJIA and S&P 500, are completely reliant on their concentrated holdings to continue to outperform the average company. These stocks have all had a major run in their stock price. The Fab Five's trailing 12-month price-to-earnings multiples are almost twice the S&P 500 (ex-Fab Five) at 36 & 19 respectively.

Some are saying that this feels like the late 90s all over again. I don't think that it feels like the late 90s. The Dot Com bust was caused by greed. There were companies going public, making the founders instantly rich and lining the pockets of the investment banks bringing them public. Many of these companies that were going public in the late 90s had negative earnings, flawed business models, and no leadership to get them out of their predicament. It was not hard for analysts to see that these firms would eventually go bankrupt or would have to sell to their competitors. In March of 2000, Barron's Magazine came out with an article citing there were over 200 publicly traded companies that didn't have enough cash to make it through the year. This was the start of the Dot Com bubble bursting.

Our Fab Five companies have plenty of cash. They aren't going out of business. There are two issues with them all. First, they are all overvalued. There is a mathematical term called "reversion to the mean." This means that if something is well above average, it will drop to become average again. This will happen. It's not a question of if… it's a question of when. The second issue is that it's really hard for the largest companies in the world to continue to grow at an above average trajectory. How many additional phones can Apple sell? I know they are trying to diversify their business model, but they are so large, will any new product or service move the needle?

Let's take a history lesson from the 1990s, since so many people are comparing this market with the 90s. The top 10 companies in the world in 1999 were Microsoft, GE, Cisco, Exxon, Walmart, Intel, NTT, Lucent, Nokia, and BP. Let's say you bought an equal share in each of the ten stocks at the end of 1999. You built this concentrated portfolio because the ten companies are the industry leaders and best of breed companies. Had you made this investment, you'd be sorely disappointed with the results. You would have lost approximately 12% of the value of your portfolio over the past 20 years, while the S&P 500 is up almost 130% during the same time period.

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Largest 10 Companies in 1999

Rank	Company	Value
1	Microsoft	$583B
2	GE	$504B
3	Cisco	$353B
4	Exxon	$283B
5	Walmart	$283B
6	Intel	$271B
7	NTT	$262B
8	Lucent	$252B
9	Nokia	$197B
10	BP	$196B

Source: Yahoo Finance

Only one stock on this list outperformed the S&P 500 from December 31, 1999 to the present, and that was Microsoft. 60% of the top 10 largest firms are worth less today than they were at the end of 1999.

Let's focus our thoughts about where things could go from here. I've listed the top 10 largest companies in the world today in the chart below. These are the stocks that are temporarily driving the stock market indexes higher, because they represent such a high percentage of the two major indexes. They are all considered fantastic companies, leaders in their industry. Will they all continue to outperform the general market? I would hazard a guess that this group of stocks will significantly underperform the S&P 500 over the next 20 years.

Largest 10 Companies in 2020

Rank	Company	Value
1	Apple	$1.965T
2	Microsoft	$1.581T
3	Amazon	$1.577T
4	Google	$1.024T
5	Bershire Hathaway	$1.006T
6	Facebook	$744.2B
7	Alibaba	$693.5B
8	Tencent	$626.1B
9	Visa	$431.7B
10	J&J	$390.3B

Source: Yahoo Finance

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Probably the biggest issue I have with benchmarking is clients often don't compare their Polaris strategy to the correct benchmark. They either don't remember what was told to them as they became clients, or most likely, they simply forgot as time went by. It is very easy to want to compare yourself to the DJIA or the S&P 500, because they are the most widely discussed indexes in the media. It's a completely understandable mistake. We've had clients say, "I don't care where you invest. Buy companies that pay dividends or buy ones that don't. It doesn't matter to me as long as you are keeping up with the S&P 500." Issues arise when these clients are invested in one of our five strategies which require Polaris to exclusively invest in large dividend paying stocks and when growth companies are outperforming value companies. We are obligated to run our strategies as we've described in our strategy brochures and in our Investment Management Agreement. Your equity benchmark for these strategies is the Russell 1000 Value, not the S&P 500. The Russell 1000 Value is down 9.72% for the year, as of August 14th.

I've also had clients who are unwilling to take the risk of being 100% invested in stocks, wanting to compare their returns with the S&P 500. That's the equivalent of telling me that you only want to go the speed limit on the highway and then want to compare our progress to our destination with someone who is driving 100 mph on the highway. They might look like they are making much better progress, but at what risk? They risk getting a ticket, and they also risk getting into an accident. There will be times that cars will pass us! Just keep in mind that we are running our own race.

If you want some growth stocks in your portfolio, please reach out to your advisor at Polaris. We do run three strategies that can buy growth companies. We will have a direct and honest discussion of whether or not our growth strategies fit into your financial plan. If they do, we'll add a strategy or two to your portfolio.

I am very proud of our portfolio management team and the work that we've done this year. All eight stock strategies are beating their benchmark, net of cost and fees, as of Friday's (August 14) close. Almost all of our stock strategies, even the ones compared to the Russell 1000 Value (that is down 9.72%), are up for the year. There are not many firms that can make the same claim.

As always, we will keep a vigilant eye on the markets and position our strategies in your portfolios according to the risk found through our research. We will keep you informed of our decisions in our quarterly updates as well as our monthly *Polaris Perspective* articles.

As always, if you have any questions or comments, please feel free to reach out to me.

Sincerely,

Jeffrey J. Powell
Managing Partner & Chief Investment Officer

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