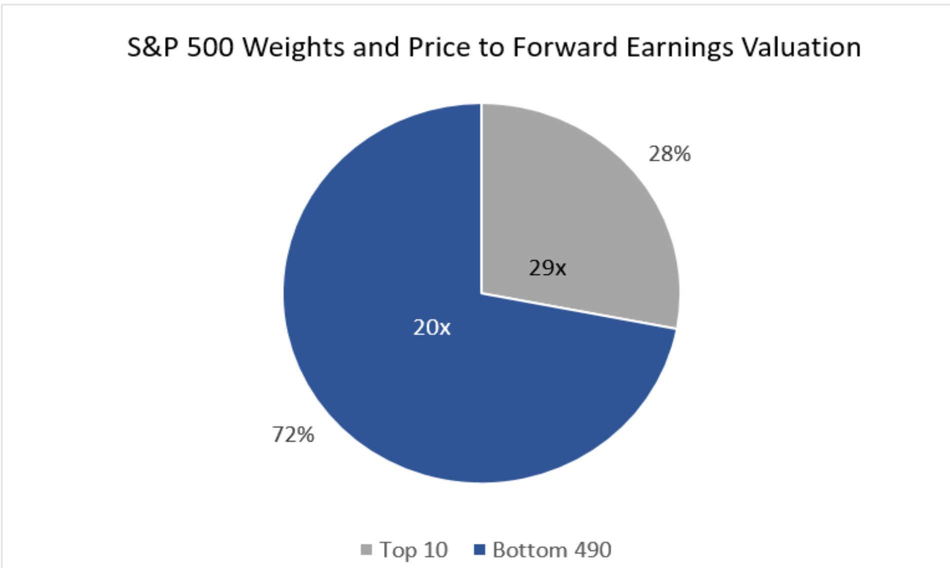
Defensive Investing – 20 Years Later

"If we assume that it is the habit of the market to overvalue common stocks which have been showing excellent growth or are glamorous for some other reason, it is logical to expect that it will undervalue – relatively, at least – companies that are out of favor because of unsatisfactory developments of a temporary nature. This may be set down as a fundamental law of the stock market, and it suggests an investment approach that should be both conservative and promising."

– Benjamin Graham, *The Intelligent Investor*



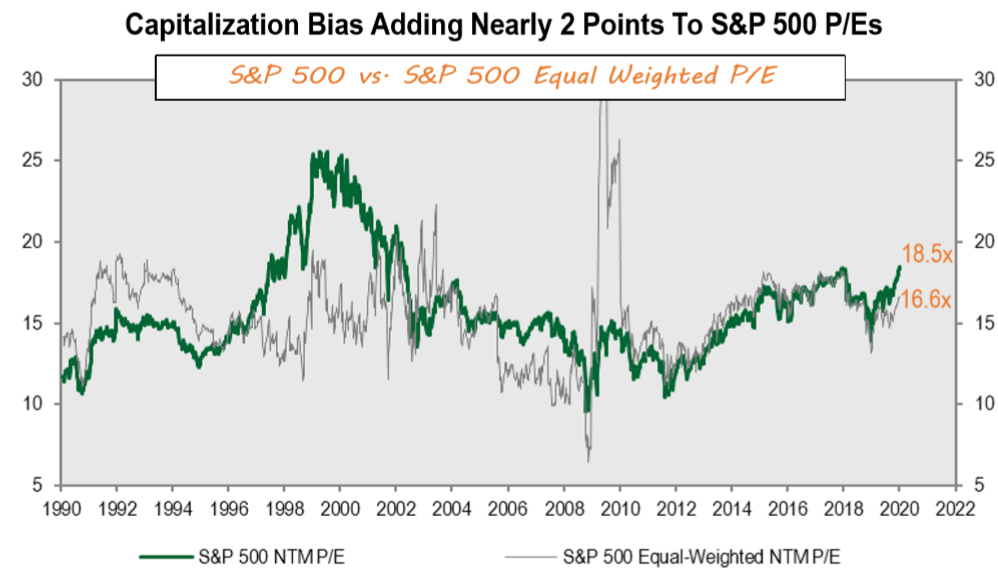
Source: (Weights) Standard & Poor's (01.29.2021), (Valuation) Bloomberg

When we closed the book on 2020, it marked the 20th anniversary of three Sterling Equity Opportunity Group investment strategies and the investment process founded by George Shipp. The quotation above is from one of the first investor communications dated 20 years ago, titled "Defensive Investing." Notably, while many factors can influence the stock market, certain principles seem to stand the test of time. The dynamics of market participants paying rich valuations for fashionable stocks are evident in 2021, just as they were when Benjamin Graham wrote his book on value investing in 1949 and during our discussions on the attractiveness of seeking a "margin of safety" during 1Q 2001.Then as now, as active managers, we believe we can take advantage of opportunities in stocks that may be "out of favor" now, but may provide promising future returns.

Bloomberg noted this month that trillions of dollars are pouring into market capitalization-weighted index funds, and that, as a team of researchers from Michigan State, the London School of Economics, and California-Irvine noted, fund flows over the past 20 years may have disproportionately increased the price of the largest stocks in the market relative to smaller-cap companies.[1]

In this study, researchers measured flows into the S&P 500® Index over the past two decades, and, contemporaneous with the flows, observed the shift of the index toward greater concentration in its largest stocks. The Wall Street Journal used the example of the "Tesla test," a stock that joined the S&P 500 to become the sixth-largest stock in the index in December 2020.

[1] *"Tracking Biased Weights: Asset Pricing Implications of Value-Weighted Indexing," Jaing, Vayanos, & Zheng, December 2020.*



Source: Cornerstone Macro

If one believes this stock was already overvalued, then joining the S&P 500 made the valuation more extreme, as its market cap increased by $200 billion just a few weeks after joining the index. The authors note that the resulting fund flows and momentum appear to outweigh classic capital asset pricing models (CAPM).

We would note that these disparities appear to be impacting relative valuations as, per month end, the top ten companies (ranked by weight) in the S&P 500 Index were trading at 29x their forward earnings estimate, while the other 490 companies were trading at over a 30% discount. The Cornerstone Macro chart above appears to support this disparity as well. Just as when we started 20 years ago, we remain committed to the same investment approach that served us well over that timeframe, as we seek to take advantage of these opportunities to source promising investments for our clients.

As always, thank you for your interest and trust in managing your investments.

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