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The Vampire Market

Folklore holds that vampires live off the blood of others by sinking their fangs into the flesh of their victims. A group of stocks known as the FANGs (Facebook, Amazon, Netflix, and Google – now Alphabet) have infused the market with life this year, with the first two returning, as we write this, approximately 30% and the latter two about 20%. This quartet has carried the torch for the growth group, though there have certainly been other growth stocks that have equaled or exceeded the FANGs' 2017 returns. In fact, it has been quite a year so far for growth stocks (generally defined as companies that have grown their sales or earnings at above-average rates), which have handily outperformed the value category (generally defined as companies trading at below-average valuations). Of course this is simply a reversal of what happened in 2016 when value outpaced growth by a wide margin, which was a reversal of 2015 when growth won the battle. These internal shifts are easy to miss if one is focused on the level of a broad index, which in recent years has risen steadily.

Many market watchers have understandably expressed concern that the market is being dominated to an extreme degree by the FANGs. Empirical Research Partners did some work on that subject, looking at their valuation, profitability, correlation of returns, the extent to which their returns differ from those of the market, share ownership trends, and other measures. Interestingly, and contrary to conventional wisdom, they concluded that the bulk of the evidence indicates the run in the stocks is not excessive. That doesn't mean there aren't risks with each of the stocks, but their work should allay some fears of being bitten.

Growth returned to favor this year as concerns about the economy resurfaced. That may sound counterintuitive, but growth stocks tend to outperform when the economic outlook is deteriorating because their superior growth is worth more in a time of slow economic growth, whereas an improving economic outlook lifts all boats, not just the crème de la crème.

The other side of the strength in growth is that value stocks have lagged in 2017. In fact, Empirical tells us that the cheapest fifth of the market just had its 9^{th} worst half-year performance in the last 65 years. Of course, we don't know how long this trend will last, nor does anyone else, and rather than try to time it, we prefer to stick to our strategy of looking for businesses with a combination of good fundamentals and reasonable valuations. Sometimes this results in our purchasing companies with excellent growth prospects and sometimes it leads us to ones whose opportunities are less obvious. We believe that flexibility enhances returns.

Our accounts have performed about in-line with the market for the first two quarters, though we always emphasize the long-term numbers. We have reduced our position in the financial stocks as the risk-reward worsened slightly in late 2016, but we maintain a healthy exposure there, which has been a drag on performance so far this year, after a strong 2016. That said, late in the second quarter the bank stocks performed well, as interest rates inched upward and the companies passed their Fed-mandated "stress tests" with flying colors, leading to promises of robust dividend increases and share buybacks.

The other story of the first half, and particularly the second quarter, was the lack of volatility in the market. At one point the S&P 500 went 15 days in a row without moving up or down by more than half a percent, the longest such streak since 1969, according to *The Wall Street Journal*. The volatility index, or VIX, has been hovering at or near all-time lows. On the margin this relative calm makes us more circumspect. We know volatility will return at some point; we just don’t know when. In the meantime we have been pulling in our horns a bit, reducing our risk, so that we are better prepared when the next storm hits.

Best regards,

Mark

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