Morris Capital Advisors, LLC

Investment Commentary
June 30, 2018

Brand Name Stocks

One of the basic tenets of effective marketing is the creation of a "brand". An entire industry is dedicated to building brand images for companies and defending them from imitators and competitors. A strategically managed brand can create perceived quality and emotional attachment, generating added value for a company or product, and pricing power. Creating a brand is generally a carefully crafted process, but there are times that it can take on a life of its own.

The stock market seems to have some internal "branding" going on, as well. Prompted by heightened attention from some in the financial media, a group of stocks have been tagged in a way that provides instantaneous recognition. Known at the "FAANG's", the group includes Facebook, Amazon, Apple, Netflix, and Google. They have drawn so much attention partly due to the fact that many consider them disruptive technology companies that are transforming their industry and others. Each of the group has been an innovator in their industry, creating dominate market share in the process. That industry dominance, combined with strong growth and high profit margins, have created substantial market capitalizations. If you add Microsoft to the group, these few stocks comprise more than 16% of the S&P 500 index and more than 28% of the Russell 1000 Growth Index.

There is a growing body of research focused on the market dominance of this group. Studies by Jim Bianco and Bank of America have concluded that these stocks are responsible for all of the market return since November 2017. Bianco has the group up 2.66% over that time compared to the S&P 500 index return of 2.26%, meaning that the remaining 494 stocks on the index collectively declined by 0.40%. The BofA study has the top 10 stocks on the index contributing even more, accounting for 122% of the S&P 500 index return since the beginning of this year. Somewhat troubling is the fact that several of these stocks, notably Amazon and Netflix, trade at extremely high price to earnings ratios, even when taking their higher growth rates into account. Those extended valuation measures create an additional level of risk over and above the risk associated with their concentrated weightings in the index.

This branding and market dominance is not just limited to US stocks. Arcus research analyst Peter Tasker adds the "BATS" to the "FAANG's" with the addition of Baidu, Alibaba, Tencent, and Samsung, another group with dominate weightings in their respective indices. Together they have a market cap approaching the size of the Japanese stock market, the third-largest in the world, and have driven returns on the global indices, pushing the MSCI World Stock Index up 1.61%, while every other stock on the index subtracted 1.07% from the index return.

It is easy for investors to become enamored with these brand name stocks as they continue to perform well. Their dominant market capitalizations insure that they will continue to receive a steady flow of new investor dollars from index investors, despite some lofty valuations. But the outsized contribution to performance by a narrow group of stocks often precedes a market top. We have seen this happen before, just think back to the "Nifty Fifty" or the "dot coms", and experience tells us that it does not end well.

Students of market history know that the reliance on a narrow group of stocks cannot be sustained over a long period of time. Growth and profitability can be difficult to sustain as new innovators arise, or as more traditional competitors adapt. It is interesting to note that the recent entry of Amazon into some industries has been met with great fanfare, but at the same time existing industry players have rolled out initiatives directly targeted at the Amazon offering. This robust competitiveness has the potential to drive long-term market performance beyond the brand name stocks themselves.

Our focus is, as it has always been, is to search for companies that have the potential for long-term sustainable growth with valuation levels that provide investors with a reasonable return expectation. Our diversified portfolios include representative weightings in the brand-name stocks combined with holdings beyond the brand that can contribute to long-term sustainable returns.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

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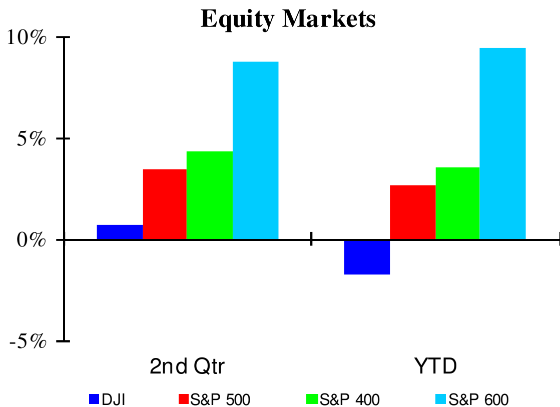
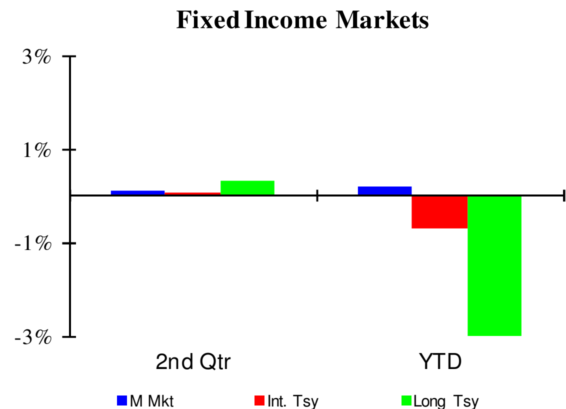
Market Summary
June 30, 2018





In the early part of 2018's second quarter, equity markets traded in a narrow range as investors assessed earnings reports, and kept a watchful eye as 10 year bond yields threatened several times to breach the 3.0% level. Markets also traded around the on-again, off-again global trade war threatened by the Trump administration.

In mid-May, economic reports from Europe and China indicated a marked slowdown in growth outside the U.S., which served to reinforce the risks to global trade from mounting protectionism. The dollar rallied sharply, as investors worldwide began seeking safe-haven shelter, which in turn sparked a rally in fixed income securities. Declining yields in turn encouraged a relief rally in U.S. equities, as U.S.-domiciled earnings growth was increasingly viewed as a relatively safe bet. Notably, smaller-cap stocks rallied sharply, as smaller companies tend to have relatively low exposure to non-US revenues.

For the quarter, small cap companies outperformed large cap stocks, and growth oriented equities outperformed value stocks.

Interest rates in medium-term securities were quite volatile during the second quarter of 2018, but ended up largely unchanged from March 2018 levels. The ten-year yield attempted several times earlier in the quarter to breach the 3.0% level, but evidence of a spreading global slowdown, and downside risk to oil prices, contributed to a sharp rally beginning in mid-May. By quarter's end interest rates had nearly retraced their moves, with levels largely unchanged and generating modestly positive total returns.

However, the yield curve continued to flatten, leading market strategists to increasingly predict that the yield curve may invert if the Fed follows through with early promises to raise short-term rates at least one more time. An "inverted" yield curve, whereby short rates are higher than yields on longer-term maturities, is viewed by many investors as a reliable precursor to recession.