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YEAR END REVIEW

WHY BIG STOCKS WILL LEAD THE MARKET

The events of 2020 accelerated changes in the stock market that were already underway. The long-standing belief that small stocks outperform large stocks over the long term is now being called into question. The past year has reinforced the case for investing in big stocks.

Small Stock Theory is under attack due to a sea change in the dynamics between big and small stocks. Historically, small stocks have provided higher returns than big stocks according to research findings at the University of Chicago in the late 1970s. Rolf Banz, a researcher at Chicago, explained this phenomenon as follows; 'it works like aspirin, but no one knows why".

We have also studied small stock dynamics and found that small stock superiority manifests itself when small company profits grow faster than overall corporate profits. These findings were published in an article I wrote in Pensions & Investment Age in 1984. The big stock dominated S&P 500 Index has now beaten the S&P Small Cap Index in four of the past five years. In addition, the S&P 500 Index now leads the Small Cap Index over the past 15 years.

Our recent research reveals that there has been a profound shift in the economy that favors big companies and threatens the historic dominance of small stocks. In 1980, the top 5 stocks in the S&P 500 Index by market capitalization were IBM, AT&T, Standard Oil of Indiana and Schlumberger. These stocks sold at an average P/E ratio of 12 at that time. As the lone tech stock in this group, IBM represented an approximate 5% weight in the index.

At the end of 2020, the top 5 stocks in the S&P 500 Index were all tech stocks: Apple, Microsoft, Amazon, Facebook and Google. The top 5 companies comprise 22% of overall S&P weighting, the highest ever by the top 5 stocks. Trailing 12-month earnings growth of 42% for these five stocks is the highest on record for non-cyclical companies and their current P/E of 45x is significantly higher than the market norm of 16x earnings.

Major differences are apparent between the economies of 1980 and 2020. Most companies in 1980 were industrial in nature and domestic in scope. In acknowledgement of the heavy influence of industrial companies in economic activity, the S&P 400 in this era was comprised solely by industrial stocks.

Globalization has dramatically altered both the economy and the stock market. Whereas business activities were principally domestic in scope in the past, globalization offers an opportunity that is five times greater than the domestic market. Secondly, tech companies possess the capability to ramp up sales and profits faster than ever before. For example, it took Apple 31 years to reach a market cap of $100 billion. DoorDash which just came public did this in just 7 years.

Forty years ago, some small companies starting from a small sales base were able to generate sales and profits growth up to 30-40% each year. Today, large cap tech companies with global reach can generate growth rates of 100%.

Our Golden Eagle Growth strategy is geared to invest in the world's fastest growing companies. More than half of its holdings are large cap stocks, and ten of its twenty-five holdings grew their earnings by 100% or more in the latest quarter. For the first time in stock market history, big companies are exhibiting faster growth than smaller companies. Thus, it comes as no surprise that the large stock S&P 500 Index has been running ahead of the Small Cap Index.

Robert Zuccaro, CFA
Chief Investment Officer

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