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Bad Breadth Always Rings Twice

It probably is not apropos of the season, but we will confess a secret: We are huge fans of film noir with its hardboiled dialog, cynical worldview, corruption and the rotten characters. Whether it is Lee Marvin throwing scalding coffee in the face of Gloria Grahame in *The Big Heat*, siren Barbara Stanwyck luring Fred McMurray (!) into murder in *Double Indemnity* or revengeful Humphrey Bogart undergoing creepy backroom plastic surgery in *Dark Passage*, noir films provide an antidote to the civics textbook view of the world we are supposed to have, a reminder that things are not always what they seem on the surface.

Current financial markets remind us of 1952's no-name-cast gem *The Narrow Margin* (and its good but little-seen 1990 remake with Gene Hackman), in which a police officer protects a distasteful but willing to testify witness to Mob crimes. The narrowness of the current market is exemplified, according to *The Financial Times*, by the acronym "Fang," standing for Facebook, Amazon, Netflix and Google. The stocks of those four companies in early December were up more than 62 percent in 2015; the other 496 stocks in the S&P 500 index were down. Ned Davis Research shows similar results looking at the "Nifty Nine" adding Priceline, Ebay, Starbucks, Microsoft and Salesforce to the Fang stocks, and the "Terrific Ten" if you wish to add Nike. There are two tiers to the U.S. stock market. A very few stocks are rising, but their success masks a substantial broad-based weakness in the overall market. This is not good for market health.

Why? There always are some stocks doing better than others, but when market breadth, or the difference between the number of rising stocks and falling stocks reaches an extreme, it is a bad sign. In *The Narrow Margin*, the protagonist policeman compares the witness he protects to the daily special in a greasy-spoon diner: "Cheap, flashy. Strictly poison under the gravy." Replace the first word with "expensive" and you have a succinct description of the dangers of a two-tier market. Investor attention focuses on a few stocks that get bid up to dangerous valuations while the rest of the market struggles to make any headway, with many individual stocks entering private bear markets.

Healthy, rising markets are broad advances, covering a wide swath of economic sectors, industry groups and stocks. In contrast, when a few stocks or industries drive widely-followed indexes to new highs while the prices of most stocks deteriorate, an important market top often follows. For example, the "nifty fifty" market of the early 1970s saw a few dozen blue chip growth stocks selling at very high multiples of earnings while the average stock languished. The 1973-74 bear market that followed saw a 45 percent S&P 500 decline. Many of the favored, high-quality companies fell 80 or 90 percent, the classic example of why great companies are not always great investments.

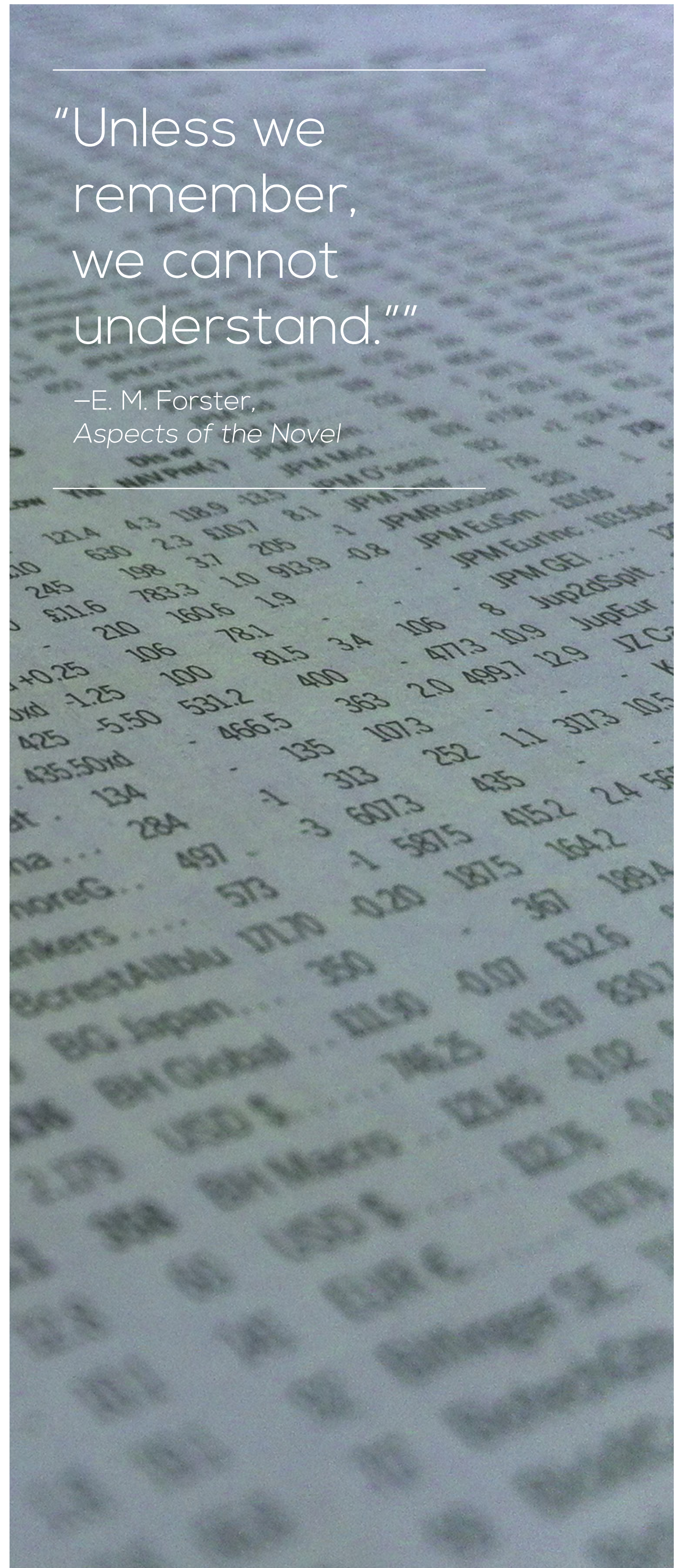
More recently, during the technology bubble of the late 1990s, the average stock peaked in 1998 but the market indexes continued to hit new highs for two more years, driven by a

small number of technology stocks. The subsequent 2000-2002 bear market shaved 45 percent off the S&P 500 and devastated to an even greater extent, or made extinct, the technology and telecomm stocks that previously were the market favorites. Speculative fervor focused upon residential real estate a decade ago, and novel securities that were derivatives of the real estate market. A few financial and real estate companies were market darlings then, hiding the struggles of the overall market. The global financial crisis that followed cut the S&P 500 price by more than 55 percent. Many financial stocks went down far more. Some ceased to exist.

There is an insidious behavioral aspect of these examples. Everyone loves a winner, and investor attention is most easily drawn to whatever slice of the market has been doing the best. The stocks doing the best, though, have gone up the most, and therefore probably sell at the worst valuation levels. Buying expensive stocks leads to bad future returns, consistently. It really is the expensiveness of prices that is the poison beneath that appetizing gravy of good trailing stock returns.

The bad returns do not necessarily have anything to do with the underlying reality of corporate fundamentals. The "nifty fifty" companies in the early 1970s truly were great companies. Their stocks were just overpriced. The technologies introduced in the boom in the late 1990s truly were transformational. The related stocks were just fantastically expensive. The winners were the consumers of the products and services of the companies in the booms, not their investors. We are active customers of most of the companies in the Terrific Ten. Recently their stocks were selling at a sky-high 49 times earnings and 5.5 times sales, by both measures more than double the valuation of the overall market. The Fang stocks are even more expensive, ending November at a price to earnings multiple of 59. None of this guarantees that we have passed a market high or that a bear market necessarily will start tomorrow, next quarter or next year. It is definitely a warning sign, though, that investors should heed.

Fang is a great nickname for a film noir heavy, but it could be terrible for investor returns. Things may not be what they seem below the surface. Narrowness of market breadth and caviar prices for the few favored stocks leaves little safety if anything goes wrong. It may be time to take a hardboiled, cynical appraisal of actual market values beneath the flashy returns of the privileged stocks enthralling investor attentions. To borrow a tagline from the 1990 movie remake, "sometimes the difference between life and death can be a narrow margin."



"Unless we remember, we cannot understand.""

—E. M. Forster,
Aspects of the Novel