COLUMBIA THREADNEEDLE INVESTMENTS

TOO FEW EGGS: INDEX CONCENTRATION, STYLE AND PORTFOLIO RISK

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- *Market activity this year has further emphasized the dispersion in performance for growth and value.*
- *Third quarter performance again saw once reliable drivers of value overlooked in favor of growth and momentum factors.*
- *The strong performance of a narrow segment of the market has created problems for diversified investors looking to avoid concentration risk.*
- *But the market activity of November 9 shows how quickly perceptions can shift. Investors should remain aware of unintended risk exposures and the influence of recent trends on decision-making.*

Overview

Following the coronavirus outbreak and subsequent shutdowns, a sharp, V-shaped recovery for domestic equity markets seemed improbable based on prior major drawdowns (Exhibit 1). Yet we have seen a remarkable recovery in equities.

Exhibit 1: Top 10 drawdowns for the S&P 500 Index since World War II

Rank	Name	From date	Trough date	Recovery date	Drawdown depth	Duration (months)	From peak to trough (months)	From trough to recovery (months)
1	The Great Recession	10/10/07	03/09/09	03/28/13	-56.8%	65.5	16.9	48.6
2	Oil Embargo	01/12/73	10/03/74	07/17/80	-48.2%	90.4	20.8	69.6
3	The Dotcom Bust	03/27/00	10/09/02	02/14/07	-46.5%	82.4	30.3	52.1
4	Vietnam War	12/02/68	05/26/70	03/06/72	-36.1%	39.0	17.6	21.5
5	The Great Lockdown	02/20/20	03/23/20	08/18/20	-33.9%	6.0	1.1	4.9
6	Black Monday	08/26/87	12/04/87	07/26/89	-33.5%	23.1	3.4	19.7
7	Post War Blues	05/31/46	06/13/49	06/09/50	-29.6%	48.0	36.2	11.8
8	Kennedy Slide	12/13/61	06/26/62	09/03/63	-28.0%	20.7	6.4	14.2
9	The Great Inflation	12/01/80	08/12/82	11/03/82	-27.1%	23.2	20.5	2.8
10	The Credit Crunch of 1966	02/10/66	10/07/66	05/04/67	-22.2%	14.8	8.0	6.8

Source: Bloomberg, Columbia Threadneedle Investments. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index.

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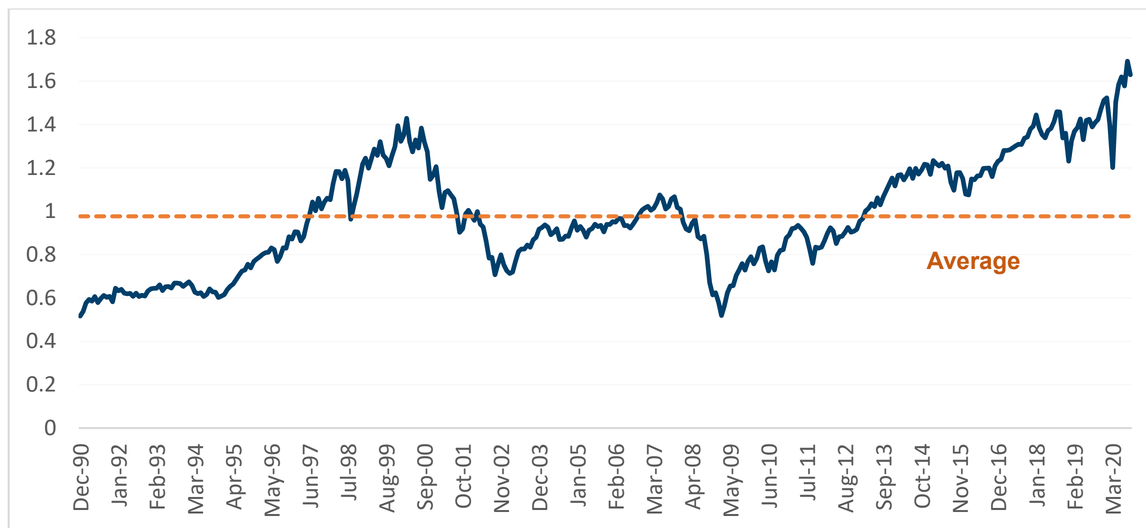
While current equity prices seem to signal a robust recovery, that same level of optimism is still absent from some measures of economic health. The unemployment rate remains at a historically high level and, despite a strong quarter of growth, the implied GDP growth rate as projected by the New York Federal Reserve Weekly Economic Index is still -3.12%, year-over-year as of October 31.

Why, then, is the stock market reflecting a far different sentiment than what is being realized in the economy? A common argument is that markets are forward-looking while many of the referenced economic indicators (for instance, GDP and unemployment rates) are backward-looking measures. Investors typically look to where the economy is heading rather than what has already happened, hence, the present rally in equities reflects a forward-looking sentiment of eventual normalcy.

Nevertheless, the stock market is not totally divorced from the fundamentals and economy that underlie its constituents. In theory, the growth of the stock market should reflect that of the underlying economy. As shown in Exhibit 2, the average stock market-to-GDP ratio during the past three decades is around one.

Exhibit 2: Wilshire 5000 Total Market Index / GDP Ratio

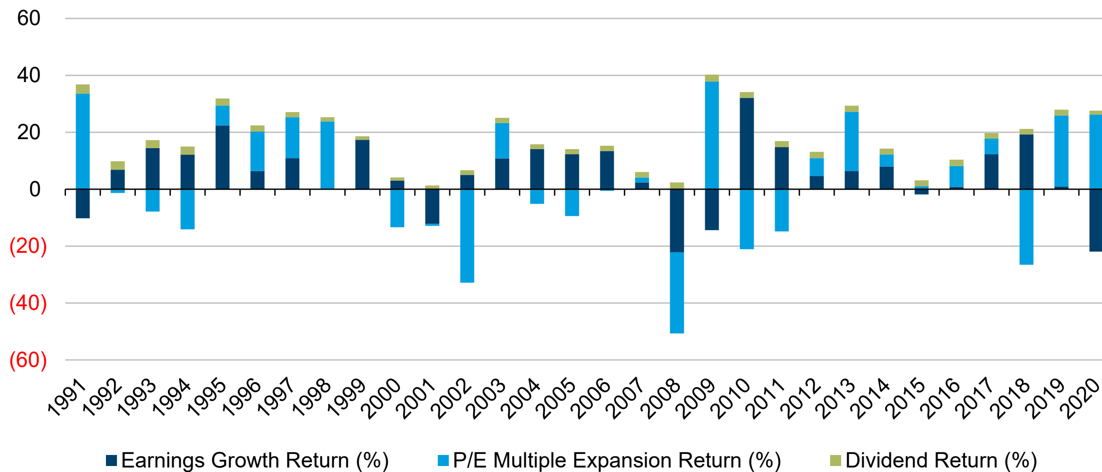


Source: Bloomberg, Columbia Threadneedle Investments. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index. Data through October 31, 2020.

It fell below that level after the bursting of the tech bubble in 2001 and the housing bubble in 2008-2009, when the stock market reached new highs. The barometer has been rising steadily since the global financial crisis and surged to a record level in the third quarter, highlighting the striking divide between a roaring market and a depressed economy. Even compared with the pre-COVID-19 GDP level, the ratio stays at 1.65, which is 2.5 standard deviations above its historical average. Therefore, the divide between market and economic performance has widened further, largely due to unprecedented fiscal and monetary actions.

Indeed, the sea of liquidity provided by the U.S. Federal Reserve, along with a lower discount rate have clearly helped drive a massive expansion of multiples over the past two years. In 2019, multiple expansion accounted for 80% of the S&P 500 Index's total gain of 32% (Exhibit 3). This year, the return from p/e multiple expansion is about 26%, which offset the sharp decline in corporate earnings and lifted the index to positive territory.

Exhibit 3: Annual total return decomposition for the S&P 500 Index (%)



Source: Bloomberg, Columbia Threadneedle Investments. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index.

Meanwhile, growth and value investing have become more divided than ever. Shares of value stocks have underperformed both the market and growth stocks since 2010. The pandemic has taken the value versus growth debate to an even more heightened level of conflicting viewpoints. Value lagged growth before, during and after this year's sell-off, unlike most historical periods. Indeed, the five largest listed companies — Microsoft, Apple, Amazon, Alphabet and Facebook — have continued to climb this year as investors maintain the conviction that their dominance will persist. Through the end of September, the Russell 1000 Growth Index outperformed the Russell 1000 Value Index by an enormous 36% year to date. To put that in perspective, the gap between these benchmarks in the decade of the 2010s was just 3.4%.

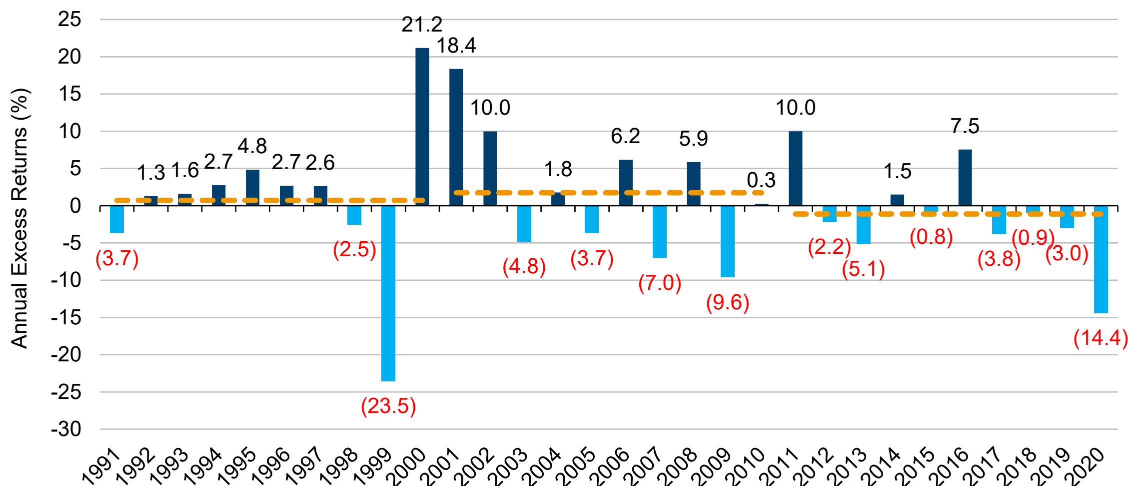
The faltering of the time-tested strategy of buying cheap shares has cast renewed doubt on the relevance of accounting information and traditional value measures. For example, intangible assets not reflected on the balance sheet, such as a skilled workforce, patents, software, strong customer relationships, brands and the like, are becoming increasingly important for corporate growth and shareholder value creation. Current accounting standards do not adequately capture the impact of intangibles, as companies cannot recognize internally generated intangible assets on their balance sheets. But the reality is that incorporating intangibles into the book equity for valuation purposes can only partially mitigate the underperformance of the price-to-book strategy in the past decade. Put differently, the value/growth divide appears to be far more than the omission of intangibles in traditional value measures — growth stocks have become increasingly

expensive. Other value metrics, including dividend yield and free cash flow yield, have also been shunned by investors in recent years.

We can summarize these evolving dynamics as follows:

- **Generous dividends are no longer virtuous.** The bird-in-hand theory for dividends argues that investors should prefer stocks that pay high and stable dividends. Historically, dividends have been an indication of financial health and played an important role in terms of their contribution to total returns. For example, dividend income (reinvested) accounts for 40% of the Russell 1000 Index's total return in the past 30 years. From 1991 to 2010, stocks with highest dividend yield outperformed the universe (Exhibit 4). In theory, those stocks should have been the ideal investment over the past decade, as interest rates were (and are) at historical lows and investors were (and continue to be) hungry for yield. What happened, however, was the opposite: the highest yielding stocks underperformed the broad universe in 7 out of 10 years, and the spread year-to-date is -14.4%.

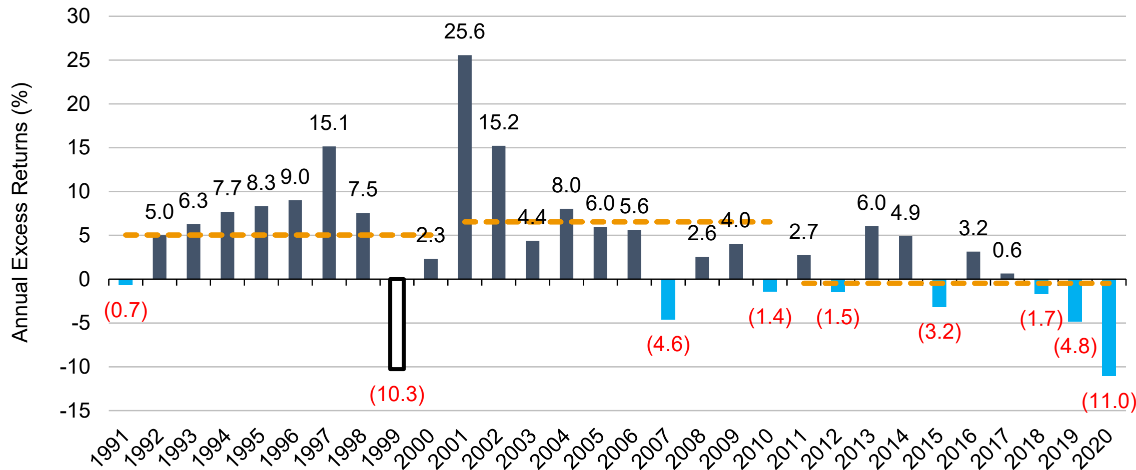
Exhibit 4: Annual excess returns for stocks with highest dividend yield in Russell 1000 (January 1991–September 2020)



Source: Russell 1000; The highest dividend yield basket represents top 25% dividend paying stocks from each sector; Square root of market value weighted; Monthly rebalancing. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index.

- **Cash, the king, has been dethroned**. One of the best-kept secrets in the investment world is the free cash flow yield tenet. This indicator can be used to compare companies across different industries, with different capital structures, and has demonstrated predictive power in most environments. A long-only investment strategy that buys stocks with the highest free cash flow yield would have generated about 6% per year excess returns during the 1991-2010 period (Exhibit 5). Since then, its predictive power has diminished significantly, as that same long-only strategy would have produced losses in each of the past three years and brought its 10-year average excess return to below zero.

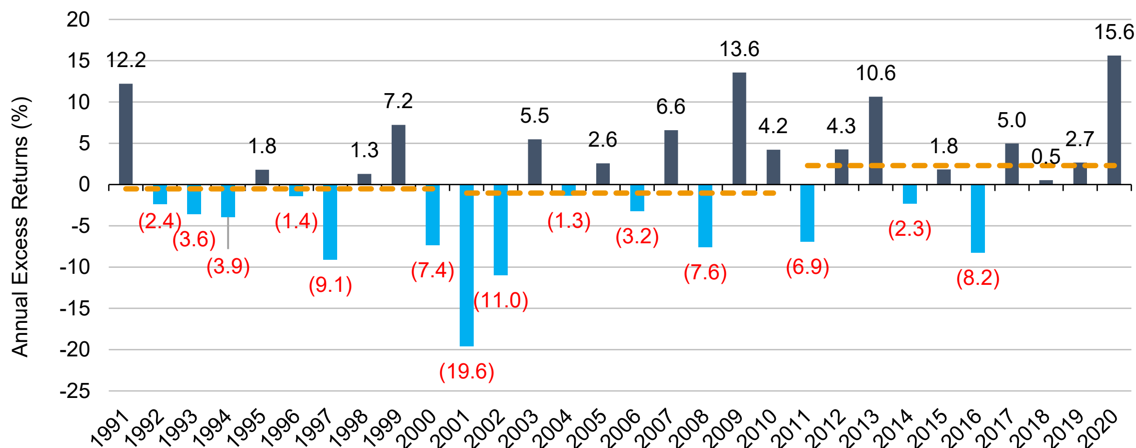
Exhibit 5: Annual excess returns for stocks with highest free cash flow yield in Russell 1000



Source: Russell 1000 excluding financials, real estate and utilities; The highest free cash flow yield basket represents top 20% from each sector; Square root of market value weighted; Monthly rebalancing. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index.

- **Growth is all that matters**. As an investment signal, the track record for long-term EPS growth rate has been poor. By looking at a sample of firms comprising all domestic common stocks from 1951 to 1997, Chan et. al. (2003) found that there is no persistence in long-term earnings growth beyond chance. They also found sell-side growth forecasts to be overly optimistic and possess little predictive power. Our own analysis also shows that the long-term EPS growth rate was more noise than signal in the first two decades of the study period (Exhibit 6). Following the global financial crisis, however, its behavior sharply changed, and it has now outperformed the overall universe in 7 out of 10 years, posting its best performance ever in 2020 with a spread of 15.6%.

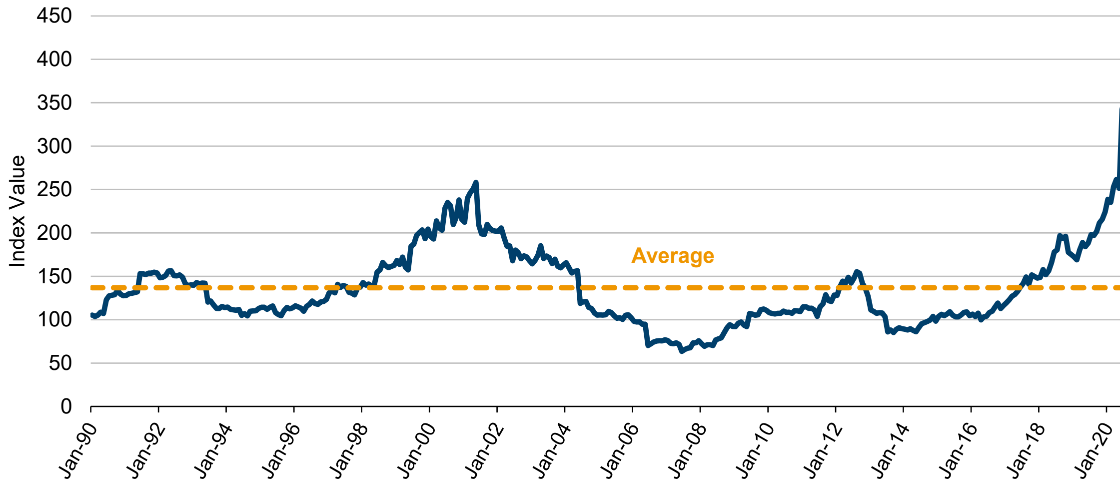
Exhibit 6: Annual excess returns for stocks with highest estimated long-term EPS growth rate in Russell 1000



Source: Russell 1000; The highest long-term earnings per share growth rate basket represents top 20% from each sector; Square root of market value weighted; Monthly rebalancing; through September 30, 2020. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index.

In our view, the reversal in performance for value and growth factors represents two sides of same coin, simply highlighting the dominance of growth stocks over the past decade. The record concentration of the Russell 1000 Growth benchmark epitomizes that divide: at the end of third quarter, the concentration level of the benchmark was 1.56x above its historical average (Exhibit 7).

Exhibit 7: Russell 1000 growth benchmark concentration level



Source: FTSE Russell; Columbia Threadneedle Investments; The concentration level is defined as the sum of the squared individual holdings' benchmark weights. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index. Through September 30, 2020.

The question is whether this is now a bridge too far; is this time really different? Are investors too confident in their foresight? Should we discard conventional investment principles in favor of this new liquidity-driven regime?

Exhibit 8: Rolling 3-year total returns: Russell 1000 Growth vs. Russell 1000 Value

Source: FTSE Russell; Columbia Threadneedle Investments; data from January 1, 2007 through September 30, 2020. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index.

Value's poor performance during the ups and downs of 2020 has only added to the crisis of confidence and rekindled the style's existential angst. For much of the last decade, growth and value index returns largely tracked each other, with the major divergence only occurring over the last few years—but for some, it may feel longer than that (Exhibit 8). This year the gap has widened further.

Value stocks can go through long fallow periods, most notably in the 1960s when investors fell in love with the fast-growing modern companies like Xerox, IBM and Eastman Kodak—dubbed the Nifty Fifty—and in the late-1990s dotcom boom. Nevertheless, each time they roared back and rewarded investors who kept the faith. In addition, it is not a foregone conclusion that the stock market surge will continue, especially if the economic turnaround investors envision takes longer than expected to materialize. A second wave of the coronavirus could compel states to implement stricter social distancing measures, which could dampen consumer spending. A failure to pass more government stimulus measures may also diminish investor sentiment, since consumers would have less cash to inject into the economy. Investment trends can play out over years or shift overnight. Investors need to be aware of the risks and adjust their portfolio exposures accordingly.

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