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DEIGHAN
WEALTH ADVISORS

Objective, unbiased *advice*

MARKET COMMENTARY

Phillip Fisher, an American stock investor best known for his 1958 book, *Common Stocks and Uncommon Profits*, once said that "…the stock market is filled with individuals who know the price of everything but the value of nothing." Taken literally, Fisher's words ring true for us. Portions of the stock market seem as irrational as they have been in a long time, and we would argue that for many stocks – especially those in the high-growth, new economy category – price has started to decouple from fundamental, intrinsic value.

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Take Tesla, for instance. The company has had a strong year, delivering a record number of cars in the third quarter and staying on pace to deliver 500,000 cars in 2020. It accomplished this despite the most challenging environment for car sales in over a decade. Of course, 500,000 cars sounds like a lot until one looks at Tesla's competitors. Volkswagen delivered over 10 million cars in 2019. Toyota? Just under 10 million. Renault-Nissan? Just over 9 million. General Motors? Nearly 8 million cars, and so on. Despite this massive difference in units sold, Tesla's market capitalization has swelled to become larger than that of Ford, Fiat-Chrysler, General Motors, Nissan, Toyota, and Volkswagen COMBINED. Yes, Tesla has incredible growth prospects, but today's price assumes that Tesla will supplant all other major car manufacturers to become the dominant market player by a wide margin. Volkswagen with its $12 billion R&D budget, or Toyota with its $10 billion R&D budget, might have something to say about that. With a forward price-to-earnings (P/E) ratio of 129 and a forward price-to-sales (P/S) ratio of 10, Tesla's stock is pricing in a perfect scenario that might not be achievable in a hugely competitive, capital intensive, low-margin industry like automobiles.

Other examples abound. Cloud computing company, Snowflake, recently debuted in one of the most widely anticipated IPOs of the year. Like Tesla, Snowflake has great growth potential. But it has yet to earn a profit, and, at anticipated 2021 sales of $574 million, its forward P/S ratio is 113. For context, the average historical P/S ratio among S&P 500 companies is 1.6. Yet, with a market capitalization of $65 billion, Snowflake is already valued higher than 390 of the roughly 500 companies in the S&P 500 Index. For a company that just went public, $65 billion is a lofty valuation. Like Tesla stock, Snowflake stock is pricing in a perfect scenario that might not come to fruition.

We could keep going. Zoom Video Communications, DocuSign, Shopify, Fastly, Twilio, Crowdstrike, and Cloudflare are all examples of companies with little-to-no earnings whose stocks have doubled, tripled, or more since the start of the year, helping to propel the NASDAQ upward at an incredible clip. These might be great companies, but their peak earnings are many years into the future. To say that their stock prices are justified is to make a big bet on uncertain and unguaranteed outcomes far down the road.

Of course, the biggest drivers behind the NASDAQ's eye-popping 25.4% year-to-date return have been hugely profitable names: Apple, Microsoft, Alphabet (Google), Facebook, Amazon, Nvidia, Netflix, and Adobe. These companies have not only been strong performers, but they are of such heft that they have dragged the rest of the market along with them.

At 12.5% of the NASDAQ and nearly 7% of the S&P 500, Apple has had a particularly outsized influence on markets. However, even Apple hasn't been immune to price distortion in this frothy market. After announcing a 4-for-1 stock split on July 30th, Apple's stock went on a tear – at one point rising as much as 40% to a total market capitalization over $2 trillion. We were happy to be long the stock, but this run made little sense because stock splits don't create economic value. It is like taking a pizza with four slices and cutting it into eight slices; you still have one pizza. In a matter of weeks, Apple was worth hundreds of billions of dollars more, simply because it had rearranged the deck chairs.

All told, the Information Technology and Communication Services sectors account for nearly 40% of the S&P 500 Index, fueled by price action like the examples described above. Roughly 22% of the index is comprised of just five companies: Apple, Amazon, Alphabet, Microsoft, and Facebook. This level of concentration hasn't been seen since the height of the Dot-Com bubble in 2000, and that concerns us.

Some will argue that this time is different. This time, the companies leading the way are highly profitable, and they are perfectly positioned to withstand COVID-19 and capture opportunities in the new economy. This time, even the unprofitable and untested companies should do well, because of long-term secular changes in the way we live, shop, and work.

The problem is that these arguments can all be true, and prices can still be too high. Arguments like these don't fully explain why Apple, a company that hasn't changed all that much in ten years, now trades at 30x forward earnings when it has historically traded closer to 15x forward earnings. We're reminded of Cisco Systems, a company that grew to prominence during the Dot-Com era and dominates the networking market even to this day. However, at $38 per share, Cisco stock is a far cry from its Dot-Com peak of $80.06.

Another parallel with the Dot-Com era has been the rise of individual day traders. A combination of factors, such as low interest rates, zero cost trade commissions, convenience (app-based trading), and pandemic-induced boredom has led to the rise of the "Robinhood Trader." These individuals, by and large, are not analyzing companies based on fundamentals. Rather, they are trading based on momentum indicators, hype, and speculation.

So, the bigger question is, are we in a bubble? The answer is, it's complicated. Certain sectors and industries appear to be approaching bubble territory, with prices that have started to decouple from fundamentals. We view these areas, which include technology and communication services broadly, as being at much higher risk for a pullback.

That said, the stock market rally has not been broad-based, and opportunities exist to purchase companies at attractive prices. Year-to-date through September, the S&P 500 Value Index was down 11.5%, compared to a gain of 5.6% for the S&P 500 overall and a gain of 20.6% for the growth half of the index. The gap between value stocks and growth stocks has rarely been as wide as it is today, and we see particular opportunities in banking, health care, and select industrials. Such companies have the added benefit of paying attractive dividend yields on top of attractive valuations.

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These are not the only places where a patient investor can find opportunities, however. We have also identified opportunities in the technology sector, where one can still find reasonably priced, high-growth stocks – if one is willing to look past the most popular, high-momentum names. And small cap stocks remain depressed relative to large cap growth stocks.

In all cases, we believe the key is to always insist on a margin of safety, especially in this market. As Warren Buffet famously said: "Rule #1: Don't lose money. Rule #2: Don't forget Rule #1." If a stock still looks attractive even after accounting for reasonable downside risks, then we will consider it. Our biggest issue with today's most popular technology stocks is that they allow for no margin of safety. Some of the companies we've listed throughout this commentary must execute flawlessly and exceed, not simply meet, investor expectations in order to continue rising in price. That is simply a bar too high, especially in the midst of a global pandemic with no clear end in sight. We want to avoid the equivalent of Cisco circa 2000, as that is how capital becomes permanently impaired.

Of course, regardless of discipline, we must all be prepared for an increase in volatility as we head into the elections and a fall season that is expected to bring a new wave of coronavirus cases. September was a difficult month for stocks, with the S&P 500 losing 4.5% and the NASDAQ losing 6.4%. Throughout the month, we saw some reversal in trends, with value stocks outperforming growth stocks and with big names, like Apple and Tesla, pulling back meaningfully. Recent jobs numbers have been a bit underwhelming, raising the question of whether the economic recovery has started to plateau. And so, it could be a bumpy few months if October and November follow suit.

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Ultimately, this too shall pass. At some point, the elections will be behind us, the pandemic will be behind us, and we will all be able to concentrate on other things. Until then, know that we are watching your portfolio carefully, and we are doing our best to generate positive outcomes while insisting on a margin of safety. And with that, may you and yours have a healthy, safe, and uplifting holiday season!

PLANNING CORNER

Presidential Elections and the Stock Market

In this hyper-partisan political environment, you might be surprised to read that a president's political affiliation has historically had little impact on the stock market, at least of any statistical significance. Certainly, each campaign has tried to make the case that their candidate, and only their candidate, will benefit the market. And yet research shows that, Democrat or Republican, it hasn't much mattered to stocks. Doubtful? Let's dig into the numbers.

At first glance, the stock market appears to have done better under Democratic presidents. Going back to Herbert Hoover, who was president from 1929 to 1933, there have been 7 Democratic presidents across 12 terms and 8 Republican presidents across 10 full terms and 1 partial term (Donald J. Trump's current term was included in our analysis through September 30, 2020). Over this period, the average annual return on the S&P 500 Index was 10.90% under Democratic presidents and 2.78% under Republican presidents.

Consistent with these findings, academic literature for decades supported the idea of a large and persistent "Democratic return premium" of roughly 9% per year for large cap stocks and 16% for small cap stocks. This premium seemed a bit suspect, however, because it was much larger than other well-researched market anomalies, like the January Effect and the Indexation Effect. In 2004, Sean Campbell of the Federal Reserve Board and Canlin Li of the University of California, Riverside, published a paper using an updated method to better account for the volatility of various market periods. They found that, when accounting for volatility, this Democratic return premium was smaller and less stable than determined by prior studies. In short, they concluded that neither risk nor return varies significantly across the presidential cycle.

More recently, Jurrien Timmer, Director of Global Macro at Fidelity, compiled stock market data going all the way back to 1789. He found that Republican presidents actually had better returns on average than Democratic presidents in the first two years of their terms (8.3% per year versus 5.8% per year). However, this advantage had disappeared by the end of each four-year term, with stocks delivering an average annual return of 8.6% under Republican presidents and 8.8% under Democratic presidents. Therefore, his conclusion is that presidential elections have less impact on markets than politicians would like to suggest. Rather, it is long-term fundamentals that matter.

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After a bit of thinking, this makes sense. Stock market returns are influenced by all manner of factors, most of which are out of a president's control. These include interest rates, inflation, corporate earnings, productivity, technological advancements, the business cycle, the level of unemployment, long-term secular trends, asset valuations, geopolitical issues, and so forth. In addition, when looking at the S&P 500 Index, roughly 50% of revenues are generated outside of the United States – reducing the impact of policy decisions originating from any one country.

Interestingly, even though political affiliation appears to have no significant impact on stock market returns, there does seem to exist a "Presidential Cycle" effect. Historically, the stock market has delivered its lowest average annual returns in the first two years of each presidential cycle. Then, in the third year, the market has had a tendency to do quite well. In fact, the third year of the cycle has finished in the black 82% of the time with an average annual return of 13.7%.

What about election years? The Schwab Center for Financial Research studied the S&P 500 Index from 1928 to today and found that the market ended the year positive in 17 of the past 23 presidential election years (73.9% of the time), delivering an average annual return of 7.1%. Of the six election years that ended in negative returns, they typically coincided with severe economic events, such as the Great Depression in 1932, the bursting of the tech bubble in 2000, and the financial crisis in 2008. Of course, 2020 is doing its best to buck the trend; we're in the midst of a severe economic event, but the market is in positive territory.

As an aside, for all those poll watchers out there, research indicates that although the president might not have much of an impact on the stock market, the stock market can have an impact on the president. When the S&P 500 Index has increased in the three months prior to a presidential election, the incumbent has won 87% of the time. When the index has fallen, the incumbent has typically lost.

To conclude, though we all have plenty to worry about this election cycle (coronavirus, recession, murder hornets, etc.), we would encourage you to set aside concerns about the president's impact on the stock market. Within an investment context, a four-year presidential term is a short period of time, and, if history is any indication, the market will do what the market will do – regardless of the next president's political affiliation. As much as we all feel compelled to attribute outsized influence to the president, he or she is but one piece of a much larger, ever-changing, random mosaic.

SOUNDBYTES

We missed welcoming you all to this year's *Seasons of Maine*, our annual art exhibit and celebration. Given the current pandemic, it seemed most prudent to cancel, as the safety and health of our friends and colleagues are of the utmost importance to us. We hope that 2021 brings a safe opportunity to resume this annual event. In the meantime, if you'd like to see some great art, we have two wonderful local suggestions. The Zillman Art Museum University of Maine located at 40 Harlow Street in Bangor is open daily with free admission. Additionally, the upcoming art exhibit at Bangor Public Library honors the 100th anniversary of the 19th Amendment, granting women the right to vote. Artists were invited to create a work in honor of this event for a juried exhibit. The works will be exhibited at the library through January of 2021. Digital reproductions of the art will be hung in downtown Bangor businesses, and the walking tour app Vamonde will be used as a guide to the downtown exhibit. Visit your app store for Vamonde, and check out the Maine tours available here: **www.vamonde.com/maine**. We're proud to sponsor this unique and exciting event.

PORTFOLIO CHANGES

In addition to the transactions below, we also increased client positions in Citigroup (C), reduced positions in NextEra Energy (NEE) and Apple (AAPL), and eliminated positions in Vanguard Long-Term Corporate Bond (VCLT).

Buy – Autodesk, Inc. (ADSK)
Autodesk sells software for computer-aided design (AutoCAD is its flagship product) and product lifecycle management. Its suite of software and related services assists customers with the entire design workflow, from initial product design to the simulation and visualization of products, buildings, and other objects. Autodesk also makes 3D animation software used in movie and game development.

Buy – Proofpoint, Inc. (PFPT)
Proofpoint provides enterprise-level software solutions for medium-to-large businesses, such as threat protection, regulatory compliance, archiving, governance, and secure communications. Its Proofpoint Protection Server and Messaging Security Gateway defend against computer viruses, hacker attacks, and spam. The company's solutions are built upon a flexible, cloud-based platform that leverages technologies like data analytics, machine learning, deep content inspection, secure storage, advanced encryption, intelligent message routing, dynamic malware analysis, and threat correlation.

Buy – Lockheed Martin Corp. (LMT)
Lockheed Martin is the world's largest defense, security, and intelligence products developer and producer. Its primary operating segments include Aeronautics, Space, Rotary and Mission Systems, and Missiles and Fire Control. Across these segments, Lockheed Martin produces missile and targeting systems, military and commercial helicopters, near-shore combat ships, the F-35 combat aircraft, nuclear deterrent systems, satellites, and space transportation systems, in addition to many other defense technologies.

Buy – ½ Position of Alphabet, Inc. (GOOGL)
Alphabet is a global technology company that owns and maintains the world's largest internet information index, which contains billions of entries for web pages, images, and videos. The company generates revenue by driving user interaction across its ecosystem – whether through the Google search page, through AdSense, through AdWords, through YouTube programming, through the use of the Chrome browser and the Chrome operating system, and through use of the Android operating system and the Google Play store.

Buy – ½ Position of Duke Energy Corp. (DUK)
Duke Energy is one of the top electric utilities in the United States, servicing 7.7 million retail customers in the Carolinas, Florida, Ohio, Indiana, and Kentucky. Duke generates its electricity through a combination of gas, oil, coal, nuclear, hydro, solar, and wind sources. The company aims to invest in renewables, battery storage, and energy efficiency programs. Since 2005, it has cut carbon emissions by 39%. Its goal is to cut emissions by at least 50% between now and 2030, and it hopes to achieve net-zero emissions from electricity generation by 2050.

Sell – Unilever, Plc (UL)
Unilever is a global leader in household products and packaged foods. However, it is constrained by top-line growth, and we see no clear catalyst to drive shares higher. The stock's dividend and its defensive attributes are its most attractive qualities, but shares appear to be fully valued and are trading near all-time highs. Therefore, we decided to exit the position.

Sell – Verizon, Inc. (VZ)
Verizon faces increased competitive pressures, a high debt load, a costly and underperforming media segment, and a legacy copper line business that will be a drag for years to come. Though the company is likely to benefit from 5G, it still sells a largely commodity product in a mature, saturated market with fierce competition. Verizon's dividend yield is its most attractive quality, but we expect growth to be an issue as cash flow gets chewed up by network upgrades, debt repayment, and the dividend. Therefore, we decided to exit the position.

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