Key Questions

S&P 500 Reaches a New High—But What Would Lew Say?

August 25, 2020

George Mateyo, Chief Investment Officer

Quality and selectivity remain core tenets of our outlook.

In the mid-1990s, as I was cutting my teeth as a buy-side equity analyst, I was dispatched to New York to attend an investment conference titled "The Internet Revolution." The event, held at the New York Hilton Midtown, was the city's largest hotel with nearly 2,000 rooms and over 150,000 square feet of meeting space.

Despite the hotel's immense size, meeting rooms were jammed, hallways cramped, but the energy was palpable. Bill Gates, then CEO of Microsoft, delivered a keynote address and captivated a packed crowd as he unveiled a new software package called Windows while delivering promises of profoundly changing the way people work, live, and play.

After the conference and before leaving for home, my boss at the time arranged a tour of the prestigious trading floor of the New York Stock Exchange (NYSE). The visit included a special meeting with its head of all trading operations, Lewis Horowitz, or "Lew" as people reverently referred to him. Lew had been a fixture of the NYSE for decades and had led the institution through bull markets and bear markets, periods of panic and periods of euphoria, and times of epic uncertainty.

As we sat in his expansive office overlooking the trading floor, Lew kindly asked me for my impressions of the conference I had just attended. Excitedly, I described how a new era was upon us: Economic growth would continue unabated, and the stock market would rise accordingly. One stock, in particular, that I felt possessed great potential was a networking storage company that — in my opinion — would undoubtedly benefit from greater usage of the internet.

While I spoke, Lew listened patiently, indulging my optimism. He then quickly charted the stock price I had just anointed as "the next big thing" on his computer terminal. After I paused and following his review of the aforementioned chart, Lew leaned forward, stared intensely at me, and pointedly uttered six simple words: "Trees don't grow to the sky." These words would become prescient as the Dot-Com bubble burst.

Fast-forward twenty-plus years later, I'm reminded of Lew's declaration when observing several high-profile stocks as they recently eclipsed various milestones at astonishing speed. For example, Apple's stock is now valued at over $2 trillion. Even more remarkable is that $400 billion in value was added in the last month alone. Putting this into perspective, $400 billion is larger than the market value of the 494 smallest companies in the S&P 500 Index. In other words, the $400 billion in incremental value Apple added in the last month would be the seventh largest member of the Index if it were a standalone company.

Similarly, Tesla – which is not an S&P 500 constituent (yet) –is now valued at over $380 billion, a gain of over 850% in the last year. Such a valuation is equal to America's three largest automobile manufacturers' combined value four times over.

Stocks such as Apple, Tesla, and their mega-cap technology peers have lifted the broader S&P 500 Index over 50% in five months, powering it to new all-time highs last week. Yet, a closer inspection of the underlying components of the index shows that only 23 of the 500 individual constituents are

Key Private Bank

currently at all-time highs, and the average stock in the index is still 28% below its prior peak. This fact begs the question: Can this concentration of performance continue? More importantly, what actions should investors be taking as a result?

Many of the mega-cap technology companies are among the biggest beneficiaries of the economic upheaval caused by the outbreak of COVID-19. They also possess vastly superior balance sheets, significantly higher profitability levels, and above-average competitive positions relative to others. Additionally, in many instances, the powerful tailwinds that enabled their ascendancy appear likely to persist, while the industries most disadvantaged by COVID-19 are expected to remain challenged for quite some time.

Still, most if not all investors know this, many of these winning stocks trade at substantially higher valuations. And given the absolute low level of interest rates, some investors also argue that higher valuations are justified.

In our view, however, valuations will ultimately matter. While valuation is a terrible timing tool and not at all predictive of near-term performance, history has shown that typically the loftiness of the price paid for an asset is inversely correlated with the asset's future value over more extended periods.

For these reasons, while we remain biased toward owning high-quality companies, including some of the perceived COVID beneficiaries that trade at rich valuations, we advocate selectivity. We also believe that active management merits consideration rather than allocating exclusively to passive capitalization-weighted indexes.

COVID-19 and its economic and financial impact will remain a force and continue to disproportionately benefit some companies while negatively impacting many others. Moreover, we continue to believe a large number of "known unknowns" exist. But once such uncertainties clear, investors should anticipate new investment themes to take hold and be positioned accordingly. This strategic approach entails maintaining a modestly neutral position to risk overall, continuing to eschew value, but emphasizing quality and owning more stocks than merely those that are most loved.

For more information, please contact your Key Private Bank Advisor.