L. ROY PAPP & ASSOCIATES, LLP
INVESTMENT COUNSEL

2201 E. CAMELBACK ROAD
SUITE 227B
PHOENIX, ARIZONA 85016
(602) 956-0980
FAX (602) 956-7053

# VIEWS FROM CAMELBACK MOUNTAIN

## *Divergences*

All of the holiday cards, year-end summaries, and other commentaries that we received have observed that 2020 has been a year like no other. In the financial markets, this year has seen great divergences. Even with all of the economic challenges brought on by Covid-19, the Dow Jones Industrial Average managed to end the year with a total return of 9.7%. By comparison, the Standard & Poor's 500 produced a total return of 18.4%. Obviously, there is a huge performance gap between these two indices, yet it pales by comparison when either are up against the NASDAQ index, which returned a whopping 44.9% in 2020.

What led to these divergences? To begin with, it's a story of old versus new. The Dow Jones Industrial Average dates back to 1896 and is calculated using the simple arithmetic sum of 30 individual holdings (then divided by a factor adjusting for stock splits). Originally, almost all the holdings in the Dow Jones Industrial Average were industrial. Today, out of the 30 Dow Jones stocks only eight would be described as substantially industrial. Some of the companies like Microsoft, Apple, UnitedHealth, Cisco Systems, Amgen, and recent-entrant Salesforce.com are technology, information, or service companies that simply didn't exist 50 years ago. Our economy has evolved from a manufacturing and industrial economy to a technology, information, and service driven economy. As this year's poor showing for the Dow indicates, more changes will need to be made to the index or it will simply become a relic of history.

The difference in returns between the S&P 500 and the NASDAQ is driven by the substantially greater concentration in the NASDAQ of technology, information, and, over the past few years, new and disruptive businesses. The heavy weightings in the NASDAQ of many brand-new disruptive businesses, some of which have never made a profit (and some of which never will!), are the key drivers of the enormous return for that index during 2020. We would argue that much like the market conditions in 1999 and 2000, irrational exuberance is front and center with many NASDAQ stocks. Our clients own a nice selection of NASDAQ companies, but all of them have earnings, strong balance sheets, and generate cash flow. While betting on the next high-flying but money-losing company may be fun and even very successful in years like 2020, ignoring valuation and underlying fundamentals is often an expensive lesson to learn in the long-term.

There has also been an enormous divergence between growth and value companies. Growth companies tend to be faster growing, carry higher valuations, and are better postured for the future. Value companies typically have lower valuations, older businesses, and limited future growth opportunities. They also tend to have higher dividends, until they don't.

Over the long-term, growth and value will take turns as market leaders. Over the past 8 to 10 years, growth has dominated and value has lagged badly, causing many to observe that value is so cheap relative to growth that these companies must be a better investment now with the expectation that the tide will surely turn someday soon. While part of this theory is correct, it is important for value investors to avoid companies that have non-sustainable businesses. This growth-value divergence has been accentuated by the Covid-19 pandemic, with almost all value companies hit very hard by the current reality. On the other hand, most growth-oriented companies have been relatively unscathed, and many are actually better off. It appears to us that Covid-19 has simply accelerated the natural decay of some older companies whose day in the sun has long passed, declining into the sunset.

Wrapping up 2020, we think it is important for our clients to reflect on the good fortune that they have enjoyed in the financial markets this year. On the back of spectacular returns in 2019, we were anticipating fairly muted returns for 2020. As of March, it seemed unlikely that Covid-19 would allow for such strong performance. This year, most investors have enjoyed very good returns compared to long-term averages and most of our clients have experienced even better returns.

We think the broad U.S. economy will show good growth in 2021 thanks to vaccines and massive stimulus. With the strong financial market performance in 2019 and again in 2020, we think most of this good economic news is already priced in. We are looking for positive, but muted returns in 2021 compared to long-term averages. Interest rates are at historical lows, but we anticipate they will rise gradually. The U.S. dollar has weakened in value this year and many expect further weakness in 2021. This is actually helpful to many U.S. businesses as it makes them more competitive worldwide. We remain concerned about inflationary pressures from massive deficits and we do expect some of today's market darlings to become valued more rationally.

While most of our clients have the means to financially cope with the challenges that Covid-19 has brought, a significant portion of the U.S. and world populations simply don't have these resources. To the extent possible, we hope that you have been generous and will continue to be supportive of the many not-for-profit organizations that exist to assist those who are not as fortunate. Of course, financial wherewithal doesn't make any of us immune to the mental and physical challenges of a pandemic. Every day we are cognizant of this. We extend our deepest gratitude to the world's healthcare and frontline workers, a tremendous group that includes many of our clients, family members, and friends.

Looking forward, we are hopeful that most Americans who wish to take advantage of a vaccine will be able to get vaccinated between now and the 4th of July. If that's true, we anticipate that much of our everyday lives can return to something a little more normal late next summer or fall. Hopefully you'll be able to go to a football game, a ballet or symphony, travel to see loved ones, or just go out to dinner and a movie with friends.

Despite a rollercoaster year, we are proud of what we were able to accomplish together. Thank you and we wish you a healthy and prosperous New Year.

Best regards,

Harry Papp

Harry Papp
Managing Partner
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