October 20, 2020

SKBA Market Update

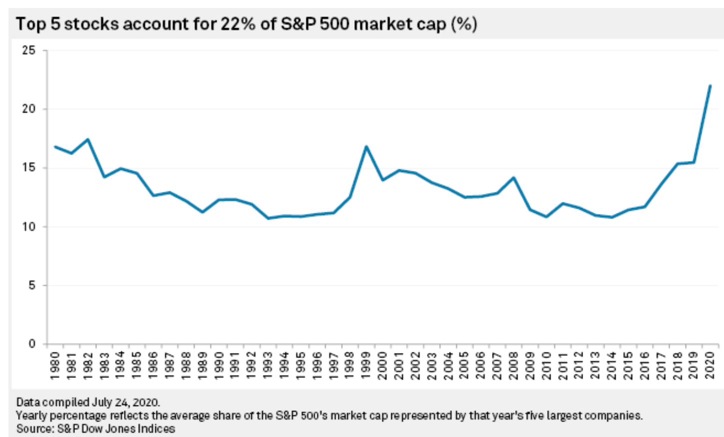
"PICK SIX" May Be Hazardous to Your Wealth

Today's "Pick Six" stocks may remind some of the horse racing bets they've lost in the past. Perhaps, like Authentic at 9-1 odds beating Tiz the Law at 4-5 odds in the last race of the delayed Kentucky Derby on September 5th this year. The betting windows at Churchill Downs, and this year the online "windows", had its hands down favorite, Tiz, at a 44% chance of winning, compared to only a 10% chance for Authentic. Someone lost a pot full of money!

While picking the winner of six consecutive races at the track seems like a long shot at best, investors have been doing just that in the equity markets. Today's Pick Six mega-cap favorites currently dominate the market capitalization of the S&P 500. At their recent September 2nd peak, Amazon, Apple, Facebook, Google (Alphabet), Microsoft, and Netflix added up to a whopping 25% of the index's market value. Furthermore, they accounted for 102% of the S&P 500's 12.3% return this year through that date! Just be sure we all understand, that represents ALL of the net return of the S&P 500. With an average total return at 61%, most of the rest of the market was left in the dust from the starting gate.

| Weightings of Top 5 S&P 500 Holdings – 1990 to 2020

Source: S&P Dow Jones Indices



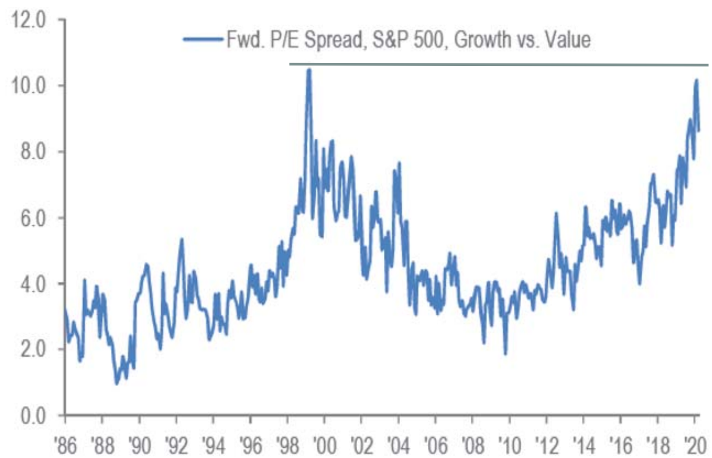
Given their 2020 success in terms of earnings and return, investors must believe their bet on these stocks is nearly a sure thing, perhaps with odds of 4-9. That translates into nearly a 70% chance of continuing to win in future years. Would that be realistic?

Why does today's market feel like Déjà vu all over again? It's because the current measures of extreme overvaluation of growth stocks relative to value stocks reminds us of 1999 when such stocks, like today, were priced for perfection. In the "New Paradigm" of economic growth (high real growth and low inflation that would last forever), the massive surge in tech, internet, and communications stocks in 1999 was driven by the market's over confidence in this paradigm. We stated and believed at that time, that the market accepted odds of the continuation of the "perfection" environment in the late 1990s as being close to a 70% chance.

What was the fundamental trigger that "popped the bubble" and sent some of those stocks down 70-80% over the next 2-3 years? A key part was the acceleration of technology spending needed to solve the "Y2K" problem that came to an end with the tick of a clock one second past midnight on December 31, 1999. The seemingly simple need to convert all computer systems and data from two-digit year designations to 4-digits created a massive spending surge that figuratively pushed two years of tech spending from the early 2000s into the late 1990s. Once it became apparent to investors early in the new millennium that such revenue growth rates would not be sustained, valuations in this segment of the market plunged. We stated at the time that the valuation disparity was so large between growth and value stocks (with P/E ratios on the next twelve-months earnings forecasts at a spread near 10 P/E points for the S&P Growth versus the Value indexes) that tech stocks could decline while the positions held in SKBA's Value*Plus* portfolio could rise.

| Relative Valuation of Growth vs Value

Source: J.P. Morgan, as of March 2020



Just as the massive spending on tech equipment, software and programming accelerated revenues in the last four years of the 1990s, today's massive tech spending in 2020 on the transition from the office to the work-at-home environment, the signups for streaming services and social media, the hoarding of personal care products, and the surge in stay at home meals has taken sales out of the future and put them into the present, 2020. Even if it takes a few more months or quarters to see it in the revenue trends, the more complete opening of the economy should bring a subsequent slowdown in revenue growth for these kinds of companies. Yet this would represent a disappointment compared to the current lofty expectations that may trigger a valuation correction, just as that air was let out of the bubble in 2000.

	% Total Return YTD 9/2/20	% Total Return Peak to 9/30/20	SKBA's Next 5 Years Risk of Loss Probability (%)
"Pick Six" Averages	**61.0%**	**-9.1%**	56%
S&P 500 Index	12.3%	-5.9%	36%
S&P 500 Growth Index	29.9%	-7.2%	46%
S&P 500 Value Index	**-7.8%**	**-4.0%**	20%

Source: FactSet and SKBA Analysis

While we believe we see the beginnings of this transition reflected in the table on the left, one doesn't need to forecast such a fundamental shift to identify the attraction of value stocks relative to the extraordinary valuations sported by what we call the Pick Six mega-cap growth stocks. Indeed, these stocks could give up all of their 61% average gain through the September 2nd peak and still be expensive.

One month of underperformance by the Pick Six may not become an immediate new trend, but it could be a precursor of what may be coming. Unlike the first eight months of the year, October's action in the equity markets appears to be a seesaw between "growth" and "value" every day. Yet, like 1999, the P/E spread suggests that the average risk of losing money in Pick Six stocks over the next five years appears, at SKBA's estimate, to be 56%, compared to 36% for the S&P 500 as a whole and only 20% for the S&P 500 Value benchmark. Naturally, estimates of the risk of loss are not a promise regarding future returns, but they do offer a reality check on today's optimistic view.

They've essentially become an even narrower version of the Nifty Fifty stocks of 1973, the energy stocks of 1980, the New Paradigm stocks of 1999, and Financials in 2007. What seems like the smart wager this time around? Throwing caution to the wind to bet on these kinds of stocks now could be dangerous to your wealth. Perhaps sticking with horse racing will give you better odds after all.

Our very best wishes to you,

Andrew W. Bischel, CFA
Chairman & CEO

The information contained herein represents the opinion of SKBA Capital Management, LLC and should not be construed as personalized or individualized investment advice. Analysis and opinion expressed in this report are subject to change without notice. Risk of loss probabilities are based on SKBA's own multi-scenario outlook. This forecasting process enables SKBA to assess the return opportunities and risk of loss inherent in today's financial market and economic environment and from today's valuation levels for stocks. Such forecasts may be changed at any time and are not intended to represent a recommendation for purchase or sales of any asset or security, nor to support any course of action as being suitable for the reader. This does not represent actual performance of SKBA or its clients nor does it predict performance a client could achieve.