WAYPOINT ADVISORS

Third Quarter 2017

"*Move fast, break things*" – Mark Zuckerberg

FANGS, Unicorns and Silver Linings

At a recent Waypoint team meeting we had a lively discussion about industry "buzz words" – those catchy phrases or acronyms made popular by traditional and social media to describe current market trends and conditions. Some favorites: "FANG stocks" – coined in 2013 by CNBC's *Mad Money* host Jim Cramer for four high performing technology stocks – Facebook, Amazon, Netflix and Google. And, more recently, high profile tech startups such as Snapchat and Uber with valuations over one billion dollars and negative cash flows, earn membership in the Unicorn Club, named for the mythical creatures that are so wonderful they can't possibly be real.

In a world where trendy buzz words can rapidly become part of our everyday vernacular – we now google and tweet – it seems that one word in particular has caught the fancy of analysts, columnists and pundits and has been the source of wide interpretation in financial, political and even environmental circles.

Disruptor

From the Latin *disruptus/disrumpere* – to burst asunder, to break apart[1]; the idea of a new innovation, product or business strategy swooping into an established market causing radical changes that create a whole new way of doing business. The term was made popular in the mid-1990s by Harvard Business School professor Clayton M. Christensen, who is now considered one of the world's top experts on innovation and growth.

In explaining why many well-managed, respected and profitable companies fail, Christensen points out that by focusing on the things that make their businesses successful – listening to customers, investing in the business, building distinctive capabilities – managers often are dismissive or ignore rivals with "disruptive" innovations.[2] A disruption, Christensen explains, is both destructive and creative, displacing an existing market, industry or technology and producing something new and more efficient and worthwhile.

It's easy to look at today's marketplace and identify some of the most well-known disruptor companies. Certainly, the FANG stocks would be on everyone's list. Considering that Jeff Bezos is challenging Bill Gates as the *richest person on earth*, the impact of Amazon on the retail world cannot be underestimated. In fact, "The Amazon Effect" has become a popular discussion in business circles, on the golf course, and at cocktail parties – with great speculation as to

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[1] Collins English Dictionary – Complete and Unabridged, 12th Edition 2014 © HarperCollins
[2] C.M. Christensen, "The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail" (New York, HarperCollins, 2003, first published in 1997 by Harvard Business Review Press)

which retail Goliaths will fall in the next few years due to the rocks that Amazon is slinging their way.[3]

And disruptors now dominate our everyday life. We communicate with our friends and families and get most of our news (real and fake) from Facebook. We stream entertainment at our convenience from Netflix. We can't function without our iPhones and use them incessantly to "google" or "text," annoying our co-workers and spouses. And, we wonder if Bitcoin will soon replace our PayPal accounts!

Even though we are the happy beneficiaries of many of these innovations, we also realize that disruptions can be unsettling. Consider the jobs that will be displaced as Amazon continues to assert itself as the dominant retail force in the world. Consider that a medallion for a New York City taxi cab was once valued at $1 million and is now worth one quarter of that amount.[4] And, consider the impact on the hotel industry as Airbnb, a "Unicorn" now valued higher than Hilton Hotels at $30 billion, readies itself to go public.[5]

The silver lining

While there can be significant upheaval in certain segments of the global market, with disruptions also come opportunities. When one part of a disrupted industry gets hurt, new innovations, products and industries often create new jobs and new market segments as evidenced by the fundamentally strong U.S. economy and record setting stock market. At 103 months and running, the current S&P 500 bull market is the second longest in history with the technology and healthcare sectors leading the way this past year with 27% and 20% returns respectively.

How much longer will the run-up last?

We believe there is strong evidence that the market will continue its slow, steady upward climb. One major indicator, the Global Purchasing Managers' Index, recently posted its monthly chart showing positive manufacturing growth over all segments of developed and emerging marketplaces. Global production was buoyed by increases in both total new orders and international trade volumes. This in turn led manufacturers to increase hiring to the greatest extent since May 2011.[6]

Another positive signal is that global GDP growth continues to tick upward from 2.6% in 2016 to 3.0% in 2017. This growth is also reflected in higher earnings of US large company stocks. P/E (price/earnings) ratios of the S&P 500 are commonly used as an indicator of whether stock markets are over or under valued. Stock prices have been rising, driving P/E ratios to higher than historical averages. However, earnings have also continued to grow with the rising stock

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[3] *"'Amazon Effect' Leads Investors to Sour on Global Retail"* by Riva Gold and Saabira Chaudhuri, Wall Street Journal, Sept. 28, 2017

[4] *"How much is a NYC taxi medallion worth these days?"* – CBS News – April 14, 2017, https://www.cbsnews.com/news/how-much-is-a-nyc-taxi-medallion-worth-these-days/

[5] *"Why Airbnb Is Now Almost Twice as Valuable as Hilton" - Vanity Fair* – March 10, 2017 https://www.vanityfair.com/.../why-airbnb-is-now-almost-twice-as-valuable-as-hilton

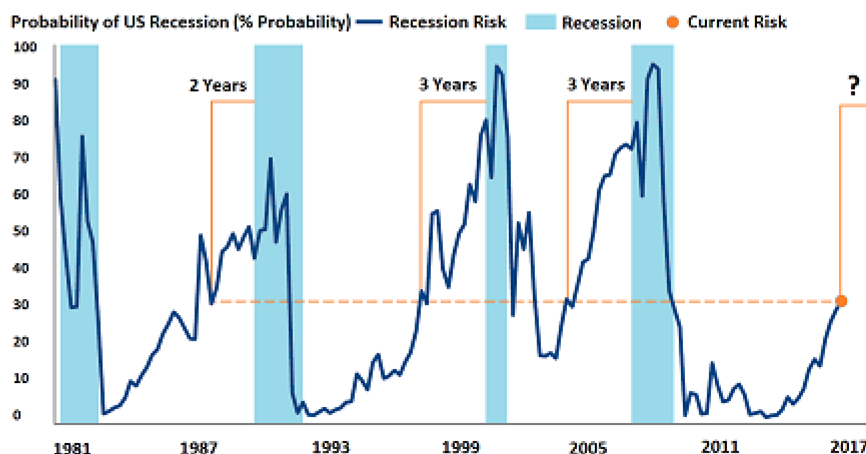
[6] *"Global manufacturing growth remains solid in September,"* J.P. Morgan Global Manufacturing PMI™ produced by J.P.Morgan and IHS Markit in association with ISM and IFPSM, October 2, 2017

prices at an annualized rate of 5% since Q4 2015. Earnings growth will likely slow, but it is expected to remain close to 4% over the next four quarters.

Other good news, inflation rates globally remain muted (1-4%), particularly in developed countries. This bodes well for equity markets as long term borrowing costs should remain low even though the Fed has started to shrink its balance sheet and is expected to raise the federal funds rate at the next FOMC meeting in December. Lower rates support higher P/Es which continue to be a little higher than their long-term averages.

Despite ample opportunity for market disruptions caused by political upheaval – such as North Korean missile launches, presidential tweets and Catalonian independence voting – the markets remain calm. The Chicago Board Options Exchange (CBOE) Volatility Index (VIX), which measures the US market's expectation of 30-day volatility, remains remarkably low, 10.17 versus the 10-year average of 20.29.

We are also reassured by the chart below from Goldman Sachs and The National Bureau of Economic Research, which shows that current economic conditions indicate only a 30% probability of recession and, at this rate, a potential recession is typically 2-3 years out into the future. Predictions are only predictions and portfolios should be structured taking into consideration the uncertainty that always lies ahead.



While the economic backdrop which drives markets looks positive, stock prices rarely move in perfect lockstep with the economy or with each other. The S&P 500 has posted double digit returns in the past seven of nine years of the current up market cycle; however, the annualized return for the 10 year period covering the full market cycle is 7.4% and the 20 year annualized return is a comparable 7.1%. We can expect stock prices to revert to more "normalized" returns and their accompanying fluctuations, but this does not necessarily mean negative returns anytime in the near future and there are no signs of an impending market collapse or the "euphoria" that typically accompanies overbought markets. Given the solid global economic fundamentals, we believe equity growth will continue, albeit perhaps at a more subdued single-digit pace. Also, remember that disruptions, growth spurts, political gyrations, and sell-offs all create an ideal environment for active managers to use their discernment to both manage risk and take advantage of opportunities to enhance returns and build wealth.