

In spite of storm warnings, a banner year for equities

The concerns about the U.S. economy, sparked by trade tensions with China, slowing global growth and an overzealous Federal Reserve, seemed to have been ignored in 2019. The S&P 500 finished the year up 31.5%, the highest return since 2013. In fact, 2019 was a banner year across all equity categories and an outstanding year for bonds, which also ended the year with exceptionally strong returns.

With an expectation of fading fiscal stimulus and burgeoning federal debt, the U.S. stock market's strong performance in 2019 was a surprise. However, we need only to step back to the fourth quarter of 2018 to put the market's rebound into perspective. During the quarter the S&P 500 dropped suddenly, almost 20%, leaving the yearly return for 2018 at -4.9%. The total return from 10/1/2018 to 12/31/2019 for the S&P 500 was 13.7%, a nice showing for equities, but by no means a result that would indicate a booming market.

To further understand 2019, we should look back over a longer time frame. For the current market cycle, which started on 10/7/2007 through 12/31/2019, the annualized return of the S&P 500 was 8.4%. Over two market cycles, starting on 3/26/2000 through 12/31/2019 (which includes the dot-com bubble as well as the Great Recession), the annualized total return of the S&P 500 was 5.9%. While we don't know when they will happen, recessions, when they do hit, can decimate a decade of good returns. So, it is important to remain diligent and not succumb to the temptation to quickly abandon strategies that protect portfolios just because the market had a great one-year return.

Another consideration as we analyze the market's success is the weighting of a few large companies that drove outsized returns during the year. The S&P 500 is a capitalization weighted index, meaning each stock is given a position size in the index (%) based on the market value of a company (# shares x price). The largest companies have a greater weight and a bigger impact on the overall price and performance of the index. For example, Apple contributed the most to the S&P 500's 31.5% return because it had the largest weight in the index as of 12/31/2019. This is the case despite Apple having the 11th highest return of all the S&P 500 constituents. Technology stocks, in general, dominated the returns for 2019. The weighting of the top 4 companies in the S&P 500 based on size are:

Rank	Stock	Weight in S&P 500	2019 Return
1	Apple Inc.	4.51%	88.1%
2	Microsoft Corp	4.21%	57.1%
3	Amazon.com Inc	3.21%	23.0%
4	Facebook Inc A	2.05%	56.6%

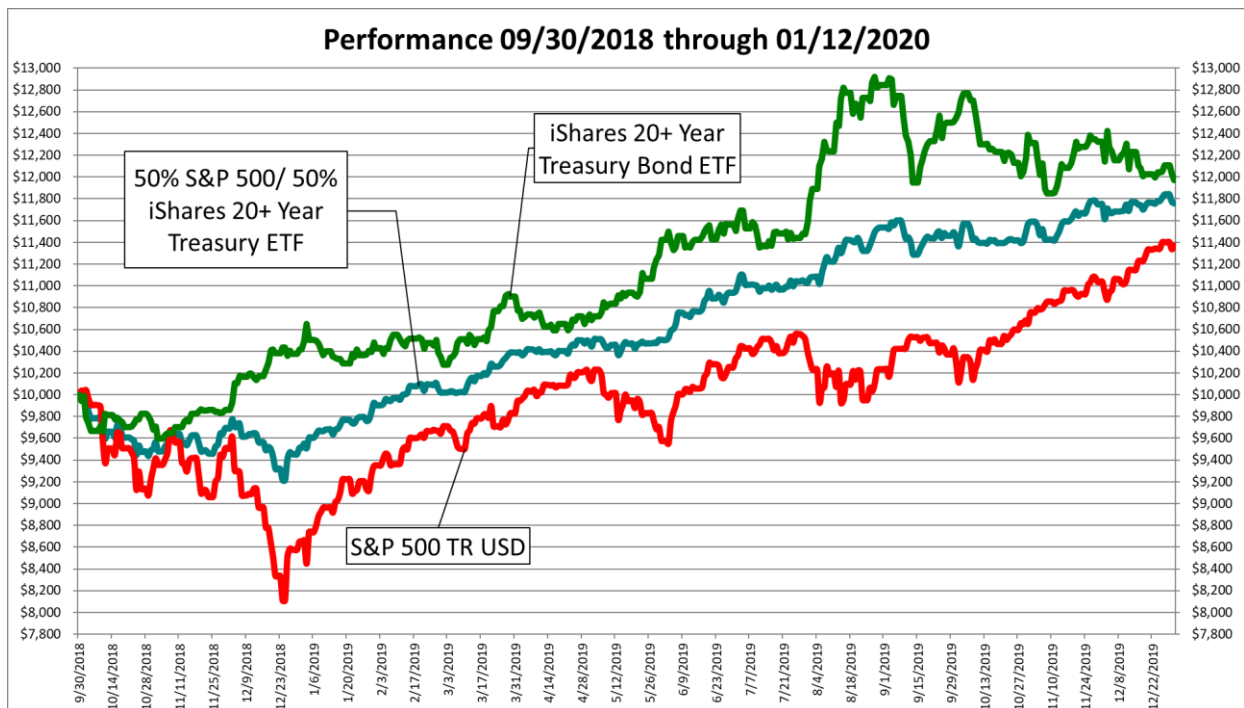
Source: S&P Dow Jones Indices, Morningstar, Marketwatch.com, Waypoint Advisors.

The returns of these four companies made up nearly one-fourth of the S&P 500's 31.5% total return for 2019. What this tells us is that the high returns of the index were achieved by a few stocks and do not necessarily reflect the performance for the majority of stocks in the index.

Another aspect of this banner year is that stock prices, especially for growth stocks, are now on the high side based on historical price-to-earnings (P/E) ratios, coming close to reaching the highest level since the dot-com period and substantially exceeding their 25-year average.

Stocks were not the only outperformers in 2019. Bonds, especially long-term treasuries, had exceptionally strong returns for the year as well. For 2019, the Bloomberg Barclays U.S. Aggregate Bond Index was up 8.7%. Driven up by recession fears that had begun in 2018, long-term U.S. treasuries, often a safe haven in times of market downturns, performed even better than the Bloomberg Barclays U.S. Aggregate Bond Index. Contrary to their typical behavior, treasuries kept going up as equities rose, peaking towards the end of the third quarter. And even as recession fears abated in the 4th quarter and equities climbed higher, treasuries still ended up ahead for the period 9/30/18 – 12/31/19 with a return of 19.7% versus the S&P 500 return of 13.7%.

The other positive is that the long-term treasuries (represented by the iShares 20+ Year Treasury Bond ETF (TLT) in the chart below) not only went up as equities went up but they also did what we normally want them to do – they zigged when equities zagged. In other words, bonds went up during those periods when stocks went down, dampening the volatility caused by the erratic stock market. Note the growth of the hypothetical 50%/50% portfolio below – higher returns than the S&P 500 alone, but less volatility than either the S&P 500 or TLT alone.



Source: Morningstar, Waypoint Advisors.

The challenge facing investors now is that both asset classes, stocks and bonds (particularly long-term treasuries), are trading at high prices and could be subject to decline. While there is a possibility for more upside for equities, a downturn could be more costly now than a year ago because valuations are higher. Similarly, long-term treasuries, having appreciated so much with the fear of recession, now have more downside if recession fears continue to recede. Furthermore, long-term treasuries may be less effective as protection against a market downturn because the Fed does not have much more room to lower rates should the economy begin to spin out of control. While the economy appears to be on a better footing and the fear of recession seems to have subsided, risks remain.

So, what should we do now?

We believe the answer to this investment quandary is to maintain a long-term perspective and remain patient. Patience is difficult to find in our fast-paced world, but there is one investor who has been rewarded for his well-known fortitude – Warren Buffett, the famed “Oracle of Omaha.” Mr. Buffett runs the fifth largest company by market capitalization in the S&P 500, Berkshire Hathaway (BRK.B), which has a long and profitable track record of investing in other companies.

Warren Buffett is known for buying companies or interests in companies when they are “cheap” and holding them for a long, long time. You may be familiar with a few of his holdings: Fruit of the Loom (acquired in 2002), Benjamin Moore & Co. (2001), Dairy Queen (1997), GEICO (1996), and See’s Candies (1972). Interestingly, Apple is currently Berkshire Hathaway’s #1 holding. Believing in the long-term value of the company, Mr. Buffett first purchased Apple in early 2016 when it was priced in the low \$100s. He has added to his position each time there has been a market pullback. The value of Apple at the end of 2019 was \$290 per share.

Because Mr. Buffett usually makes his investments when the markets are down and good companies are cheap, he has not been tempted to try to keep up recently while equities have boomed. Instead, as the markets have continued to rise, so has the level of Mr. Buffett’s cash reserves. At the end of the 3rd quarter in 2019, Mr. Buffett was sitting on \$128 billion of cash (25.1%), doubling the amount of cash that he held five years ago. He knows that by not being tempted to buy stocks when they are high, his patience will protect him against market downturns and, because he has plenty of cash, he will be able to move quickly when there is an opportunity to buy low.

The reason we bring Warren Buffett and Berkshire Hathaway to your attention is to illustrate that building an investment portfolio that will be successful over the long run takes patience and discipline. Focusing on growth can be enticing and can be lucrative when the stock market is going up. However, the market does not always move in a positive direction and when it goes down, it often goes down with gusto. By also being value oriented and price conscious, and by remembering the importance of diversification (as demonstrated by the success of bonds in 2019), your portfolio will be better positioned to succeed no matter which way the economic winds are blowing.