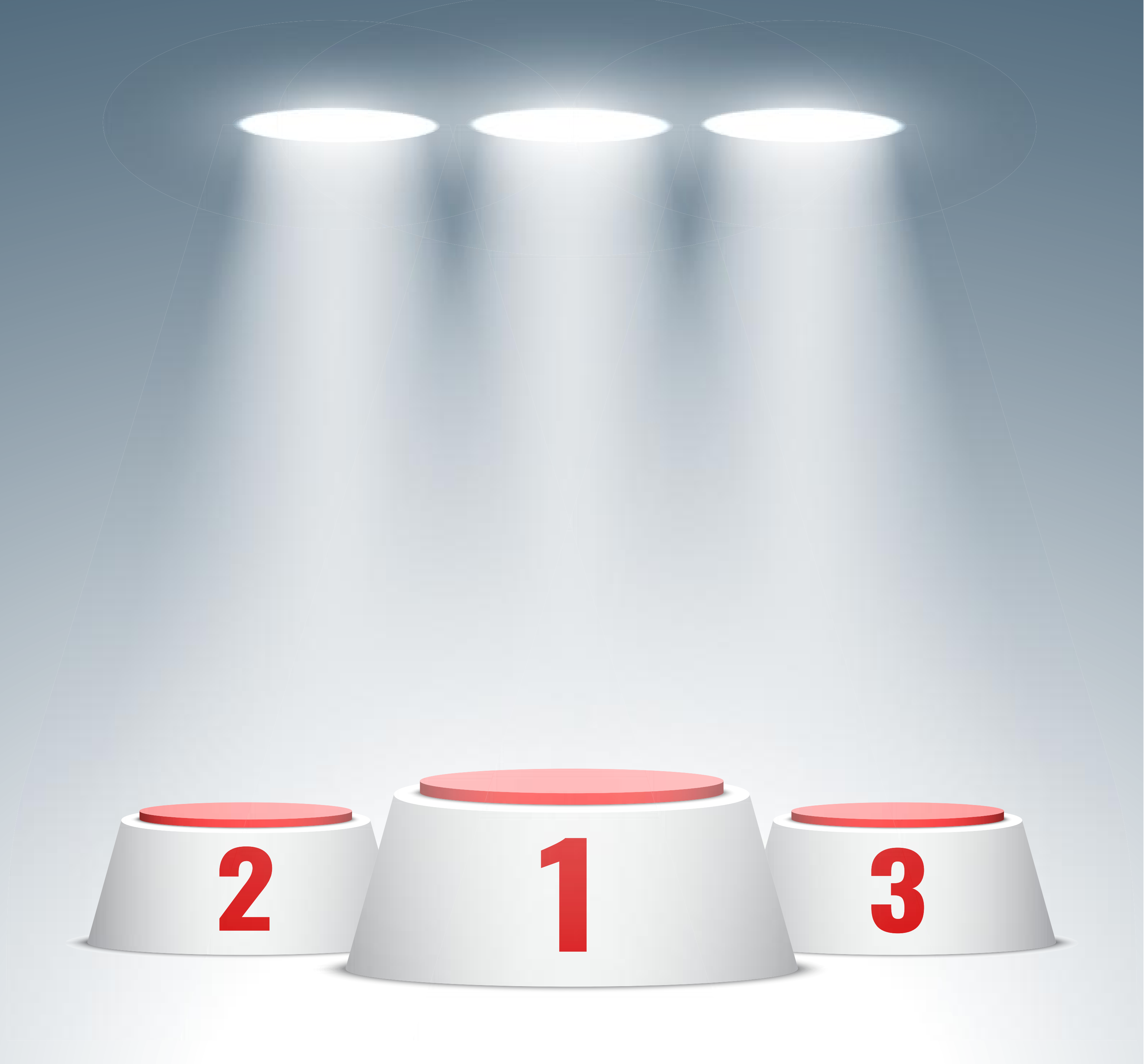

NEWSLETTER

JUNE | 2021

WINNER-TAKES-ALL
A minority of stocks produce the majority of market returns.

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INSIDERS WINNING EDGE
Corporate insiders signal the direction of the stock-market.

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TURN LOSERS INTO WINNERS
Learning to love the unloved is proven to be a winning strategy.

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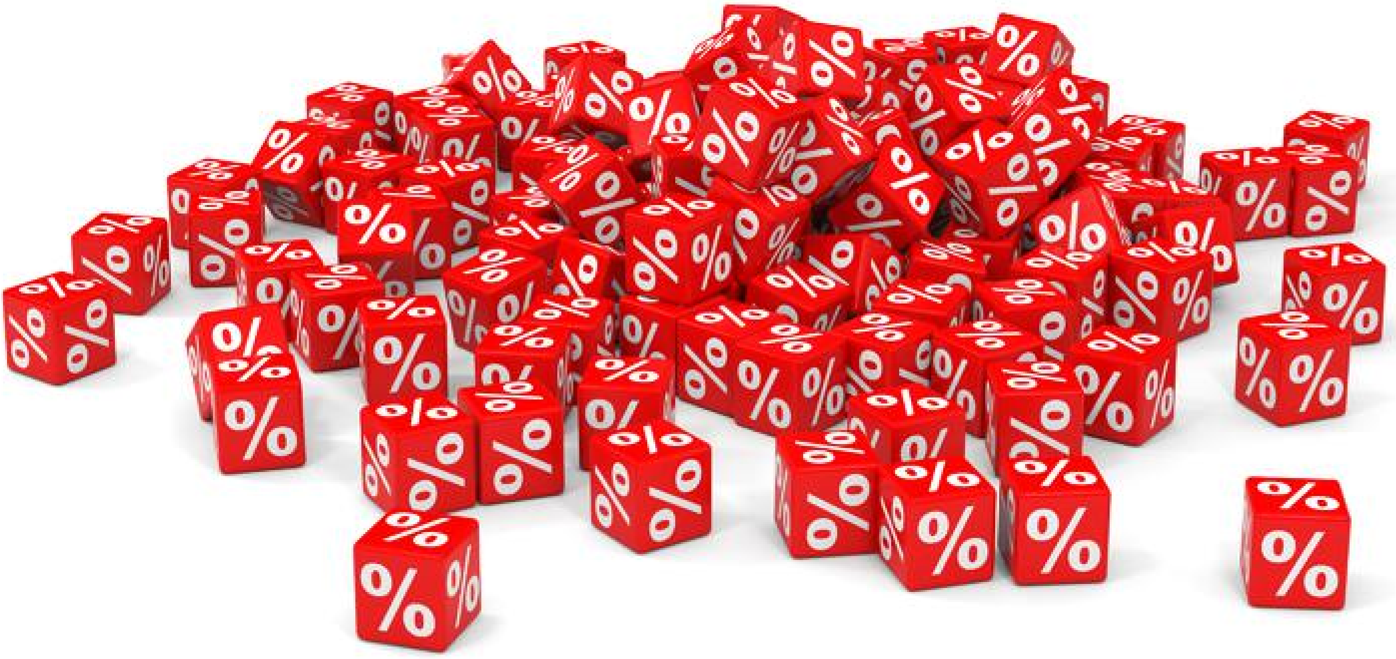


OF THE 500 TOP US COMPANIES THAT MAKE UP THE S&P500, JUST THREE, APPLE, AMAZON AND MICROSOFT, ACCOUNTED FOR OVER HALF OF THE INDEX GAIN IN 2020.

Without the contribution of the 30 top stocks, the S&P500 would have ended 2020 marginally in the red.

From 1998 through 2017, the median return for the 500 stocks that make up the S&P was 2% pa. Over the same period the S&P 500 index returned 6% pa. This gap between median and mean returns can be attributed to a minority of out-performing stocks having lifted the market, after the majority of stocks under-performed the index.

This conclusion is supported by research undertaken by JP Morgan, which in its analysis of 3,000 US stocks that make up the Russell index, found that from 1980-2020:

- Over 40% of stocks produced negative returns.
- Two-thirds of stocks under-performed the index.
- 10% of stocks were 'mega-winners', beating the index by huge margins.

Historically, those stocks that do well, have done very, very well. Out of a field of more than twenty-five thousand, just five, Exxon, GE, IBM, Microsoft and Apple produced 10% of all wealth created by the US stock market between 1926-2016.

Over these ninety years, the best performing 4% of stocks generated ALL the shareholder wealth. The other 96% collectively contributed no more than risk-free treasury bills.

The 'mega-winner' phenomenon is also observed in emerging markets:

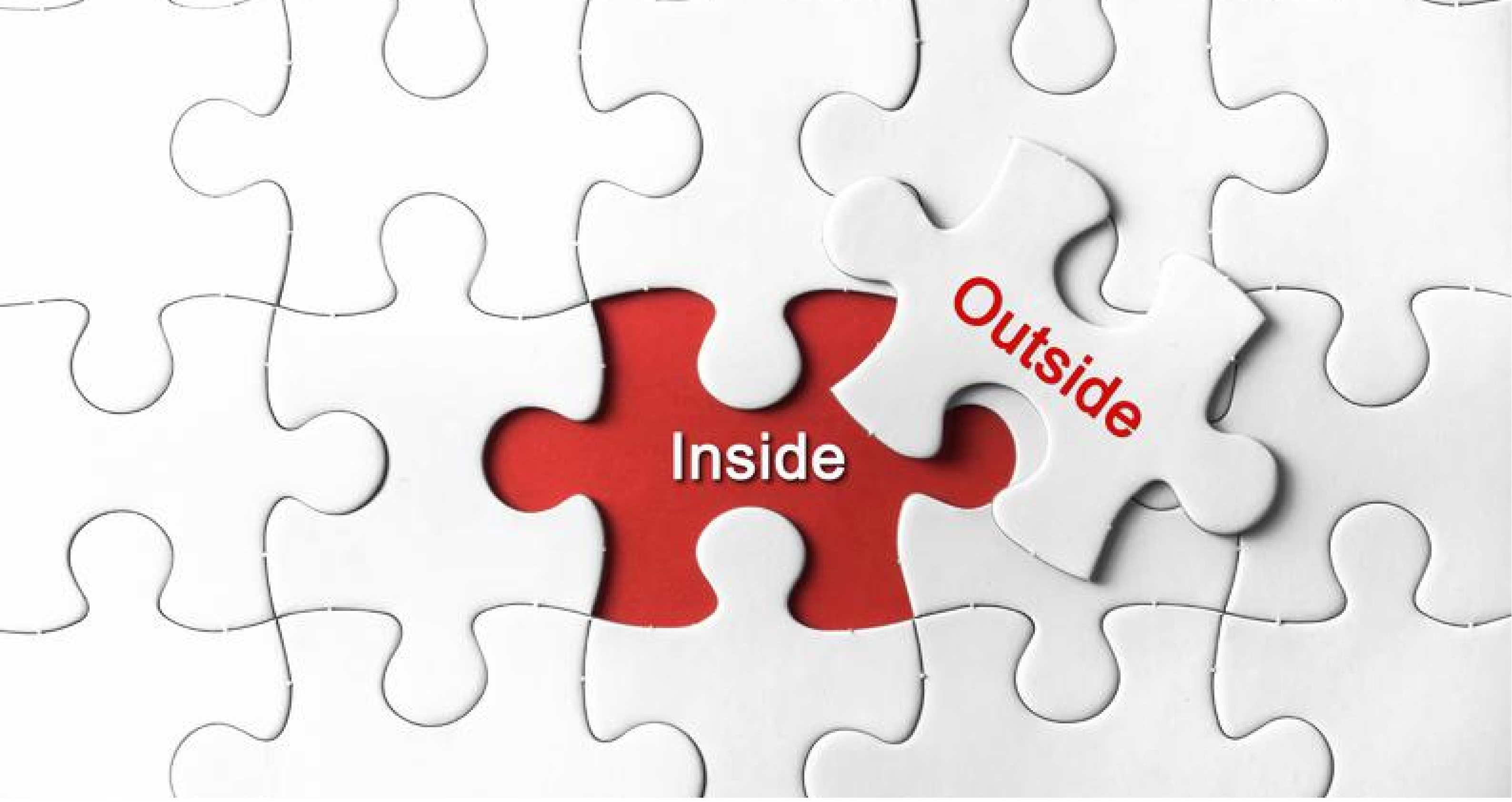
ACROSS THE GREATER CHINA REGION FROM 2011-2020, 3% OF STOCKS PRODUCED 87% OF MARKET RETURNS.

For much of the last decade the US has enjoyed a bull market and yet almost half of its stocks failed.

This was the finding from a study of 5,000 US stocks by Morningstar. From the beginning of 2011 through to the end of 2020, 36% posted ten year losses. Another 22% disappeared, some as a result of mergers and acquisitions, but history suggests half were delisted due to plummeting valuations.

Even during a bull market, stock-picking is as likely to make one poorer. For every winner like Apple, there is a Blackberry and a Nokia.

But the stock-market beats cash and government bonds and by a significant margin - this 'equity risk premium' in the US has averaged between 5% to 8% pa. Own the market and you own the winners.



IN THE TWELVE MONTHS PRECEDING THE COLLAPSE OF BEAR STEARNS AND LEHMAN BROTHERS, EXECUTIVES AT BANKS WITH THE MOST EXPOSURE TO THE SUB-PRIME HOUSING MARKET, WHICH PRECIPITATED THE CREDIT CRISIS, SOLD 40% MORE EQUITY THAN INSIDERS OF LOW-EXPOSURE BANKS.

Company executives should have greater insight into their business prospects than the rest of us. Buying and selling activity by these ‘insiders' has been shown to provide valuable insight into the future direction of stock prices.

Researchers at the Simon Fraser University and the Ross School of Business analysed the insider transaction activity that took place throughout the first few months of the pandemic. Interestingly, they found those insiders with Chinese backgrounds appeared to have more forewarning of what was to come, as they sold shares in higher numbers in January through to early February, then bought shares in higher numbers after the stock market rout in March last year.

When pandemic panic set in, insiders In the US reacted to the -35% fall in the stock-market by snapping up their companies stock at the fastest pace in nine years. It is clear insiders thought outsiders had overreacted to the pandemic threat.

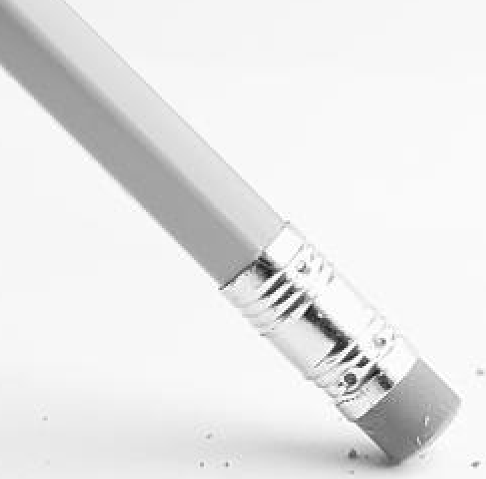
Since then US stock valuations have climbed to a level only exceeded during the dot.com bubble. Company executives are cashing-in: insider selling in the first quarter of 2021 was at a 14 year high.

CONCENTRATED INSIDER SELLING IS ASSOCIATED WITH 15-MONTH-AHEAD CRASH RISK, ACCORDING TO RESEARCH BY DURHAM UNIVERSITY.

Since the 1980s getting an inside tip from a company executive could put a fund manager in jail. Perhaps the most egregious case of insider trading was that of SAC Capital, who managed the world's highest-returning hedge fund, despite the burden of a 3% management fee and taking 50% of the profits.

A SEC investigation attributed their performance to $1.4 billion made from insider information, such as having paid for the results of an Alzheimer’s drug trial before they were publicly disclosed.

Since the conviction of eight SAC employees for insider trading, $1.8 billion in fines and the forced closure of its fund to outside investors in 2013, hedge funds have under-performed the stock-market.



UNLOVED Strategy

WITHOUT INSIDER INFORMATION, TRYING TO PICK WINNING STOCKS IS MORE LIKELY TO RESULT IN DISAPPOINTMENT. WHAT CAN INVESTORS DO? TURN YOUR BACK ON THE WINNERS IS THE SEEMINGLY COUNTERINTUITIVE ANSWER.

Nineteenth century investors viewed trains much as today's investors view Teslas. Trains were the original disruptive technology. They transformed Britain from a land of slow, agricultural villages into a fast, urban, industrialised nation. As railways expanded across America, they made up more than half of the country's stock market capitalisation at the start of the twentieth century.

As recently as the 1950s the S&P500 was divided into just three sectors, industrials, utilities and railways. But as planes, trucks and cars supplanted trains, the sector declined in importance until in 1982, Standard & Poor's ceased reporting railways as one of the main sectors of the US economy.

Railways remained 'unloved' by investors until in 2009, Warren Buffett surprised everyone by buying the Burlington Northern Santa Fe railway, one of the US largest.

No one was else was interested in railway stocks at the time, so Buffet paid just $0.89 for every $1 of assets on Burlington's books - the deal was so good, one Buffett watcher later remarked, he had stolen the company.

The $44 billion cost of the takeover has since been fully recouped, from the $42 billion in dividends paid out by the railway and $2 billion it still holds in cash. As part of Buffett's Berkshire Hathaway conglomerate, the railway's shares are no longer separately listed, but one can gather a measure of how they have grown in value from the remaining six listed Class 1 North American railroads: since the day before Buffet purchased Burlington shares, these have on average risen 700%.

When Buffett first bought a stake in Apple in 2016, there was little of the reassurance that today's investors get from being part of the herd. It is hard to believe now, but in 2016 Apple was also very much 'unloved'. Trading at just ten times earnings, after its share price had fallen 30%, one venture capitalist tweeted Apple stock "trades like a steel mill on its way out of business."

But Apple shares were also a steal, evident from the rise in its valuation since to twenty-nine times earnings, after its share price had risen 400% over the last five years.

In his latest annual letter to Berkshire Hathaway shareholders, Warren Buffet describes these technology stars of the 19th and 21st centuries as two 'crown jewels' in his portfolio.

For over twenty-five years Morningstar has been testing the results of its 'Buy the Unloved' strategy, that points investors away from the popular, but expensive sectors, towards cheap or out-of-favour parts of the market, based on those that have suffered the largest investor outflows. Every three years the portfolio is sold and the proceeds reinvested in that year's unloved categories.

'Buy the Unloved' is not an easy strategy to implement - Blackrock likened the difficulty to 'looking at the last loaf in the baker's shop: investors don't spot a bargain, they wonder why no-one else wanted it.'

But in comparison to the 'loved' portfolio (consisting of those sectors with the greatest investor inflows) the results of Morningstar's unloved strategy have been startling:

$10K INVESTED AT THE BEGINNING OF 1994 IN THE 'LOVED' PORTFOLIO WOULD BE WORTH NEARLY $58K BY THE END OF 2020 – THE SAME SUM INVESTED IN THE 'UNLOVED' PORTFOLIO WOULD HAVE GROWN TO $183K.

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