



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

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Caution About the Information Technology Sector of the U.S. Stock Market

Nothing goes in one direction forever. Trees don't grow to the sky.
Few things go to zero. And there's little that's as dangerous for investor
health as insistence on extrapolating today's events into the future.

Howard Marks, *The Most Important Thing*, 2011

At Bradley, Foster & Sargent, we believe that investing is a long game. It is a marathon, not a sprint. Like Warren Buffett, Peter Lynch, Bernard Baruch, and a host of other great investors, we do not think that it is possible to consistently predict stock market tops and bottoms. Therefore, our investment approach is not to dart in and out of the market, selling at market tops and waiting to buy until the market bottoms. We also don't engage in a great deal of sector rotation in and out of industries, seeking to time the business cycles over the short or medium term. We believe in investing in great companies at opportune moments for the long haul. Our average holding period for a stock is more than four years, and in some cases, we own stocks of great companies in client portfolios through bull and bear markets for decades.

We also believe that diversification in a portfolio is vital to moderate volatility and risk. Accordingly, we diversify client portfolios into a broad range of stocks of quality companies in differing industries in key sectors of the stock market. The S&P 500 Index organizes itself into eleven sectors – broad groupings of companies that have similar economic characteristics. In previous years, there were ten sectors, but in September 2018, the S&P 500 Index added Communication Services as an additional sector. The following companies, among others, were removed from the Information Technology and Consumer Discretionary sectors and added to the Communication Services sector: Alphabet (Google), Facebook, Netflix, Disney, and Comcast. The following is the breakdown of the percentage weightings of the eleven sectors of the S&P 500 Index as of July 15, 2019:

Industry Sectors in the S&P 500 Index July 15, 2019

Sector	Percentage Weighting	Sector	Percentage Weighting
Information Technology	21.7%	Consumer Staples	7.3%
Health Care	13.9%	Energy	4.9%
Financials	13.1%	Utilities	3.3%
Communication Services	10.4%	Real Estate	3.1%
Consumer Discretionary	10.4%	Materials	2.7%
Industrials	9.2%		

Within each sector, there are various industry groupings which are characterized by the similarity of their business models. For example, the Communication Services sector includes the telecommunication service industry with companies such as Verizon and AT&T; the entertainment industry with companies such as Netflix and Disney; and the interactive media and services industry which includes companies like Alphabet, Facebook, and Twitter.

Should a Portfolio Own Stocks in Each Sector?

At BFS, we work closely with our clients to determine their financial goals and objectives – not only for the overall relationship but also for each of their individual portfolios. For example, we may construct a portfolio for which the investment objective is aggressive growth with an asset allocation of 90-100% equities, and another portfolio might have an investment objective of capital preservation and income, utilizing a mix of stocks with robust dividends and various fixed income instruments. Currently, an aggressive growth portfolio might have 30% or more invested in Information Technology and Communication Services stocks and little or no holdings in the Utilities, Real Estate, and Consumer Staples sectors. On the other hand, a portfolio with an investment objective of capital preservation and income might own some Utilities, REITS, and Consumer Staples – quality companies in each sector with strong business models and robust dividend yields. Thus, portfolios with disparate investment objectives will be structured with different sector weightings, but each portfolio will generally own stocks in at least six or seven of the S&P sectors in order to achieve real diversification in the portfolio.

Times to Avoid Certain Major Market Sectors

Over the past 40 years, there have been a handful of occasions when a sector of the S&P 500 Index turned in truly terrible investment performance for years – sometimes even for a decade. A classic example of this was the Energy sector during the decade of the 1980s. In 1972, the weighting of stocks in the Energy sector of the S&P 500 was only 7%. Then, OPEC's oil embargo in 1973 caused the price of oil to rise globally from roughly \$3 per barrel to \$12. With inflation rampant during the 1970s, investors poured money into “hard asset” stocks in the Energy sector. During the Iranian Revolution in 1979, the price of oil in the U.S. spiked from approximately \$16 to \$39 a barrel, and stocks in the Energy sector accounted for 22% of the S&P 500. Stock prices of companies in the Energy sector of the S&P 500 rose dramatically as profits mushroomed. Prices of energy stocks in the U.S. were up 68% in 1979. They rose another 83% in 1980. The Energy sector of the S&P 500 reached a weighting of 28% at the end of 1980. In 1981, there were few buyers left for energy stocks; investors' portfolios were already full of them. That was the time to exit the Energy sector – for many years. The following table shows the performance of selected stocks in the Energy sector versus the S&P 500 in the 1980s:

Investment Performance of Energy Stocks 1980–1990

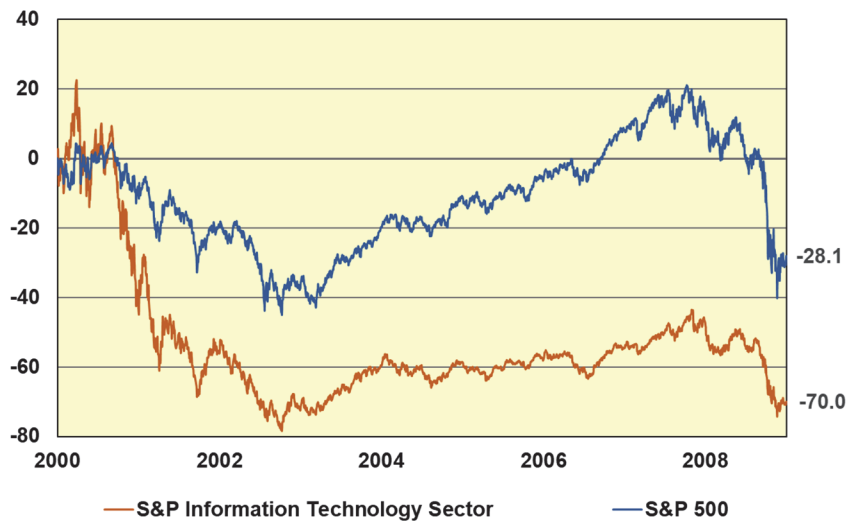
Company	Cumulative Total Return
Schlumberger	-19.5%
Noble Exploration & Drilling	-24.7%
Halliburton	-25.4%
Chevron	+133.0%
S&P 500 Index	+280.2%

The only major company in the Energy sector whose stock performed admirably was Exxon. During the 1980s, Exxon managed to keep its revenues and operating profits from declining, and with little debt and massive cash flow, Exxon reduced its share count from approximately 7 billion shares to 5 billion shares – almost 29%. Exxon also increased its dividend 50% during the 1980s. Consequently, Exxon’s stock achieved a cumulative return of 368% for this period.

Shunning Information Technology Stocks at the End of the Internet Bubble

The dot.com bubble was a period of historic excessive speculation in U.S. internet and technology stocks that ran from 1995 to 2000. On March 10, 2000, the NASDAQ Composite, where the great majority of these companies traded, peaked at 5049. At the end of 1999, the Information Technology sector represented almost 30% of the S&P 500 Index. The enormous speculative fervor of investors pushed the U.S. stock market to an excessive valuation by 2000, and this was the main reason for the execrable performance of stocks during the next decade. Over the next two years, the NASDAQ fell 77.4% to a low of 1140 on October 4, 2002. Many companies failed; Amazon’s stock fell 95% from \$113 to \$5.51 during this period. *While the S&P 500 had a negative total return of 28.1% from 2000 through 2008, the Information Technology sector plunged 70.0%.* To avoid serious losses and preserve as much capital as possible in these trying markets, investors would have been wise to avoid this sector almost entirely for the whole first decade of the 21st century. The chart below tells the story:

**Investment Performance of the Information Technology Sector
2000 – 2008**



Source: Bloomberg

The Lost Decade for the Financials Sector

Many barrels of ink have been used to describe the Financial Panic of 2008. We will not rehash it here, but we will point out that financial stocks had a great run from the mid-1990s until the end of 2006. Investors poured money into financial stocks, as regulation moderated in the financial industry and profits soared during the housing boom. By the end of 2006, stocks in the Financials sector had the largest weighting in the S&P 500 – 22.3%. For a period of almost ten years, the Financials sector actually had a negative total return, while the S&P 500 was up 85.1%. The chart on the following page shows this dramatic underperformance of the Financials sector:

Investment Performance of the Financials Sector 1/1/2007 – 10/31/2016



Source: Bloomberg

Should Investors Be Cautious About the Information Technology Sector Now?

A common thread runs throughout this investment commentary: When the weighting of one sector of the stock market, as represented by the S&P 500, grows to more than 20%, that sector tends to underperform the stock market significantly for years. What seems to happen is that the apparently bright and limitless future of one or more industries in a sector attracts a great deal of money from investors, driving up stock prices to unsustainable levels. The levels are unsustainable because the valuations of the shares assume unending rapid growth, and when this growth is not achieved, investors run for the exits.

The table on the first page shows the weighting of the Information Technology sector of the S&P 500 currently at 21.7%. If several of the social media stocks in the Communication Services sector such as Google, Facebook, and Twitter are added to this sector, the weighting increases to 26.4%, and these three companies are surely technology companies of a sort. A sector weighting of 26.4% does raise a flag. Perhaps not a red flag but at least a cautionary one. We own many quality technology companies with quite reasonable valuations in client portfolios. But with inflation at 2% or less, the market is infatuated with companies which can grow revenues at 20% or more. Many technology companies, especially SaaS (software as a subscription) companies, are currently growing revenues well above 20%, and although many of these companies have no GAAP earnings and have negative operating cash flow, investors have elevated the valuations of these companies dramatically – valuing some at 20 times sales rather than 20 times earnings. At BFS, we tend to avoid these companies, believing that one can learn from experience. Perhaps Henry Ford was right when he famously said, “History is bunk.” But we don’t think so. Our approach is to pay attention to historical patterns, and this leads us to be cautious about the stocks we own and their weightings in the Information Technology sector. Caveat emptor – buyer beware!

Bradley, Foster & Sargent, Inc. *Investment Management*

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