Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

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The NASDAQ Composite Crosses 5,000 Again: What a Difference 15 Years Makes

> When a share price, or an index, goes higher than it's ever been before, it's telling you buyers are finding a new reason to pay more than they ever have before. This is Starship Enterprise on its way. The market is going where no man has gone before.
>
> Robin Griffiths, HSBC Securities,
> *Investor's Business Daily*, January 8, 1999

With the NASDAQ Composite (NASDAQ) crossing the 5000 mark last month, there has been much attention in the media comparing the stock market to March, 2000. And naturally, not all of the press attention has been favorable. Some pundits are suggesting that the NASDAQ (and indeed the whole stock market) is now very expensive and selling at extreme valuations – just as it was in 2000. Accordingly, we thought it would be a useful exercise to compare the composition and valuation of NASDAQ now with the same index in early 2000.

Many investors will never forget the great bull market of the 1990s. At the end of 1990, the NASDAQ traded around the 350 level. Less than ten years later on March 10, 2000, the NASDAQ peaked at its all-time high, trading at 5132. The NASDAQ, which was previously called the over-the-counter index, increased more than fourteen fold during this bull market of bull markets. It was beyond "irrational exuberance" – a phrase coined by Alan Greenspan in a speech in December, 1996. It was Starship Enterprise, charting a course to a new galaxy. It was the "new era" of investing; the old rules apparently no longer applied. As the NASDAQ Composite rocketed to new highs each day, even Warren Buffett, the Sage of Omaha was mocked, as his investment approach of focusing on high-quality, reasonably-valued companies underperformed the market and was called "old hat." The chart below chronicles the parabolic ascent of the NASDAQ Composite during this storied investment decade:

NASDAQ Composite
January, 1990 - March, 2000

Source: Bloomberg

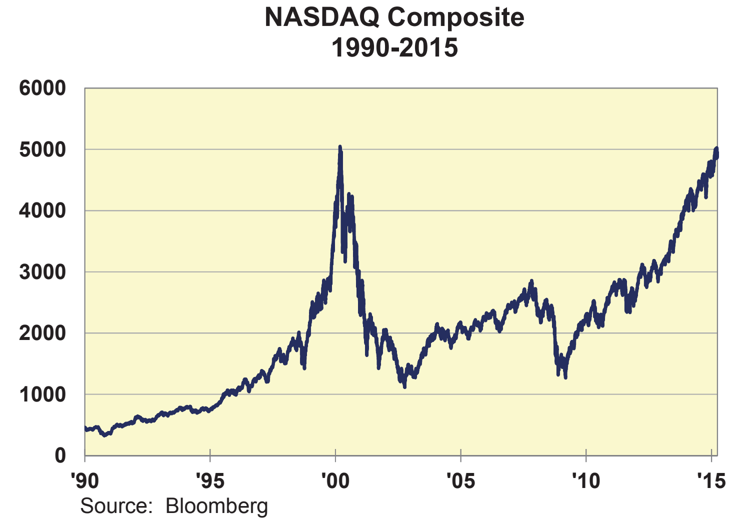
The incredible bull market of the 1990s was destined, of course, to end badly. It took four years for the NASDAQ to double from 500 to 1000, and then another 3½ years to double to 2000. The NASDAQ was compounding at 18-20% a year from 1990 through 1998. Then, propelled by the huge spending involved in the massive technology replacement project called Y2K and the mania which developed around companies involved in the Internet, the NASDAQ doubled in 1999, zooming from 2000 to 4000, and then ascended another 25% during its final wild climax run during the first three months of 2000, cresting at 5132.

The Great NASDAQ Bear Market of 2000-2002

This magnificent bull market did end very badly indeed. Two-and-a-half years later, the NASDAQ bottomed at 1108 on October 10, 2002 – a drop of 78.4%. It was a bear market which closely rivaled the bear market in the Great Depression, when the Dow Jones fell 89.2% from 1929 until 1933. But fortunately, the economic consequences of the 2000-2002 bear market were not as dire as those of the Great Depression, when unemployment reached 25%. One of the reasons why the 2000-2001 recession was so mild was because 65% of the market capitalization of the NASDAQ was in technology and Internet shares, which did not affect the service or industrial sectors of the economy very much. For example, *the market value of the Internet sector in 1999 was approximately $1 trillion, yet the entire sector had only $30 billion in sales and aggregate losses of $3.4 billion*. This was America's homegrown version of the "tulip bulb" craze in Holland in 1636-1637, when some tulip bulbs sold at prices equal to 10 times the annual salary of a skilled Dutch worker. Yet the market values of even the best of the technology companies were inflated in much the same manner as the "Internet bubble" firms, as the table below demonstrates:

Company	12/31/99 Price	2000 EPS (Estimates)	P/E Ratio
Lycos	$ 80	$ 0.25	318
Yahoo	$ 433	$ 0.69	281
Broadcom	$ 173	$ 0.62	279
Qualcom	$ 89	$ 0.39	225
AOL	$ 76	$ 0.39	195
Nortel	$ 860	$ 8.29	166
CMGI	$1,192	$11.29	106
Cisco	$ 107	$ 1.13	95
Oracle	$ 112	$ 1.25	90
EMC	$ 109	$ 1.42	77
Microsoft	$ 116	$ 1.76	66
Intel	$ 75	$ 1.21	62

In the sickening 2000-2002 bear market which followed the climax run of the NASDAQ, the stocks of the above companies fell between 72% and 100%. The P/E ratio of the NASDAQ was 152 at the peak in 2000; it fell to below 25 by the end of 2002. At the peak in early 2000, 5,169 stocks were part of the NASDAQ. Since then, almost 3,700 of those stocks are no longer part of the index, having failed, merged, or been acquired. Including companies which have gone public in the intervening years, the current number of stocks traded on the NASDAQ is 2,570. This means that there are roughly 50% fewer companies in the NASDAQ now than in 2000. Many investors thought that they would not see the NASDAQ retrace its path to the 5000 mark in their lifetime. But now, 15 years later, it has happened. The chart which follows shows the NASDAQ Composite's ascent to reclaim the 5000 level.



As can be seen above, the NASDAQ's climb back to 5000 was not easy or smooth due to the near collapse of the U.S. financial system in 2008-2009, but as of this date, the NASDAQ is currently trading at 5020 – just 2% below its all-time high.

Another Bubble in the NASDAQ?

As the NASDAQ nears its all-time high, it is natural for investors to remember the dizzying heights of the market in 2000 and fear that another bubble is forming. But the NASDAQ is a very different animal now. This can be seen from the make-up of the top ten stocks in the NASDAQ as shown below:

Top Ten NASDAQ Components
February 28, 2015

	NASDAQ Weighting	Market Capitalization ($ Billions)	2015 P/E
Apple	9.60%	$748.2	14.5
Microsoft	4.61%	$359.7	15.5
Google (Class A & C)	4.46%	$381.4	19.2
Facebook	2.24%	$221.8	38.6
Amazon	2.24%	$176.5	105.2
Intel	2.05%	$157.5	13.6
Gilead Science	1.99%	$154.2	10.8
Cisco	1.92%	$150.6	13.3
Comcast	1.68%	$150.7	18.0
Amgen	1.53%	$119.7	16.6

In March, 2000, eight of the ten largest components in the NASDAQ were technology hardware and software companies; the other two were WorldCom and Yahoo. The lowest P/E ratio of any company in this group was 60. The composition of the NASDAQ currently is in stark contrast to that of 15 years ago. The largest components of the NASDAQ now consist of two biotechnology companies (Gilead and Amgen), a cable company (Comcast), an Internet retailer (Amazon), a search firm (Google), a social media firm (Facebook), and four technology hardware and software companies.

Moreover, the P/E ratio for eight of the ten companies on 2015 estimated operating earnings is below 20, and below 15 for four of the companies. The only real outlier is Amazon with a P/E ratio of 103 (although its price to cash flow is approximately 15). Facebook is the other high P/E stock, but with an estimated annual earnings growth of 25%+ over the next 3 years, many investors view its valuation as appropriate.

Another reason to view the current valuations of some of these key companies as modest is the amount of cash that they are carrying on their balance sheets. For example, Apple, as of the end of 2014, had net cash and liquid investments (cash minus debt) on its balance sheet of $141.5 billion – more than $24 per share in cash. Microsoft had net cash of $62 billion ($7.50 per share in cash), and Google had net cash of $59.2 billion ($88 a share in cash). Thus, many investors view the P/E ratios on some of the companies on the previous page as quite reasonable when taking the cash per share into account.

Some NASDAQ Sectors are Frothy

While the great majority of companies listed on the NASDAQ have reasonable valuations, there are several sectors attracting much speculation. One such sector is biotechnology. All four of the big biotech companies – Gilead, Amgen, Biogen, and Celgene – have great drugs on the market, significant revenues and earnings, and strong cash flow. These stocks sell at reasonable valuations. There is another tier of biotech companies with one or two approved drugs on the market which promise rapid sales and earnings growth. The valuations in this group are expensive, if not stretched. However, there are dozens of biotech companies on the NASDAQ with drugs only in Phase I and Phase II of the FDA approval process. Most have little or no revenues and have large annual losses. This is the group where speculation is rife, and investors are often buying the stocks of these companies on the greater fool theory. Other frothy sectors include alternative energy, social media, and "cloud" based companies. Many companies in these sectors trade on hope and the promise of a rainbow on the horizon. Our word of advice after six years of a bull market: Caveat emptor! (Let the buyer beware!)

Summary

The fact that the NASDAQ is trading around the 5000 level, not far from its 2000 all-time high, is not cause for investor anxiety. The main takeaway is that the NASDAQ is now trading around 22 times estimated 2015 operating earnings. This is more expensive than the S&P 500 which is currently valued at a P/E of 17.4. But the NASDAQ's premium over the S&P 500 is well-justified because the NASDAQ is comprised of hundreds of small and mid-capitalization companies with more rapid growth in sales and earnings than the typical company in the S&P 500. For us at Bradley, Foster & Sargent, the key to investment success over the long term is to stick to quality companies with strong brands, good managements, growing sales, and robust cash flow, and to buy them at reasonable prices.

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