A Rising Tide Has Not Lifted All Stocks

When the daily media reports focus on all-time highs in the stock market, you have to wonder whether your portfolio is doing as well. The odds are that it's not.

What's going on?

It's true that the Standard & Poor's 500 and the Dow have been climbing steadily at a modest pace, which has them both standing about 10% above where they began the year. Even so, it's likely that your portfolio has not done as well. This year's gains have been registered primarily by mid and large cap stocks. That's the constituency of those two major indexes.

When you look at what has been happening with small cap stocks, the picture changes dramatically. They've been little more than dead in the water since late February, rising less than 1% in the five and a half months since then. This lackluster activity is well illustrated by the Value Line Geometric Index, which measures the price movements of the 1700 most actively traded stocks that Value Line follows. That's a larger universe than the Dow or S&P and it includes the stocks found in both indexes. When viewed in perspective, it becomes clear that the 1200 companies not in either of the major indexes must be doing quite poorly.

For smaller stocks, this is good news since earnings are rising while prices remain steady. This results in more reasonable valuations. So while the valuations of the stocks of bigger companies continue to stretch, small caps become more interesting. That's not to suggest that it's time to back up the truck and load up, but it does point to where values are better and prospects for future gains are more substantial.

The narrowing group of advancing stocks brings to mind the Nifty Fifty of the late 1960s and early 1970s. They were singled out by Morgan Guaranty as some of the world's fastest-growing companies, which prompted investors to bid them up, regardless of the excessive valuations at which they sold. The Nifty Fifty included such names as McDonald's, Coca Cola, IBM, Eastman Kodak, and Polaroid as well as Wal Mart, then a mere upstart.

The key parallel between then and now is the disparity in valuations between the Nifty Fifty stocks and the rest of the market. The overall market price-earnings multiple then was about 19 times current 12-month estimated earnings. The multiple for the Nifty Fifty stocks was more than double that.

Today's Nifty Fifty stocks are also priced toward the stratosphere. Amazon is 217 times earnings. Facebook is at 32 times earnings. Netflix is at 154 times. And Tesla, currently priced at almost 350, isn't even in the black.

The upshot of the Nifty Fifty era wasn't much different from what took place after the dot.com debacle, except that it was even worse. So much air was let out from stock valuations that the multiple for the S&P 500 dropped below 10 times at the end of 1974. That was the beginning of an eight-year stretch when stocks were on the bargain table. Even so, investors had been burned so badly that few were willing to take the plunge again. Not surprising, on August 13, 1979, the headline on the cover of Business Week was "The Death of Equities".

When that magazine was published, the Dow Jones average was about 2,900. Three years later, the Dow had slipped even further, to just above 2,000.

Was it the end of the world? Obviously not, but over time stock prices swing far more widely than underlying earnings, which underscores the impact of changing psychology. At the moment, the world of stock investing seems rosy, corporate earnings are rising, and interest rates are still low. Although that's usually the basis for a strengthening market, there's good reason for an extended time-out so earnings can catch up with advancing stock prices. In the absence of a meaningful slowdown in this rally, we'd dial up the worry meter considerably.