OLIVAR & ASSOCIATES

The Value Investor Note

Insights & Think Pieces for the Prudent Investor
Summer Wrap-up: September 11th 2017

Market Snapshot
DOW JONES: 21,797
S&P500: 2,461
NASAQ: 6,360

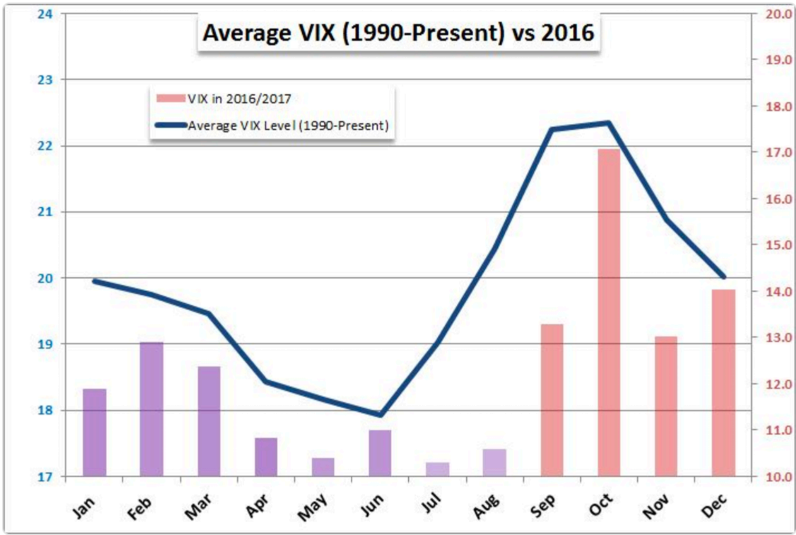
The Rise of Bitcoin

Bitcoin was the first of what have become known as "crypto currencies", forms of digital money that use encryption to secure transactions. Bitcoins are used for electronic purchases and transfers, with every transaction logged digitally. The ability to provide secure transactions using a form of currency independent of central banks has lead to mounting popularity. Let's put the growth of bitcoin value into perspective. On May 22, 2010, a developer bought two pizzas using 10,000 units of bitcoin. Today, those two pizzas would be worth an eye watering $50 million in bitcoins. Further increasing the volatility is the Chinese Government; after saying they would shut down local bitcoin exchanges, the price of bitcoin quickly dropped 7%, bringing the current bitcoin price to $4,200 from $5,000 just last week.

This nuclear growth has caught the eye of investors (and gamblers), yet many caution against trying to chase prices higher and higher. Bitcoin is supposedly a currency, but almost no one uses it to buy anything. In July, Bloomberg published an article "Bitcoin Acceptance Among Retailers Is Low and Getting Lower", explaining how Bitcoin is accepted at just three of the top 500 online merchants (down from five last year). The striking discrepancy between virtually no merchant acceptance and bitcoin's recent gains highlights the dangers of euphoric investing. A dangerous spectacle occurring in US stock markets as well.

Why a Value Investor Welcomes Volatility

With the end of summer upon us, we enter a period of historically heightened volatility. The "VIX" is an instrument that measures market volatility, and typically stays between 10 and 20. Per Figure 1, notice how September and October average towards the top of that range. During periods of extreme volatility (2008 financial crisis), the VIX has soared as high as 80. If we experience the foretold rise in volatility this fall, the stock market may falter.



Some may wrongly interpret this as a signal to liquidate stock market holdings. A more prudent choice is to build a portfolio that limits risk, while maintaining exposure to value within the stock market. To address this task, let's start by discussing what has been driving the significant US market returns this year. Technology. The S&P technology sector is close to 23% of the total market weight, the highest percentage since the tech bubble. Five stocks (Facebook, Amazon, Netflix, Google, Alphabet) account for 10% of S&P500 returns. Most disturbing are the extreme valuations attached to these highly influential stocks. The historical average P/E ratio (common valuation metric) of the S&P500 is roughly 16x. All of the before mentioned companies have ratios at least twice the average, with Netflix and Amazon each over 200x.

Jack Ablin, CIO of BMO Private Bank summarizes the concerns of such a phenomenon: "As an investor, you have to be concerned when so many investors are on the same side of the canoe. It's an unusual market. One that appears to be defying gravity, but if there's any indication that things are turning around, there are a lot of weak hands holding tech". As a result, we are content with missing out on short-term gains in pursuit of a long term and resilient value portfolio.

We start by setting the course; we succeed by staying the course.