Douglass Winthrop

New York Washington, D.C. West Palm Beach

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Dear Clients, Partners and Friends,

The controversial English polymath and cousin of Charles Darwin, Sir Francis Galton, was a math prodigy during the Victorian era. While developing his theories of "correlation" and "regression to the mean," he never passed up an opportunity to apply his inquisitive mind to everyday life. In 1906 while visiting a livestock fair, he became intrigued with a weight guessing contest. Eight hundred fair attendees submitted their guesses as to the weight of an ox. Analyzing the written responses, Galton discovered to his surprise that while none of the guesses were accurate, the average guess was exactly the weight of the ox.

Citing Galton's work, many economists have written extensively about the "wisdom of crowds," especially to support the hypothesis that the stock market is an efficient pricing mechanism, and therefore particularly hard to beat. Nobel Prize winner, Eugene Fama, theorized that stock market prices incorporate the cumulative effort of millions of investors evaluating all available information. He concluded that his "efficient market hypothesis" means that, at any moment in time, the prices of stocks are reasonably fair and account for all known risks and potential outcomes.

"I can calculate the motion of heavenly bodies, but not the madness of people." Attributed to Sir Isaac Newton

Newton, the author of the theory of gravity and creator of calculus, lost a substantial portion of his fortune in the South Sea Company stock market bubble and subsequent crash in 1720. The South Sea Company was focused on speculative ventures dependent on future profits from unproven trade routes. The company had limited actual operations. Driven by investor excitement, the company's share price soared from around £100 at the beginning of 1720 to a peak of approximately £1,000 in August. It crashed dramatically, falling to about £124 by December. After initially purchasing shares in the South Sea Company, Newton cashed out in April 1720, generating a substantial profit. Newton, however, succumbed to the allure of the persistently rising stock price. He re-entered the market, purchasing shares at much higher prices, close to the peak of the bubble. His decision proved disastrous. Newton's holdings plummeted in value, leading to significant financial losses estimated to be in the millions in today's dollars. The shares never recovered, remaining well below £200 for years to come.

While the stock market today is more highly regulated and operationally sound than in Newton's era, investor sentiment can nevertheless achieve levels of irrational exuberance. During the "Dotcom Bomb" of 2000, a rapid rise in U.S. technology stock valuations was fueled by investments in internet-based companies, many of which had no revenues and few prospects of earning a profit. Driven by speculative frenzy, equity values grew exponentially. The technology-dominated Nasdaq index rose from under 1,000 to more than 5,000 between the years 1995 and 2000. In the crash that followed, the Nasdaq tumbled 77% from a peak of 5,048.62 on March 10, 2000, to 1,139.90 on Oct. 4, 2002. Even the share prices of blue-chip technology stocks like Cisco, Intel, and Oracle lost about 80% of their value. While the dominant technology companies of today such as Microsoft and Amazon survived the implosion, it would take 15 years, until April 24, 2015, for the tech-heavy Nasdaq to reclaim its Dotcom Bubble peak.[1]

While Eugene Fama's work on efficient market theory might have won him a Nobel Prize, the "fairness" of the price of stocks also depends on an investor's timeframe. The theory, in practice, does not banish bubbles. It can take

[1] https://www.investopedia.com/terms/d/dotcom-bubble.asp

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years, if not decades, for prices to recover to bubble-peak highs. Over the long haul, the stock market is likely to produce strong risk adjusted returns. The shorter an investor's time-horizon, however, the riskier that proposition becomes.

The United States tech industry has been unusually productive in recent years and has driven large gains in the S&P 500. These gains have outpaced stock market returns in the rest of the world.[2] As passive index-based investment vehicles begin to account for an ever larger and more impactful share of total investment in equities, however, anomalies can arise, and price discovery becomes more suspect. We have recently been witnessing the sorts of extremes that can occur in such conditions: Over the past decade, the S&P 500 compounded at 13.35%, well above its long-term average of 11.60%.[3] During this period, the multiple investors are willing to pay for a particular stream of earnings expanded from 15.4x to 21.8x earnings per share.[4] This stock price "inflation" has been led by a handful of tech companies, including the so-called "Magnificent Seven," and likely represents the narrowest advance in the S&P 500 in history.

The average price-to-earnings (PE) multiple of the Magnificent Seven is now 29x their estimated next twelve months' earnings per share.[5] By comparison, the PE multiple of the other 496 companies of the S&P 500 (the S&P 500 has 503 companies currently!) is "only" 19.4x, still above its historical average PE multiple of 16.95x**.**[6] The disparity between the Magnificent Seven and the rest of the market is cause for concern. Corrections, when they arrive, can be sudden and violent. In a single week between July 10 and 17, 2024, the Magnificent Seven collectively lost $1.2 trillion in market value. On a single recent trading day, Monday, August 5, 2024, the Magnificent Seven shed over $650 billion in market value.[7]

Since those unexpected market "air-pockets," investor complacency has returned and the Magnificent Seven have largely recovered. Because the S&P 500 is market-cap weighted, the Magnificent Seven now make up more than 31% of the index.[8] We believe there is growing concentration risk in the S&P 500. An investor buying an S&P 500 index fund today is committing approximately one-third of their capital to seven of the most expensive stocks in the market.

Different By Design

The concentration risk in the S&P 500 is magnified by sector risk. Eight of the top ten companies in the S&P 500 are technology companies. By contrast, the largest ten holdings in a typical Douglass Winthrop (DWA) flagship equity portfolio represent a broader cross section of the economy. These include three of the large tech companies, **Alphabet**, **Amazon** and **Microsoft**; two financial services companies, **Mastercard** and **Markel**; Warren Buffett's **Berkshire Hathaway**, a conglomerate we consider a proxy for the US economy with ownership of North America's largest railroad, vast insurance operations, a large asset base in electrical generation and transmission, and a variety of other holdings;[9] a staple retailer, **Costco**; an entertainment company, **Netflix**; a vertically integrated paint company, **Sherwin-Williams**, and a specialty parts supplier to the aerospace industry, **Transdigm**.

As each sector of the economy is driven by unique structural dynamics as well as specialized drivers of supply and demand, we feel more comfortable having exposure to a portfolio that reflects a greater diversity of opportunities

[2] https://www.morganstanley.com/ideas/international-stocks-opportunities-2024
[3] Bloomberg. Long term average is 75 years from 09/30/1949 – 09/30/2024
[4] Bloomberg 12 month forward PE from 09/30/2014 – 09/30/2024
[5] Bloomberg. The "Magnificent Seven" includes, Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla.
[6] Bloomberg Historical avg. period of 30 years between 09/30/1994 – 09/30/2024
[7] https://www.wsj.com/livecoverage/stock-market-today-dow-sp500-nasdaq-live-08-05-2024/card/magnificent-seven-tech-stocks-shed-more-than-700-billion-in-market-value-XZiWrR72gcYDbspI8vBi
[8] Bloomberg
[9] Berkshire Hathaway 2023 Annual report: https://www.berkshirehathaway.com/2023ar/2023ar.pdf

across multiple sectors. Over the last year, of the seven largest DWA positions not included in the Magnificent Seven, three have outperformed an equal-weighted basket of those seven stocks: Transdigm, Netflix, and Costco.[10] Of those large DWA holdings that have not kept pace with the high-flying basket, we are content to own them for the long run. We believe Berkshire-Hathaway's current share price understates to some degree the value of its unique assets. Mastercard will not soon be replaced as part of the essential "plumbing" of an increasingly cashless world. Highly profitable, Mastercard has grown earnings on average over 17% for the last ten years.[11] If you hire someone to paint your house, there is a 60% chance they will be using Sherwin-Williams paint. The company has grown its revenues and dividends every year for fifteen years, while compounding earnings per share 15% annually over that period. Wielding a strong balance sheet, Sherwin's management is squarely focused on returning capital to shareholders through dividend growth and share repurchases.[12]

We should be careful to point out that we do not believe current equity valuations in the technology sector constitute a bubble. Real earnings growth has driven much of the success of the stock prices of the Magnificent Seven. Amazon and Alphabet have grown profits faster than their share price over the last decade, meaning the multiple paid by investors for their shares has contracted. Additionally, it is hard to imagine people giving up their smart phones, their internet searches or demanding less intelligent data and fewer applications. These have become the staples of modern life, nearly as necessary as food, energy and shelter.

Nevertheless, we would not commit one-third of our clients' capital to seven of the most expensive companies in the single most expensive sector of the market. By design, DWA's investments will nearly always diverge from the performance of any index. Our aim is to be a patient steward of our clients' capital, and to achieve a strong risk-adjusted return that will enable them to reach their most cherished goals throughout their lives. To accomplish this objective, we remain wary of market dynamics driven by investor fear or greed and do our best to preserve and prudently grow our clients' assets. This philosophy requires us to forge our own path rather than simply mimic the wisdom of crowds.

As we celebrate our 25th Anniversary as a firm, we remain humbled by the trust our clients have placed in us. We are committed to serving them to the best of our ability while always putting their interests first.

Sincerely,

Douglass Winthrop Advisors

[10]Bloomberg. Past Performance Is No Guarantee of Future Results.
[11] Bloomberg
[12] Sherwin-Williams Investor Presentation, August 29, 2024

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