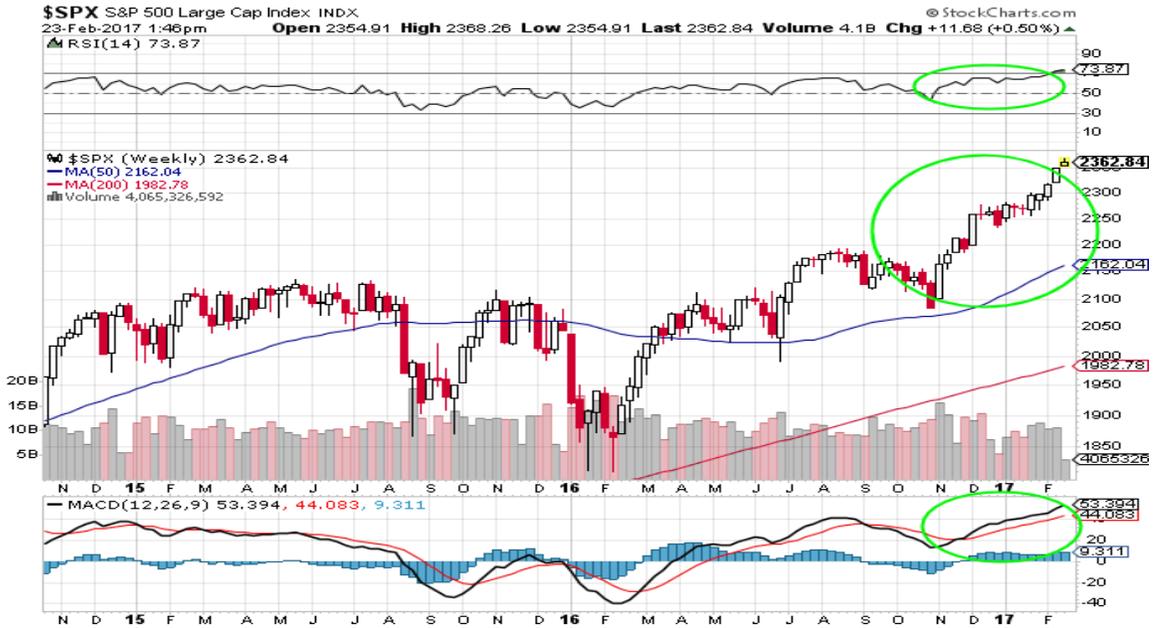


## Starboard Weekly Report Ending February 24, 2017 Charts of the Week



We have two completely different pictures in these weekly charts from StockCharts.com. The top rosy image depicts the S&P 500 (SPX) Trump rally. The bottom chart, SPX vs. RUT, illustrates the real relative strength of new market highs compared to small caps. It's a study of the current upsurge of a market driven by index investing into only large cap stocks.

## **TECHNICAL**

There have been three key drivers of this eight year bull market: three episodes of Quantitative Easing (QE), massive corporate share buybacks and the current driver of Index investing. As we can see, the index of choice is the S&P when compared to the Russell 2000 (RUT). It has become the market of generals (S&P) whereas the troops (RUT) have not been invited to participate. Please note how since late 2016 the RUT has declined in relative strength to the S&P. This divergence is serious because it indicates narrow bias regarding the excitement about the markets making new highs. The reason for the S&P and DOW's leadership movement in the market is due to the popularity of passive investment into index funds. When demand is centered on a small group of stocks, like today's indexes and the tech companies in 2000, they move to dazzling new heights. When holders head for the exits, it can often create sharp and lengthy declines like the 2000 to 2002 bear market.

## **FUNDAMENTAL**

Index investing is a convenient way to diversify. When these funds become over-owned as they are today, they actually are creating market liquidity issues nullifying the risk benefits of diversification. This concentration reduces interest in non-indexed equities to the point that there becomes a premium evaluation for indexed companies. This premium makes the indexed securities more risky which in turn increases downside. An example of this is the average PE of the top 10 securities in the S&P index which is almost 42 times earnings (PE); while the average PE of the market is slightly below 30 times earnings. This same premium metric applies to price to book and price to revenues; indicating a further example of the indexes being much riskier than the market itself. During 2016 the second largest index mutual fund manager, Vanguard, brought in close to 400 billion increases in new assets. This type growth can continue, but when it ends it won't be pretty. The RUT represents 2,000 companies in its index. Thirty percent have no earnings. What do you think will happen to it when selling begins? Possibly the market is already discounting the risk factors by indicating lower relative strength to the S&P (second chart). When the decline embarks the S&P and RUT will be in a race to a bottom.

## **ASIDE**

*"Participation is easily obtained with Latin chant."* Richard Morris

Cui Bono (Who benefits)

When it comes to Index investing, it won't be the investing public.

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