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What the 'Nifty Fifty' can tell us about bond proxies

Shares with high valuations were a problem for US investors in the 1960s, says **Terry Smith**

ADVICE & COMMENT

Terry Smith

Last week, I suggested that we might learn something about the outlook for so-called bond proxy stocks by studying the events of the Nifty Fifty era and its aftermath in the US.

So what happened? The term refers to a period in the 1960s and 70s when 50 large-cap stocks on the New York Stock Exchange that were widely regarded as solid buy and hold growth stocks reached towering valuations. The stocks were often described as "one-decision". They were viewed as extremely stable, even over long periods of time, so that only a decision to buy them was required as they never needed to be sold.

Their most common characteristic was solid earnings growth, for which these stocks were assigned extraordinary high price/earnings ratios. Critics of the quality investment strategy cite the Nifty Fifty as evidence of the bad things that can happen to investors who ignore valuation. Drawing comparisons with bond proxy stocks today, they point to the subsequent underperformance of most of the Nifty Fifty list as a warning today's investors should heed. Yet like many other stock market events, I find that they rely more frequently on urban myth than analysis.

So let us examine the data. The first problem? There was never an official Nifty Fifty. Various lists of stocks published by Morgan Guaranty and Kidder Peabody have been taken as a proxy. The Morgan Guaranty List was cited by Malcolm Forbes Jr in a Forbes Magazine article in 1977 entitled When Wall Street Becomes Enamored. The Kidder Peabody list is actually from a monthly list published by Kidder of the stocks traded on the NYSE which had the highest PE ratios. A research paper then christened the 24 stocks found on both lists as the Terrific 24.

However, whichever list you want to take, the average PE was somewhere between double and treble that of the wider market:

How this group of stocks came to be so highly valued is not clear. It wasn't a typical episode of market mania such as the 1920s excitement over mass production, or the dotcom era's blind zeal over the promise of technology — though the Nifty Fifty lists were sprinkled with new technology stocks that have since proven to be costly disasters. Eastman Kodak, Polaroid and Xerox are the most obvious examples.

What seems to have happened is that investor behaviour somewhat mirrored that of society as a whole. There was a kind of Woodstock moment as investors decided to throw away their old conservative dividend-paying stocks and move into so-called growth companies.

This became self-fulfilling as an investment strategy while the performance lasted. One commentator concluded that it was a "change in the zeitgeist of Wall Street".

The bursting of the bubble is rather simpler to explain. The S&P peaked on January 5 1973 and then fell 48 per cent over the next 22 months as inflation rose from 3.2 per cent in 1972 to 11.8 per cent by the beginning of 1975. Oil prices almost quadrupled after the Yom Kippur war, the 1973-75 recession began and the US became gripped by Watergate. Data are difficult to come by but the Nifty Fifty stocks held up somewhat longer than the market — although they eventually succumbed to the inevitable. That said, CocaCola's share price peaked in January 1973 at the same time as the market peak and then fell 66 per cent over the next 22 months. Johnson & Johnson stock also peaked in January 1973 but held its decline to 42 per cent between then and October 1974. Of the highest-rated names, Disney lso peaked in January 1973 and then fell 82 per cent by October 1974. The bear market of the 1970s that lasted until 1982 caused valuations of the Nifty Fifty to fall to low levels along with the rest of the market, with most of these stocks underperforming the broader market averages. This might seem to confirm the doom-laden forecast for bond proxies.

PE RATIOS, END OF 1972

Stocks	Average multiple
Morgan Guaranty Nifty Fifty	45.2
Kidder Peabody Nifty Fifty	57.9
Terrific 24	59.8
S&P 500	19.2

Source: Fundsmith research

If a Nifty Fifty exists today, which stocks would it contain? Taking the same methodology as that used for the original Nifty Fifty, the 50th highest rated stock in the S&P 500 today is Welltower, the healthcare property provider, with a PE of 40.7. This valuation is very similar to the 50th stock on the Kidder 1972 list — Clorox, the consumer goods company, with a PE of 41.4.

Furthermore, the overall PE of the S&P 500 index today, at 20.5, is similar to its PE back in 1972. In contrast, the current PE of the S&P 500 Consumer Staples sector — which is the largest constituent of the so-called bond proxy stocks — is only 22.8. The parallels with 1972 look rather clear, but the read across to bond proxies does not.

In fact, the only consumer staples stock in my updated version of the Nifty Fifty is Monster Beverage, the energy drink company. What type of stocks make up the remainder? Well, here is a selection that may help explain: Activision, Adobe, Amazon, Broadcom, Digital Reality, Expedia, Facebook, Illumina, Micron, Netflix, ProLogis, Red Hat, TripAdvisor, Yahoo, and Alexion Pharma, Allergan and Regeneron.

Of the current Nifty Fifty, only 29 pay a dividend which is not often a good sign and not an accusation you could level against the bond proxies. None of the current constituents of the Nifty Fifty is in the portfolio of the fund I run, the Fundsmith Equity Fund, or our "investable universe" of stocks we would be prepared to own.

If you are looking for something to worry about in terms of valuation and the possible loss of value caused by a rise in interest rates, I think there are far more extreme valuations to worry about than the so-called bond proxies.

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