Goldman SMALL CAP RESEARCH

The Goldman Guide

VOLUME 7 | ISSUE 22 | MAY 22, 2016

INSIDE THIS ISSUE:

5 Secrets Behind The Indexes

The stock market indexes we all follow (and some invest in) are not exactly what they seem to be. In fact, it is the very nature of some of these indices that make investing in an active manner seems like a shell game since the only way to consistently make money is with indexing. Then, when you try to do that, you get burned when the active, sector-picking, stock-picking, traders do laps around the passive indexes. We have been sitting on this story for weeks, so here goes:

Here are 5 Secrets About the Indexes No One Knows:

1. The NASDAQ Composite may be the most representative index for growth stocks since there are over 2600 stocks in it, but its fortunes are tied to technology. Over 42% of the Composite is in technology stocks, and 10% is in **Apple (NASDAQ—AAPL)** alone. Financials are only 8%!
2. Not all indexes are equal. For example, the S&P 600 (small cap index) is more weighted toward Financials (24%) than the Russell 2000.
3. Institutions like to benchmark against the Russell vs. the S&P 600 because its weighting make it easier to beat.
4. The change in sector weightings over the years makes all the prognostications about average historical P/Es moot. (More on this later.)
5. Changes in index components (like the Russell in the coming weeks) can have a huge effect on stocks and the underlying indices, and can be used as trading plays.

KEY TAKEAWAYS

⇒ *Index investing isn't as great as advertised and can make valuations confusing*

⇒ *To really succeed, investing in right sectors is the key*

⇒ *Upcoming Russell 2000 reconstitution will impact small caps and can be used as an investing tool*

⇒ *While the Fed is trying to crush stocks, some short positions have been reduced*

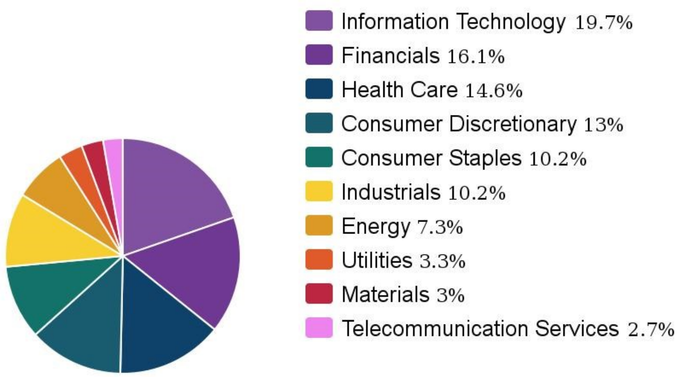
⇒ *Last week's controversial pick did well, this week's is boring*

THE MAJOR INDICES

Index	Close	2016
DJIA	17,501	0.4%
S&P 500	2052	0.04%
NASDAQ	4770	-4.7%
Russell 2000	1112	-2.1

(figures are rounded)

Indexing, Sector/Stock-Picking, Nose-Picking



Based on GICS® sectors
The weightings for each sector of the index are rounded to the nearest tenth of a percent; therefore, the aggregate weights for the index may not equal 100%.
As Of Apr 29, 2016

The table adjacent to this text is a sector weighting breakdown of the S&P 500 Index, as of 4/29/16. You are probably saying to yourself, this sector weighting kind of makes sense right now. However, these weightings are way off, on an historical basis.

For example, 10 years ago, Financials were 22% and Energy were over 9%. In 1989, Energy was in a virtual tie with Technology. Even 5 years ago, Technology was 19% of the index, and the next 6 sectors were 11-13% of the index, showing very tight concentration. This means that while the index is dynamic in that its components and weightings change to reflect the current and future growth of these sectors, investors and investment pros are static. They continue to use historical P/E averages for the S&P 500 Index to determine whether the index is overvalued or undervalued, without accounting for the dynamic shifts noted above.

Financials and energy, which formerly dominated the weightings early on, carried lower P/Es than say, IT or consumer discretionary sectors. For that matter, health care valuations have been on the rise in the past couple of decades which also shapes the relative P/E. That means that the average P/E may not be an accurate measure of the current P/E since the weighting compositions and associated growth rates and multiples are markedly different. If Financials take the top spot, the average P/E will be lower since the industry carries a lower P/E. When Tech is the largest, the P/E is higher.

Therefore, you need to be aware of what sectors are working and what kind of multiples are associated with them. Only then can you really determine whether “the market is overvalued or undervalued.”

Indexing, Sector/Stock-Picking, Nose-Picking (2)

There are some active investors who hate indexers and think that index investing is a shell game to some degree. Perhaps the short-sellers too, for that matter. For example, take a look at the last 5 change in the DJIA. In 2015, **AT&T (NYSE—T)** was dropped and Apple (NASDAQ—AAPL) was added. At that time, the prevailing thinking was that AAPL was on a tear, was the most widely held stock, the largest component of the S&P 500 Index, and its good fortunes would continue. Therefore, rises in the DJIA were set to be a fait accompli and short sellers were probably not too happy.

Fast forward to today. T is up 14.4%, excluding dividends and currently trades 14.2x this year's projected EPS. AAPL is down 25% and carries a P/E multiple of just 10x this year's EPS. Who woulda thunk it? Truth be told, this Apple/ATT switcheroo and subsequent changes are not the norm.

The index that has the most bang for its changes is the Russell 2000 Index and the next "bang" is due to occur in its annual re-constitution next month. Here is the schedule of events. Note key dates are in the middle of June:

This year's annual Russell 2000 Index Reconstitution will occur after the close 6/24/16. Reconstitution ensures that the index accurately reflects the current state of equity markets based on market cap, and sector breakdowns. Reconstitution 2016 Rank day is May 27, preliminary membership lists (adds and deletes) are to be released June 10, preliminary reconstitution adds and deletes appear in daily change file June 13. Updates to membership lists (including adds and deletes) on June 17, and final Reconstitution after the close June 24.

Additions to the index get a boost, deletions take a hit, although the additions rise longer than the deletions drop. You can make yourself a little crazy trying to ascertain/guess which stocks could be dropped and which ones could be added. Of course, buying new names after the fact can be a profitable short term trading tactic. However, we recommend using the reconstitution as a measure for sector strength (performance, growth/valuation) buying. Given the current narrow trading range, the best way to invest/trade is to buy the top GARP stocks in the best industries. This strategy has been a hallmark of our approach to stock profiles and recommendations, especially in *The 30-30 Report*. In fact, we believe that by buying the right sectors and GARP stocks in those sectors, your performance can often exceed that of indexes. Of course indexers think you'd be better off picking your nose than trying to pick sectors or stocks, since that involves "risky timing." What do they know...

The Stock Market Today

U.S. Stock Market Index Performance 5/20/2016								
Index	Close	52-Wk Hi	52-Wk Low	Hi Date	Low Date	% off High	% from Low	% Above 200-DMA
DJIA	17,501	18,315	15,370	5/20/15	8/24/15	4.4%	13.9%	2.2%
S&P 500	2,052	2,134	1,810	5/21/15	2/11/16	3.8%	13.4%	2.0%
NASDAQ	4,770	5,232	4,210	7/20/15	2/11/16	8.8%	13.3%	-1.0%
Russell 2000	1,112	1,296	943	6/23/15	2/11/16	14.2%	17.9%	-0.4%
Average						7.8%	14.6%	0.7%
Sources: www.BarChart.com, Goldman Small Cap Research								

It is very hard to make money in a market that hasn't really moved in the past year. Of course we have had the rollercoasters from time to time intra-year. Remember when the Fed raised interest rates and that helped spark a nearly 10% drop in big stocks earlier this year? Of course you do. Well, these putzes may do it to us again. Even though earnings growth is abysmal, top-line growth is on vacation, unemployment ain't so great, they are worried about inflation. We get it. Basically zero percent rates aren't a good thing. But can't you wait until we actually have sustained corporate revenue and earnings expansion again?

One good thing about the end of earnings season is that we can revisit short interests in key stocks. In a bit of a surprise, a number of stocks have seen short interest as a percentage of their respective public floats actually decline. Moreover, even though bricks and mortar retail sucks, updated data regarding short-selling there is inconclusive.

One thing that is noteworthy, however, is that 6 of the top 15 stocks with the greatest increases in short interest appear to be biotechs. Interestingly, the stocks that trade on the NYSE MKT, which is the NYSE version of a small cap group, aren't heavily shorted, as the number 10 stock short as a percentage of the float is at the rate of 14%. Conversely, the NYSE and NASDAQ number 10 stocks shorted as a percentage of the public float is at a rate in excess of 40%. While past of this phenomenon reflects a lack of liquidity in small caps, it also tells us that upside is greater in smaller stocks.

Say What?

Great info, insights, and hard-hitting stories make up this week's *Say What?* feature...

The New York Times

http://www.nytimes.com/2016/05/23/business/facebooks-troubling-one-way-mirror.html?ref=business&_r=0

Unsettling and rightfully so.

247WallSt

http://www.wsj.com/articles/the-wicked-humor-of-party-games-1463153007

Successful offerings are usually a positive for stocks.

The New York Post

http://nypost.com/2016/05/21/listenfirst-combs-social-media-to-find-viewers-tendencies/

Very clever.

Marketwatch

http://www.marketwatch.com/story/fed-speakers-data-to-take-over-as-earnings-slow-to-trickle-2016-05-21

Damn Fed, screwing up the works.

ZeroHedge

http://www.zerohedge.com/news/2016-05-22/rapper-threatens-kill-donald-trump-if-his-mommas-food-stamps-are-taken-away

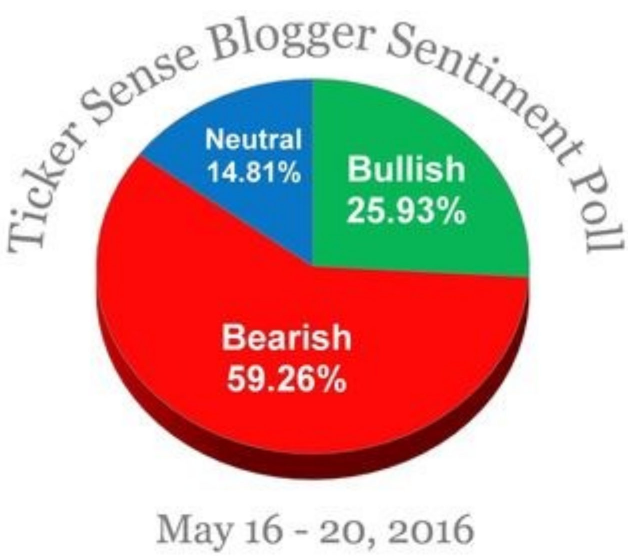
Is it wrong of me to find "yu-mor" in this silly story?

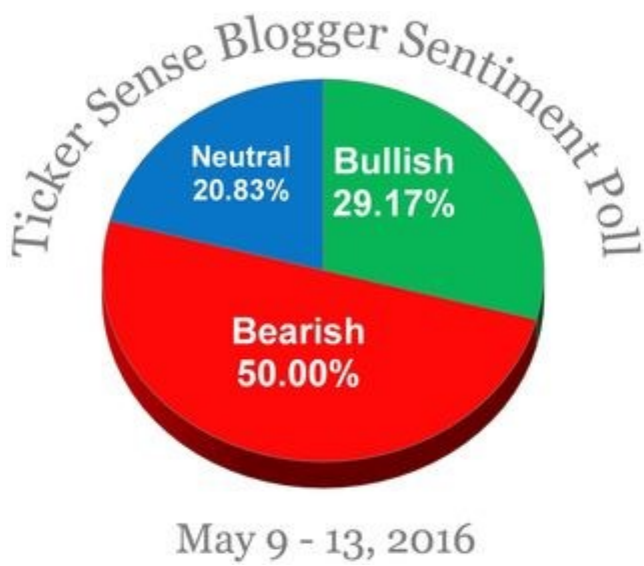
Notable Numbers

AAII Sentiment Survey (figures rounded)

	Current	Last Week	*Long Term Avg*
Bullish	19%	20%	*39%*
Neutral	47%	48%	*31%*
Bearish	34%	31%	*30%*

Now we are getting somewhere. The advisers in the TickerSense poll have taken a clear approach in their sentiment that rough waters are ahead, as the Bearish segment rose sharply, while the Neutral category dropped a fair amount as well. Still, the AAII survey has a huge percentage of individual investors in the Neutral category. Interestingly, the Bullish category is smaller in the AAII survey than the TickerSense poll. Separately, the Lipper Fund Survey notched the biggest taxable fund inflow in four weeks, indicating that some funds leaving equities may go to bonds for a spell, even in the face of a potential rate hike.





Can I Be Half-Right?

Last week, our bottom fish candidate was **Perry Ellis (NASDAQ—PERY—$19.27—NR)** was up 17% after the company beat the hell out of the forecasts. However, we predicted that numbers and guidance would be light and you could buy it for a bounce, after a drop. Oops. Do I get credit for at least getting the stock right? I think that I should work just on stock selection not this when/how to buy stuff. It is hard enough to pick a winner to begin with.

Last week's stock profile was surely controversial. So, it is fitting that this week's is thoroughly boring. And, that's a good thing for narrow markets.

TTM Technologies, Inc. (NASDAQ—TTMI—$6.99—NR) is a leading global printed circuit board manufacturer, focusing on quick-turn and technologically advanced PCBs, backplane assemblies and electro-mechanical solutions. TTM stands for time-to-market, representing how TTM's time-critical, one-stop manufacturing services enable customers to shorten the time required to develop new products and bring them to market.

I should note that since the Analyst Day on May 17th the stock is up 10% on twice average daily volume. Clearly, the group there left there impressed. At current levels, the stock is about 35% off of its year-high and has had its best one-week performance of the year. Although the EPS growth rate the next year or so is limited, the stock trades just 8x this year's EPS forecast. With 4 straight quarters of kicking ass in the EPS-beating department, outperformance is likely in the cards. Plus, judging by comments and performance of key players and competitors in the space, the future is bright, especially on a cyclical basis.

We project a 20-25% return in the next quarter or so and given its low valuation, it could weather a brief market sell-off.

The Goldman Guide

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