Picks, shovels and bubbles

In which we ask, where are all the original picks and shovels companies now?

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Every now and then an example of Levi Strauss's original workwear from the nineteenth century comes up for auction and, depending on condition, can go for quite a fancy price extending into six figures. There are people out there who hunt for old Levis in abandoned mines from way back when, in the hope that, sheltered from the elements, a great example with a story attached has survived. And it's not hard to see why. As if the straightforward romance of being associated with a gold or silver mine wasn't enough, it's no exaggeration to say that Levi's workwear is woven into the fabric of American life, literally and figuratively.

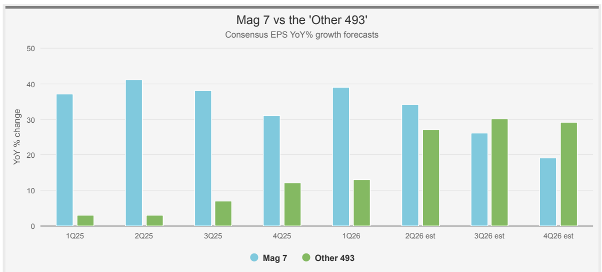
Which leads us onto a topic that in some circles is referred to as 'market narrative analysis'. Many of us probably do a simple version of this already: in reading different sources of information on markets, we start to notice how certain phrases pop up and evolve over time. Having an awareness of this can give us some qualitative insights into what investors are thinking, and maybe even help us stay slightly ahead of the curve. Some phrases are newly minted, and the most famous recent one is 'Magnificent Seven'. But notice how the narrative never stands still. Even the abbreviated 'Mag 7' is being supplanted by 'hyperscalers' and no doubt an evolution of that can only be weeks away.

Other words and phrases recur over the decades and although 'recession' is the all-time classic, there has been a recent spate of the old 'picks and shovels' concept. At which point the reader starts to see where the 'goldrush' thing above is going. It's an incredibly beguiling thought, isn't it? With all that hyperscaling going on, for which read 'staggering amounts of money being spent on stuff like semiconductors, buildings, wires, cables, air-conditioning, power generation and security fences' - the list goes on. If one is worried about the equally staggering valuations of those very same hyperscalers then buy shares in all the 'picks and shovels' companies making all that other stuff. This phrase isn't limited to discussion of US equity markets but nowhere is it more apposite, given the origins of the phrase.

Let's look at a chart that shows how this is starting to manifest itself. Taken from a presentation by the excellent **North American Income Trust (NAIT)**, the fund manager of which presented at our most **recent online event**, it shows the earnings forecasts for the Mag 7 versus the 'Other 493'. And yes, the 'Other 493' is yet another phrase to add to the market narrative analysis.

As the chart clearly shows, those companies' earnings growth forecasts are catching up with the Mag 7. We know that some of the slower growth earlier on is due to a wider hesitation in corporate America around the time of the initial tariff confusion. And we also know that changes to corporate tax mean that, more recently, there are significant benefits to reinvesting for growth. It's not hard to find other reasons that explain why the Other 493 is seeing earnings growth rise after a slow start. But it's also easy to see how that 'picks and shovels' phrase entered the narrative. Not every Other 493 company is selling something the Mag 7 wants to buy, but plenty are.

Fig.1: Consensus Earnings Forecasts



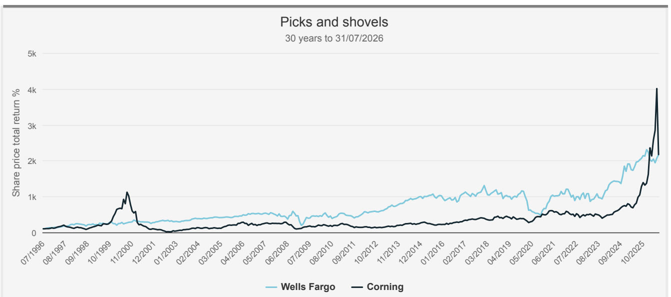
Source: North American Income Trust

And picks and shovels companies can have a pretty good time, right? Well, two of the most widely recognised success stories from the nineteenth century goldrushes are the abovementioned Levi Strauss and banking giant Wells Fargo. But, conspicuously, neither of those makes, or ever made, picks and shovels. Both took the excess profits from selling their products and services to invest in their business, and both offered something with a much wider audience than just a bunch of day-dreaming gold prospectors. Hence, both are still very much in business and listed on the New York Stock Exchange. Whereas it seems most 'pure play' picks and shovels businesses went under the minute the goldrush ended.

Being listed on a stock exchange means, of course, that from time to time a perfectly sensible business can be buffeted by external bouts of excessive optimism and pessimism that are beyond the control of management. Let's look at the share price performance of one of those goldrush survivors, Wells Fargo, compared to a more recent picks and shovels business. We use the word 'recent' to mean the last thirty years because this is the second time that US glassmaking business Corning has been caught up in the picks and shovels theme. By a nice coincidence Corning also traces its origins back to the nineteenth century, suggesting it's generally a very sensible business. In very simple terms, if there is an advanced use of glass, Corning probably has something to do with it. It's quite likely one is reading this article through some Corning glass, and equally possible that the article arrived through cables with Corning products in them. It's therefore easy to see how investors can identify it as a picks and shovels company.

Here's the thirty-year share price total return for Corning and Wells Fargo. Isn't it striking? Wells Fargo is long since past the point where anyone sees it as a picks and shovels business, so its price performance is a record of its own business success over the years. But look at Corning. Just like in 2000, the market has latched on to the picks and shovels idea with extraordinary glee, and for almost identical reasons. And if one looks closely, one can see how, very recently, the market has been, ahem, moderating its optimism.

Fig.2: Picks, Shovels And Bubbles



Source: Morningstar

To be clear, this is not any kind of comment on the merits or otherwise of Corning's business. The point we are making is, how easy it is for the stock market to get into that picks and shovels mindset, and quickly start applying the same levels of optimism there as is being applied to the companies it is trying to diversify away from.

The simple lesson of all this being that, yes, there's a lot of capital expenditure right now and yes, lots of companies are going to make tons of money as a result. But first, how much of that money they are making is transient, and second, is the stock market taking an excessively optimistic view. Therefore, the diversification strategy that helps us shield ourselves from the moment when all that spending starts to slow might not be quite so simple. And as we know, stock markets react to changes not absolutes so even if slowing capital expenditure is still a staggering amount of money in absolute terms, markets probably won't like the 'slowing' part. It seems to us that one of the important roles of the active fund manager right now is to distinguish between those businesses that can and will take short-term boosts to earnings and use those to reinvest in their businesses and those that can't.

In an article a few weeks ago we noted that it was a bit of a myth that corporate activity such as mergers or wind downs often signal the point at which investor sentiment has capitulated. Predictably, a short time later one of the US small cap specialists, **Brown Advisory US Smaller Companies (BASC)** announced a strategic review to consider options that will likely offer a cash exit opportunity. BASC's manager has an excellent long-term track record predating their appointment to BASC in 2021, but the last few years have been a tough time for a quality growth manager, and this has been exacerbated recently by the same picks and shovels theme in the small cap world. The Russell 2000 index has performed very well this year, but this has been driven largely by a small group of, you guessed it, companies serving the hyperscalers. BASC's manager viewed the valuations of these as being much too optimistic and this largely explains why the trust trails the index. Again, our point isn't that the picks and shovels strategy isn't valid, and hence the long-term success of Levi Strauss and Wells Fargo, but one needs to apply some filters. We can't know if BASC's manager will be proved right the day after it completes its cash exit, or in three years, but we do know that excessive optimism has a habit of spreading to picks and shovels companies and it's likely an active manager will need a strong dose of self-belief to push through this.

So what should investors be looking at?

One strategy an investor could consider is a passive ETF tracking the S&P 500 'equal weighted' index, which reduces every constituent to the same weight, drastically reducing direct exposure to the hyperscalers and increasing exposure to the Other 493. And over the last year, and despite the impression one might have got from market reports, this index has performed more or less in line with the S&P500. Our view is that this 'all ships rising' phase will likely pass and a much more focused strategy such as that employed by North American Income Trust (NAIT) will be required. NAIT has an income target, and in fact has a very impressive dividend growth record of almost 7% annualised over the last ten years, and this means it tends to own conservatively managed businesses with good visibility over cashflows and earnings. There are no doubt some of these that will have some products or services that are seeing a bump in sales from the hyperscalers, but these are, if not literally that at least figuratively, the Wells Fargos and Levi Strausses of today's goldrush.

Then there's a sector such as healthcare, which despite some very strong performance has been flying a little under the radar due to the enormous attention being paid to AI and the hyperscalers. It's certainly true that even here, there are big hopes for the impact that AI will have on a sector where being able to assess vast datasets could be the key to unlocking many new products, but perhaps we can make the distinction that healthcare could be an AI beneficiary rather than a supplier of picks and shovels. Better, faster cheaper analysis of data can only help this sector, which has strong demographic tailwinds, particularly in the US. A good way to play this would be **CT Healthcare Trust (CTHT)**.

One of the most impressive turnarounds in performance in the whole trust sector recently has been the **BlackRock American Income (BRAI)**, which just over a year ago adopted what we might call a human first investment strategy that employs systematic screening and use of AI to sift through big sets of data. This strategy biases to 'value' and the portfolio metrics show a much lower price to earnings and price to book than the S&P 500. This also results in much less concentration on those big technology names. Since this strategy was implemented BRAI has turned in one of the strongest performances in the North American sector, which again shows that behind the headlines, there is a resurgence in the fortunes of many of the Other 493.

Last and very much not least, the two JPMorgan trusts that specialise in US equities are both managed with a conservative eye on all the excess we discuss above. **JPMorgan American (JAM)** is a proven 'core' US equity trust that combines the skills of two managers, one with a value and one with a growth bias to form one portfolio of US companies. Here we've seen strong performance on the back of the gradual shift to a more value conscious portfolio and again, this provides a more focused approach than a passive strategy that will help navigate the picks and shovels phase. Its sister trust **JPMorgan US Smaller Companies (JUSC)** operates in the smaller companies world and, as for BASC noted above, has held its nerve in the face of a few striking share price performances among what might turn out to be picks and shovels meme stocks. A switch from a passive to an active small cap strategy such as JUSC right now would be a very good way to avoid the potential downside of all those memes.

It's just a phase

To conclude, there's nothing at all wrong with the picks and shovels strategy but it's a good idea to think about what happened to all the companies that literally made the picks and shovels in the nineteenth century, versus those that had something to offer a wider audience and the ability to use excess profits to grow their business. On top of that, remember that once a company is listed, even the most conservative well-run business can see its share price pushed up by market optimism and it will take a skilled active manager to assess whether that optimism is justified or not. And finally remember that one of the greatest lessons from the last big technology bubble was that some valuations that at the time appeared excessive were in fact hopeless underestimates and from the rubble some extraordinary businesses were built. The moment will eventually come to start thinking about that.

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