Manager Outlook for 2018

February 2018

For the open-minded and well-read investor, the perpetual onslaught of attention seeking headlines calling for "DOW 30,000" or "The Bear Market Attack Around the Corner" is annoying at best and disorienting at worst. It's all too frequent to turn on our television to see a well-dressed "market strategist" at a Wall Street firm make a *bold prediction*, substantiated by a rapidly presented argument that passes your defenses at first listen. You are left thinking, "I don't really understand the details of the argument, but the strategist seems to know what he is talking about." The strategist hopes that you finish your breakfast, log in to your brokerage account later in the day and either buy or sell stocks, based on the strategist's "tip", generating revenue for his or her firm.

You'll never hear me say, "I think the market will do x, y, and z over the next 12 months." There are too many factors influencing the markets over the short term in my experience, many of which are random, causing the market to zig and zag in unpredictable ways. Those that attempt to predict or control the short-term gyrations grow frustrated, wear down.

The disciplined investor focuses on the areas he or she can predict at an above random rate. They focus on the signal, not the noise. From a high level, my focus is on: (1) Business Fundamentals (improving/declining) (2) Price (always in relation to some form of profitability metric) and (3) Risk. While not always the case, price and risk are usually tightly linked and thus can be grouped in the analysis.

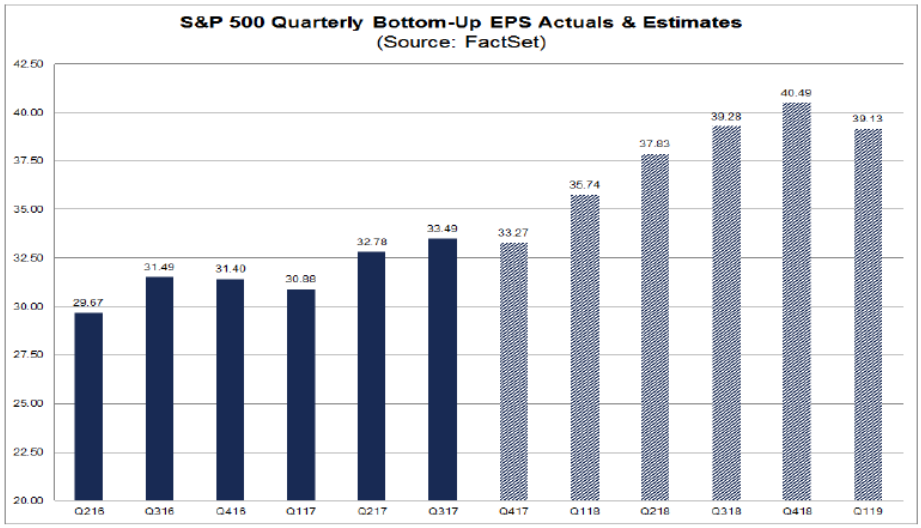
The Fundamentals

Stock prices over the long run follow the fundamentals of the underlying businesses

Looking at the market, the S&P 500 as a proxy, the data is pretty clear - the fundamentals are strong and improving. It takes a creative argument to say otherwise. I provide a brief fly by below and save my analysis (and wordcount) to evaluate "The Price" below, the next section, a topic with a larger divergence of opinions.

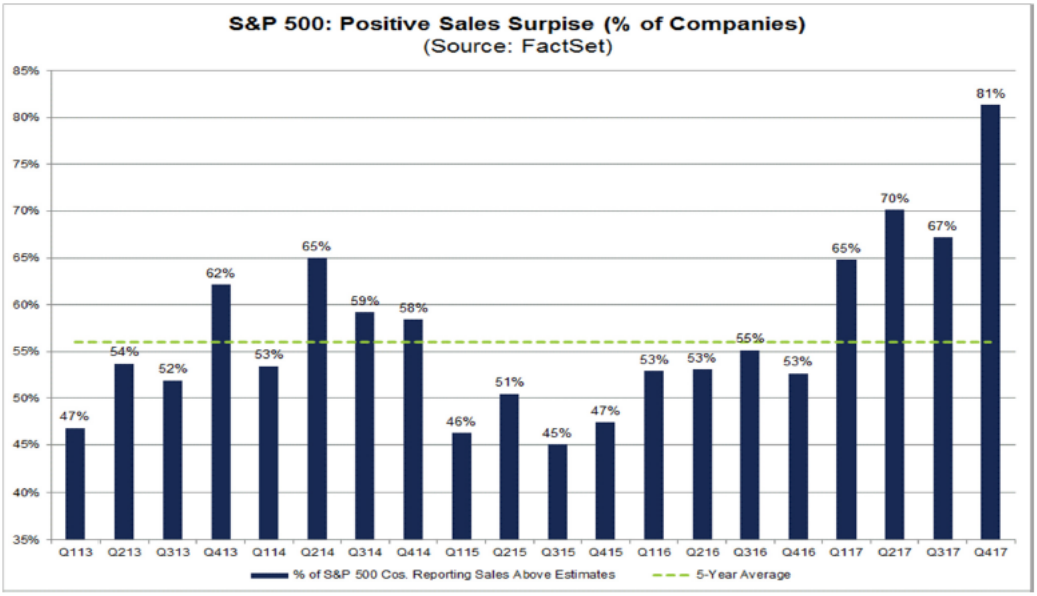
- Corporate Earnings were robust in 2017**.** S&P 500 earnings grew 10% in 2017, the highest rate since 2011.
- Analysts expect even better growth in 2018, partially driven by tax reform. S&P 500 earnings growth are expected to be a robust 18% in 2018, aided by a ~ 7% to 9% tailwind from tax reform.

Exhibit 1 – S&P 500 Bottom-Up Quarterly Earnings Actuals and Estimates



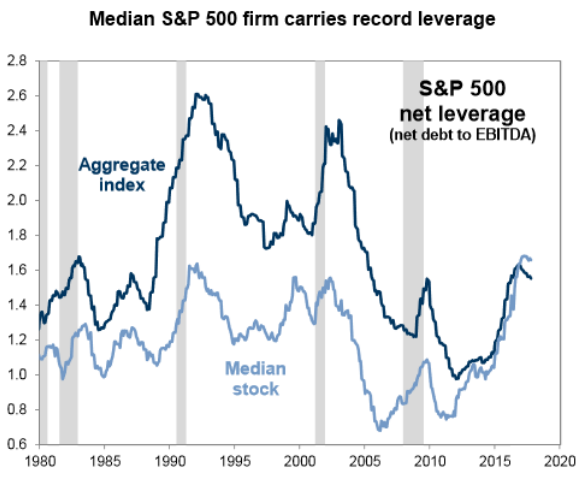
- Companies have been beating estimates at an increasing rate, 84% so far in Q4, the highest mark since 2008. The surprises are in the context of already high expectations. Surprises are used to signal that analysts are underestimating growth, sometimes viewed as an inflection point or growth acceleration

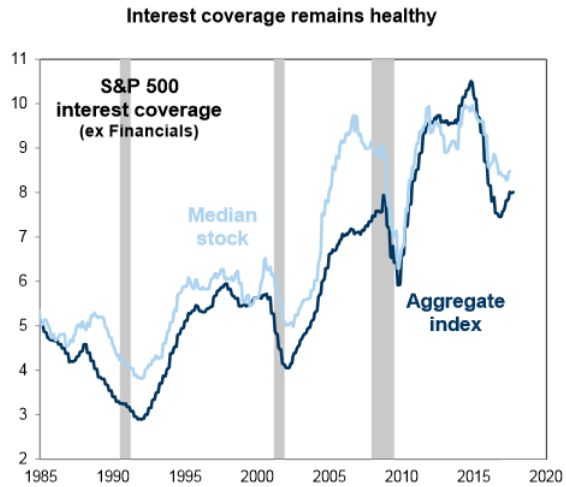
Exhibit 2 – S&P 500 Bottom-Up Positive Sales Surprises



- Balance Sheets remain healthy

Exhibits 3 & 4 – S&P 500 Net Leverage and S&P 500 Interest Coverage





The Price

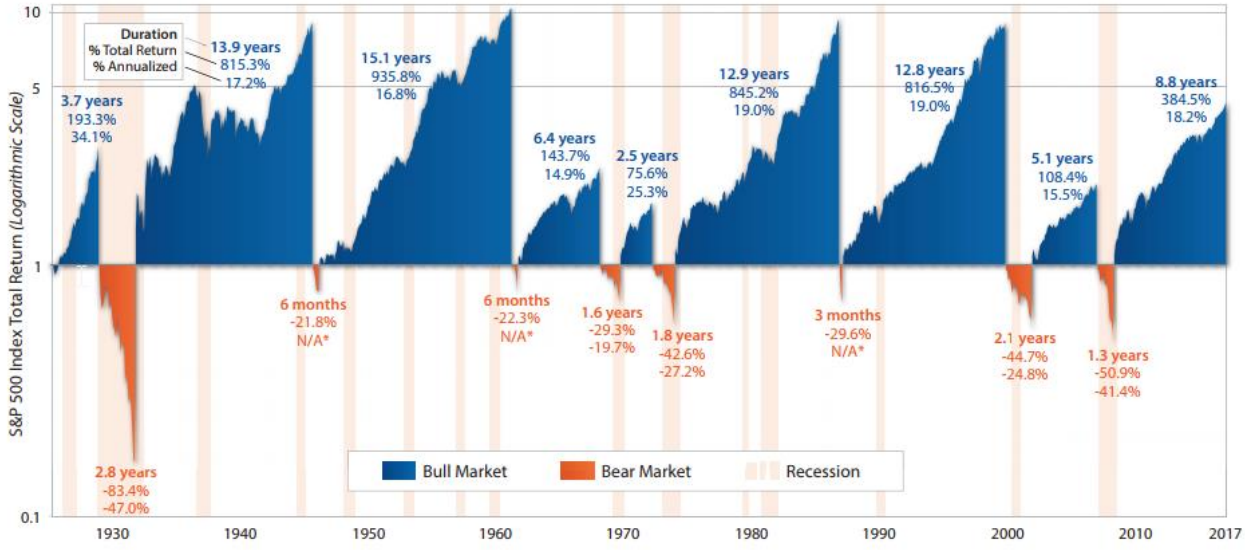
Valuation (and financial flexibility) are key factors in an investment decision

Summary - The consensus view is that equities are expensive, which I disagree. I highlight two of the more common bear arguments for equities and evaluate their merit. Overall, in the context of low rates, our view is that equities remain undervalued.

(1) "We're on the back of a 9-year bull market and thus the market must be slowing down soon." The heuristic people use is that bull markets last 8 to 10 years. I am unsure of the rationale behind it, but let's look at the data to see if it has legs.

The exhibit below includes 90 years of bull and bear markets for S&P 500 price adjusted for scale. Bull markets are depicted in blue and bear markets in orange. From the exhibit, bull markets have lasted 2.5 years, 3.5 years, 5 years, 6.5 years, 9 years, 13 years x2, 14 years, and 15 years, which averages to 9 years. So, the bull market rule of thumb is correct. But does that mean selling at the end of year 9 is the right decision?

Exhibit 5 – S&P 500 Bull and Bear Markets 1921-2017



Source: First Trust Advisors L.P., Morningstar. Returns from 1926 - 2017.

Conclusion: Selling at the 9-year mark of a bull market would cost you $2,869 on average on a $10,000 investment.

Analysis: The 4 extended bull markets (> 9 years), the upside missed from selling at the year 9 mark is +116.6%, or an average of 18% a year for 4.7 years. The average drop for a bear market is -40.6%.

$10,000 (Initial Inv) * 2.1667 (1+ % Bull Return) = $21,656 (Value of investment before crash)
$21,656 (Value) * .594 (1 + % Bear Return) = $12,870

Your return of holding throughout will give you $12,870 on a $10,000 investment, greater than the $10,000 you would have

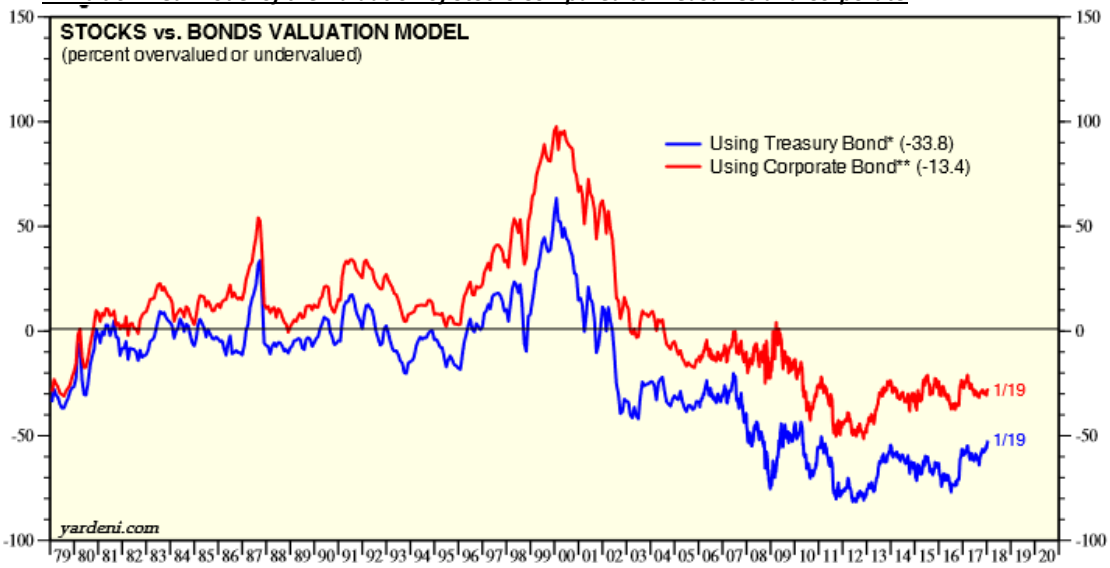
from selling automatically the end of year 9. The $10,000 in the market timing scenario assumes you perfectly time your investment on the way back in as well, at the market bottom, a very generous assumption.

This is a very important point. Market timing is so difficult because of the bipolar nature of markets. To time successfully, you need to be right twice – on your way out and your way back in. Selling too early is a very costly mistake, one that is frequently glossed over when you hear stories of investors that successfully predicted a crisis. The focus is always on their return in one year, but the question that should be asked is what was the total return before, during, and after the crisis.

(2) "The market is expensive. Look at the price to earnings!" The consensus view is that stocks are expensive. The most frequent reason cited is the market's high price to earnings relative to its long-term average. I disagree with this conclusion because it's built on flawed analysis - interest rates are excluded, and they should not be. One of the most fundamental question investors decide is their allocation to stocks compared to bonds – and the level of interest rates is a significant variable in this decision – a topic I've written about previously.

I find the below exhibit to be a useful model to determine the relative value of stocks and bonds. At a high level, it compares the earnings yield of the S&P 500 (inverse of the price to earnings) to the Treasury Bond rate (top) and corporate bond rate (bottom). A value of greater than 0 implies stocks are overvalued and vice versa.

Exhibit 6 – Fed Model of the Valuation of Stocks Compared to Treasuries and Corporate



* S&P 500 52-week forward consensus expected earnings divided by 10-year US Treasury bond yield converted to percentage. Monthly through 2005, weekly after.
** S&P 500 52-week forward consensus expected earnings divided by average of Moody's Aaa and Baa yields through 2005, then BoA Merrill Lynch data for AAA and A-BBB yields, converted to percentage..
Source: Thomson Reuters I/B/E/S, Bank of America Merrill Lynch, and Federal Reserve Board.

Ass you can see from the exhibit, stocks had a brief stint in 1979 of being undervalued by as much as 35% to 40% per the valuation model before spending most of the 80s, 90s, and early 2000s hugging the fair valued line. The notable exceptions are 1986/87 and 1999/2000/2001, when stocks approach greater than 50% overvalued. The model accurately forecasts 2 of the 3 crashes, the exception being 2008. Fast forward to 2011 through today, the model indicates are between 25% and 50% undervalued, more so than any time in the last 40 years. I do not believe stocks undervalued to that extent, but they do appear to be significantly undervalued in historical context even if we were to adjust for an equity risk premium and an expected future increase in rates.

Context and nuance are vital and attempting to place a market price to earnings ratio into historical context without factoring in historically low interest rates leaves out vital context.

Conclusion: When factoring in interest rates, stocks remain undervalued.