KLCM Advisors, Inc.

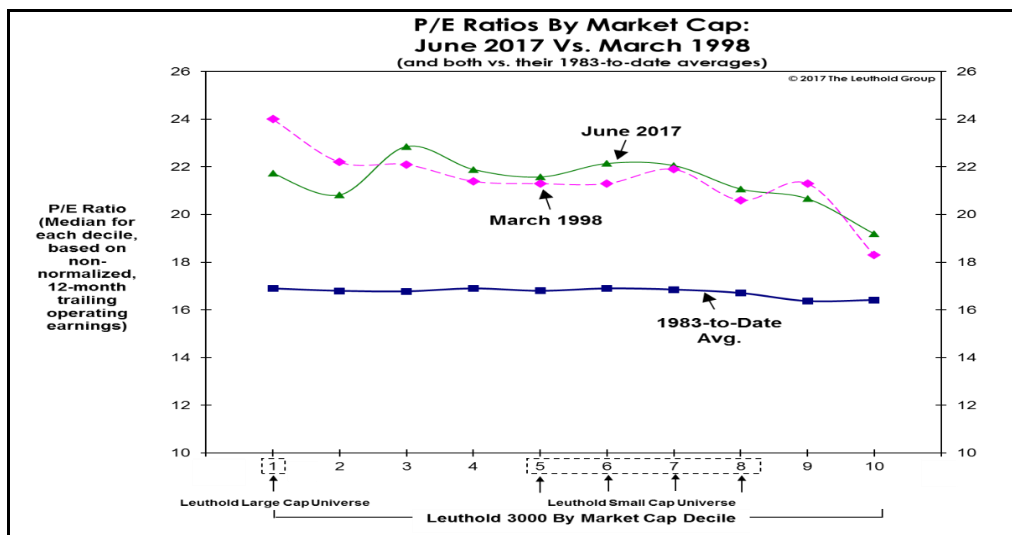
July, 2017

Principled

In June we attended a small group meeting with our peers from a Minneapolis based research firm, The Leuthold Group. Two other local value managers were also in attendance. This was a grizzled group of industry veterans who collectively manage more than $30 billion of assets, all with 30+ years of investment experience. Given the tenor of the meeting, it could have been the cast of “Grumpy Old Men – Investment Manager Edition".

Growth and momentum managers are winning again this year. Value investors had a brief moment in the sun during the second half of 2016, but in 2017 it has been back to the same experience of the past several years. With the current economy seemingly unable to accelerate beyond 2% GDP growth, the market has continued to narrow towards secular growth stocks at the expense of everything else. Worse yet, passive investing, driven by large cap growth stocks has also outperformed the assembled managers; it felt like the late 90’s again. Value shops along with many active managers are closing, assets are being withdrawn and moving to passive strategies; the group seated around the table was in a particularly foul mood.

The consensus view of the participants is that there are few cheap stocks or sectors, other than financials and possibly energy. One cannot construct a portfolio around those two options. We are eight years into an economic cycle, profit margins are full, growth is slow and valuations are high. No one at the table could identify what would tip the economy or market over in the next year or two; they just do not think investors are getting paid enough in stocks to own "the market" or longer maturity bonds to justify the risks of owning them. There were two issues that enjoyed complete consensus, **stocks are not cheap and valuation is a poor timing tool.**



330 E. Kilbourn Ave. · Suite 1180 · Milwaukee, WI 53202 · 414-765-1234 · klcm@klcminc.com

This chart from Leuthold quantifies the view that the market across all sizes of companies is expensive. It compares current valuations with valuations in March of 1998 and the average of all markets from 1983 to date. While market indices did not peak until March of 2000, the average stock peaked in March of 1998, giving, in hindsight, two full years of warning before the bear market began.

The table below highlights the challenges of value managers relative to growth managers and the dichotomy between large and small stocks in 2017. In summary, todays valuations across all market caps are significantly higher than their long-term averages. There is a scarcity of cheap stocks and most active managers, particularly value types, are lagging. The market is narrowing, not unlike the late 90's, as the five largest stocks in the S&P 500, Apple, Google, Microsoft, Amazon and Facebook have produced nearly one third of the market return this year.

Index	Q1 2017	Q2 2017	YTD 2017
S&P 500 (Large Companies)	6.06%	2.93%	**9.34%**
S&P 500 Growth Index	7.43%	4.26%	**13.15%**
S&P 500 Value Index	3.11%	1.34%	**4.67%**
Russell 2000 (Small Companies)	2.47%	2.52%	**5.04%**
Russell 2000 Growth Index	5.35%	4.30%	**9.87%**
Russell 2000 Value Index	-0.13%	0.87%	**0.74%**

Given this backdrop, how does one "win"?

We will continue to adhere to the discipline we established 25-years ago. Buy good companies at reasonable prices and sell when fully valued. When we are unable to build portfolios under this construct, we build cash as a strategic weapon. That relatively simple methodology has and will continue to reward our investors.

There have been two major market tops since KLCM was founded, 2000 and 2007. Leading up to March of 2000, we were able to remain relatively fully invested as many smaller value stocks remained investable. The S&P 500 peaked in March of 2000 at 1527, and it did not return to that level until September of 2007 a significant portion of the "lost decade" that many have written about. That period of time was not lost for our clients, as their portfolios appreciated significantly (many in excess of 100%).

Leading into the second market top, our portfolios peaked in early 2006 while the S&P continued climbing until October of 2007. In the current bull market, the S&P did not get back to its previous highs until March of 2013, while our portfolios more than recovered by the end of 2010 and were in excess of 30% higher than their previous peaks by March of 2013. We have historically left the party early, only to return ready to fully participate in the next up cycle.

There are many axioms on Wall Street. One that inevitably appears toward the end of each bull market is "The fools are dancing, the bigger fools are watching". We have heard this and others like it in the past. In 1999, as tech stocks went up daily, critics of our style told us we were dug in and just didn't get it. Those same critics in 2001 praised us for being principled and adhering to our core philosophy.

We shall remain principled.