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Simple, Not Easy

As Vice Admiral James Stockdale asked in a Vice Presidential debate in 1992, "Who am I?" and "Why am I here?" While his introductory debate did not work out well for the Vice Admiral, his questions are relevant to investment managers almost six years into this equity market cycle. We expect to beat the market over full equity cycles, but is our charter to track the S&P 500 even as potential returns diminish and risk escalates, or is it to make discrete decisions prudently weighing risk and reward on behalf of our clients? As stewards of client capital, the answer for us is simple, if not easy.

The nature of equity market cycles is that stocks get too cheap at times and too expensive at other times. When stocks get too cheap, as pessimism mounts in a correction or bear market, it is a time to evaluate the merits of individual stocks and begin the accumulation process. Early purchases may look foolish for a while as further lows are made, but typically work out over time. Later purchases, nearer to the bottom, require less patience to work out and may actually look inspired. Unfortunately, no one has ever given us a schedule to help further refine this accumulation process. Instead, to minimize emotional influences we rely on our own research and valuation methodology, and make decisions one security at a time.

Conversely, when the risks begin to outweigh the upside for any given stock, we begin to sell. If we can't find new stocks with upside to more than compensate for the risks involved, we accumulate cash as a store of value for better opportunities later. In the later stages of a bull market, the early sales will look as misguided as the early purchases in a bear market. Subsequent sales may appear clairvoyant relatively soon. Eventually, sticking with our disciplines pays off and cash cushions the portfolio when the market finally rolls over. With time, cash reserves become a weapon to be deployed on more attractive terms.

When stocks push through fair valuation levels in an upcycle, there is no way to discern how overvalued they will get. In the most extreme case, we thought that large caps stock were fully priced in 1995 when the S&P 500 hit 18 times earnings, yet the bull ran for five more years with the P/E reaching 31. It is not easy answering to clients when the market is in gear and we are not fully participating. However, we'd prefer to own a combination of reasonably valued stocks and cash than to have to explain the long-term destruction of capital that can follow from owning overpriced stocks.

Today, we are in the advanced stages of an historic bull market. The S&P 500 has more than tripled off of the extreme bear market low in March of 2009. The advance has been driven by both stellar earnings growth and expanding valuations. Corporate earnings growth has been stunning, particularly relative to moderate sales growth. For example, in 2014, sales for the S&P 500 are estimated to have grown 6% and earnings per share about 11.5%, as margins have continued to expand. Implicit in this math is that expenses grow slower than sales. This has been the case throughout this bull market, but **profits are now 40% above the last cycle's peak in 2006 and net margins are at all-time highs.** It gets tougher from here.

Low-cost debt has directly aided corporate earnings and also made share repurchases and acquisitions more additive to earnings. Lower tax rates for global companies have further boosted earnings growth. Looking forward, **decelerating growth in many regions of the world and a stronger dollar will be serious headwinds to earnings growth in 2015.** On the other hand, **consumers, some companies, and oil importing countries are receiving a tremendous windfall from the decline in oil prices** from over $100 a barrel to under $50.

Overall, with the US economy threatening to break through to 3% growth, consensus estimates calling for 7% earnings growth are reasonable, but not a given. Nevertheless, that unabated earnings growth is the primary bull argument for stocks, since valuations are already full. The other bull argument is that there are few appealing alternatives to US stocks so that valuations may push beyond our comfort level. While absolutely true, **we are not interested in participating in unsustainable gains that can turn into unrecoverable losses**. This is especially true given the **unsettling distortions and imbalances in global capital, currency and commodity markets as well as geopolitical tensions**

that cannot be timed or ignored. The market may not be priced for perfection, but it is certainly not priced for the uncertainties that we see.

The unsettling variables in the world begin with our own unprecedented experiment in monetary policy. For six years the Fed has held short-term interest rates near 0% while expanding their balance sheet by $3.7 trillion to $4.5 trillion. **The Fed's explicit goal was to boost housing prices and stocks to improve confidence and spending.** Now, just as the US ended the money printing/quantitative easing (QE) phase and prepares to start edging short rates higher, the European Central Bank (ECB) is preparing to take their QE to the next level. With the Bank of Japan (BOJ) already in full gear in their own QE, the world is awash in liquidity. Ten-year Japanese government bonds yield a scant .33% and German ten-years yield only .54%. **The intent of the ECB and the BOJ is to drive their currencies lower to enhance their industrial competitiveness and to fight off deflation.**

This type of prolonged monetary stimulus displaces the normal, market-based function of setting interest rates across the yield curve. When reference rates are repressed it sends distorted signals to the marketplace. Incentive structures for consumers, investors and businesses alike, are altered. With no return on risk-free assets, investors are herded into riskier assets around the world. The short-term effects of this stimulus have proved helpful for asset values and the economy. The long-term impact of the behaviors encouraged may not. Unfortunately, **many investors will find that they took on more risk than they bargained for, again.**

The intended effect of the ECB's and BOJ's monetary policy on global currencies is also destabilizing. As the Euro and the Yen depreciate, industrial competitors are disadvantaged. Protectionist policy responses are a risk and capital flows transmit the distortions to financial markets across borders in unexpected ways. For instance, capital is pouring out of the depreciating Euro and Yen based markets into dollars. With the appreciation of the dollar, dollar denominated debt issued by emerging market companies is becoming more burdensome, reminiscent of the lead up to the 1998 Asian financial crisis.

Another fault line has been created by the cascading price of oil. At home, oil producing regions, companies and suppliers will feel the pain of diminished cash flow while consumers enjoy a real boost to disposable income. The Venezuelan meltdown has been accelerated. Russia, which has seen the Ruble's value fall by almost half, has entered a recession, will see inflation accelerate and standards of living suffer. Iran's budget is based primarily on oil. Both of these producers have the means and incentive to cause mischief. We cannot predict how the stresses on oil exporting countries, energy companies, suppliers and regions will ripple through the capital markets, but accidents could overshadow the benefit of lower oil prices to the US, Europe, China and India.

After an extended bull market with diminishing volatility there is a natural tendency to become complacent. We believe that recent developments should serve as a wake-up call. The extended period of low interest rates, full equity valuations, the breakdown in oil, the turmoil in currencies and geopolitical risks do not provide the underpinnings of an environment that gives us comfort, nor the upside to justify full exposure. No one can say how or when these imbalances will be resolved. In 2000, we were able to avoid the destruction from overvalued stocks deflating and even take advantage of the wide dispersion of valuations within the market. In 2008, we did not foresee the financial meltdown and felt the market's pain. We have fully participated in the tripling of equity values since 2009 and are beginning to think that those returns may be enough for this cycle. The complicating factor is, as always, that we own solid companies with fundamentals and valuations that offer reasonable upside over time. Yet, experience has taught us that the only refuge from a weak market is cash. Today, we hold about one sixth of equity portfolios in cash, but would not be surprised if that trends higher as we maintain our buy and sell disciplines. We may not fully participate in continued market advances, but we do know that cycles have not been repealed and that the best purchases are made when the outlook is not cheery. It's really that simple!