January 2020

Q4 2019 Commentary: Hunting for value in a rising market…

On December 31st we turned the page on a startlingly successful year in the stock and bond markets. The US markets lead the way, but global markets also performed very well. Fourth quarter results put a nice cap on the year with the S&P 500 adding 9.1% to the gains of the first nine months pushing the total return for the year over thirty percent. Interest rates continued to drift lower which added modestly to the year's 8.7% return for the aggregate bond market index. Over the course of 2019, the US 10-year Treasury bond yield fell from 2.68% to 1.92% on the reversal in Fed policy from planned interest rate increases to ultimately lowering rates twice. As we wrote early in the year, don't fight the Fed when they are lowering rates.

Stock market analysis does not have to be complicated and we try to keep it as simple as possible. Stock prices are a function of earnings and how much investors are willing to pay for those earnings. The year's success was due to investors being willing to pay more for the same earnings because S&P 500 earnings in 2019 will finish essentially unchanged from those in 2018. The stock market's more than thirty percent surge higher resulted from paying more than 18x those earnings at year end, up from 14x twelve months earlier. Growth prospects improved and investors are paying more for earnings. The price to earnings (P/E) multiple at 18.6x, is toward the higher end of our comfort zone. As earnings expectations move higher, those expectations will need to be met to justify current prices. Fortunately, with interest rates moving lower and the Fed on hold with regard to interest rate policy, we do not feel we are at dangerous levels and are merely proceeding with a measure of caution.

Just what is expected? The consensus estimate of earnings growth in 2020 is 9.5% with much of the growth expected in the second half of the year. That kind of growth is reasonable, particularly given the favorable economic backdrop and if a rumored middle-class tax cut comes to pass. Beyond general market levels, we are reminded that it is not just a stock market, but also a market of stocks (apologies for use of that hackneyed phrase, but stay with us) and there are sectors of the market that we view much more favorably than others.

Large growth companies and many technology stocks have moved to significantly higher valuations, while value stocks have languished. Value stocks have underperformed growth stocks for years now and in the last three years, in particular, the spread in the P/E valuation between the highest and lowest quintiles of the S&P 500 has become as large as it was at the peak of the technology bubble in 2000. This disparity cannot continue forever. So, while valuation for the S&P 500 has moved significantly higher, a significant portion of those companies have not participated. As a value investor, this spread has our attention and has coincided with a period of good performance in our portfolios despite the broad market struggling.

Despite our tilt toward value stocks, our portfolios have performed well over this period of growth stock dominance. The reason is because we have bought high quality growth stocks when they have been temporarily out of favor and reasonably priced. Those opportunities among growth companies have become scarcer as valuations have risen. However, other parts of the stock market have been relegated to investment oblivion and it is from this group that we can continue to find good companies at good prices. It's a recipe for success that is proven over time.