OCT 2018 | Woodmont Market Commentary

3Q 2018: "There's No Place Like Home!"

In 2018, the place to be for investors has undoubtedly been U.S. stocks. Up 11% year-to-date, the S&P 500 has outperformed virtually every other major, and not so major, stock market in the world and by wide margins. The disparate performance has given new meaning to Dorothy's proclamation in the Wizard of Oz that "there's no place like home!" This nostalgia for "home" is particularly strong among U.S. investors with enough income independence to allow for meaningful exposure to U.S.-listed growth stocks, which generally do not pay dividends.

There are exceptions to this 2018 growth stock success. Tesla and Facebook probably prefer a 2018 do over, or at least the retraction of a few tweets. Yet, in general, the strength of U.S.-listed large-cap growth stocks has pulled the market higher. In fact, Apple, Amazon, and Microsoft alone are responsible for almost 40% of the S&P 500's 11% year-to-date increase, resulting in approximately $500 billion of additional market capitalization for just these three companies.

Relative Valuation of US Value vs US Growth Stocks

Source: Bloomberg
As of September 30, 2017. The Russell Value Index is represented by the Russell 1000 Value Index. The Russell Growth Index is represented by the Russell 1000 Growth Index.

On the heels of the strong year-to-date gains, the performance divide between growth and value stocks has reached historic levels. Same thing for U.S. and international stocks. With the MSCI International index down 3% year-to-date, international stocks are trailing U.S. equities when looking at one, three, five, and ten year timeframes.

Over the years, we have generally maintained a U.S. and growth at a reasonable price or value investment bias. Few investment firms (including us), however, hold either just U.S. or international stocks, or just growth or value stocks. Instead, an investment portfolio pursuing the best risk-adjusted returns will be diversifed such that it invests in some of each, not to mention a mixture of fixed-income and cash. This means diversified portfolios won't necessarily track any one market index - up or down. It also reflects an understanding that investors should seek to increase exposure to the most attractively priced assets, and that one year's market hero may be several years' goats, or vice versa. The hero to goat characterization is applicable for last year and this year with regards to international stocks. It applies as well to the mid 2000's, when international stocks outperformed U.S. stocks five out of six years between 2004-09 before lagging for several years.

Staying on the Path Requires a Little Courage (and a Plan).

In this commentary, we will discuss the current landscape for stocks and bonds, shrinking public equity and growing private equity markets, and provide some insight into how we are positioning portfolios. While the idea of investing "someplace where there isn't any trouble…do you suppose there is a place,"(Wizard of Oz, Dorothy to Toto) sounds appealing, the returns from the "safe" asset classes will only take one so far.

Of course, taking equity risk may require a little courage as U.S. stocks, in particular, have continued their ascent in the face of trade uncertainty, global and local political tensions, and an extended economic cycle. The effort certainly requires a thorough evaluation of the stocks purchased, a long-term view, and a plan for investment execution that reflects one's financial goals and risk tolerance. Investing within this context makes the path much less scary (yellow brick or otherwise).

Finally, We're Now Paid Something to Wait

As recently as 2016, investors couldn't earn much of anything on their cash or cash equivalents. A three-month Treasury Bill paid 0.3%. A two-year U.S. Treasury note about 0.5%. With inflation that meant investors in these "risk-free" securities saw meaningful erosion of their purchasing power. Today, the rate on the Three-Month T-Bill is 2.1%. The two-year Treasury yields 2.8%. Two to three-year Federally insured and freely tradeable bank CDs are offered at 2.9-3.2%. If the Federal Reserve reaches its stated "neutral" stance forecast, its lending rates could increase another 1%. This is welcome news for savers and fixed-income investors. It also helps investors who want to preserve flexibility but at the same time avoid significant erosion of their purchasing power.

Three-Month US Treasury Yield

Whether the Federal Reserve follows through on its plan for higher rates will depend upon future economic growth and the rate of inflation. This "data dependent" approach is why markets are often volatile whenever economic data is released. We'll be watching the data like everyone else, and are also interested to see the impact as approximately $50 billion per month of quantitative "tightening" works through the system. This action represents a reversal of the quantitiative "easing" efforts that have characterized the post financial crisis landscape.

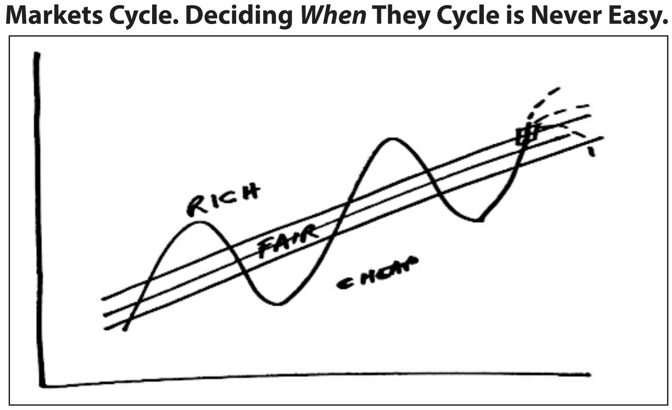
Given the potential interest rate implications of these moving pieces, our view remains that the risks of higher interest rates are reason enough to avoid long duration bonds, especially given the very tight spreads between short and long-term rates. Put another way, the flat yield curve makes it difficult to justify loaning Uncle Sam money for ten years at today's 3.1% when a two-year loan yields 2.8%.

U.S. Stocks: Ten-Years Later and Still Climbing

On September 15, 2008, Lehman Brothers filed for bankruptcy. With over $600 bilion in assets, the bankruptcy was the largest in history and a major landmark leading up to the 2008 market crash, financial crisis, and ensuing "Great Recession." Ten years removed and the market stats from the crisis are no less startling. Before hitting bottom, the S&P retreated 58% from its 2007 peak, including a 17% decline in October 2008 alone. The market rally that started in March 2009 represented investors recognizing that our economy would survive. Whereas, the continuation of this Bull market almost ten years later, reflects the prolonged nature and recently accelerating economic recovery.

Public companies' success in harnessing the economic growth in the form of strong earnings has also contributed to this historic market run. For instance, in the first half of 2018 S&P 500 earnings were up 26% from the previous year. This was the fastest pace of growth since 2010. Forecasts are for 20% earnings growth in the second half. Helping to fuel this impressive corporate earnings growth are a strong economic backdrop (including recently the best consumer sentiment data for low-income families since 2000), reduced regulations, and corporate tax reform. Suffice it to say, the economic and earnings recovery has proved extraordinary in its duration and accelerating pace.

Markets Cycle. Deciding *When* They Cycle is Never Easy.



Source: Howard Marks' on the Challenges of Market Timing, WSJ, 9/14/18

The lapping of the corporate tax reform boost and an anticipated slow down in corporate buybacks have reduced expectations for S&P earnings growth in 2019. Current forecasts call for just 10%. This slower growth and the threat of rising interest rates could limit the near-term upside for equities. However, at 16X 2019 estimated adjusted earnings, stocks aren't historically cheap but they remain within a reasonable range. That is, of course, assuming the economic cycle extends and interest rates simply creep and don't race higher. Admittedly, these are big assumptions. Consequently, for most clients we will hold some cash and short-term fixed income to preserve the option of buying stocks at cheaper prices. And, in the interim, we can get paid a little something given the increase in short-term interest rates.

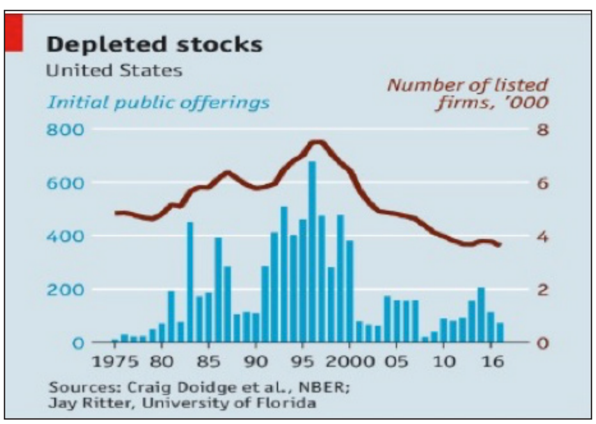
International Stocks: A Gap too Big to Ignore

Within the equity portfolio, we believe most clients should have some exposure to international stocks. They are considerably cheaper than U.S. stocks at just 13X forward earnings estimates and have more attractive dividend yields. This international exposure includes emerging markets. Companies in countries like India, Vietnam, and China should benefit from higher population growth and the emergence of a middle class. Adding international exposure also provides the opportunity to use an appreciated dollar to purchase assets overseas. This strategy is akin to deciding to travel abroad during periods when a strong dollar offers more bang for your buck.

We recognize 2018's 21% spike in dollar-weighted oil prices, the threat of more trade tariffs, and still nascent corporate governance practices represent risks for non-U.S. stocks, particularly those in emerging markets. Also, many U.S. companies will successfully penetrate these faster growing overseas markets improving their long-term growth prospects. Nevertheless, the valuation gap, benefits of the currently strong dollar, and opportunity to directly participate in a long running wave of positive demographic trends are too meaningful to ignore.

To Go Public or Go Private? A Popular Question These Days.

The shrinking universe of publicly traded U.S. companies has received considerable attention in recent years. Having peaked in the mid 1990s at over 7,000, today there are approximately 4,000 publicly traded U.S. companies. According to a recent Vanguard study, the primary factors contributing to the decline have been micro-cap company delistings following the bursting of the tech bubble and subsequently fewer initial public offerings to fill the void. Instead of pursuing an initial public offering (IPO) for growth capital, potential replacement companies are selling to private equity or larger public companies at prices above public market valuations, all the while avoiding the regulatory burden that befalls public companies and the risk of executing a successful IPO.



While the absolute value of public equity has increased considerably as markets have climbed, the ratio of private companies' equity value relative to public companies continues to increase. Diversification and exposure to growth companies outside of the public equity realm are important reasons why allocations to private equity are a valuable complement to most portfolios. Record levels of private funds chasing these opportunities, highly leveraged balance sheets, and persistently high-cost investment fund structures, are reasons why we think allocations should be measured and deployed over multiple years.

What to Make of What's Left?

Of course, it is important to evaluate what the changed public company landscape means. Fewer corporate headquarters spread across large and mid-market communities, less competition, greater concentrations of equity ownership at the upper levels of management, and only a handful of investment banks supporting the capital needs of this universe of companies will have long-term economic implications. Yet it would be shortsighted to highlight the negative impact of fewer small and mid-cap public companies without acknowledging the benefits that accrue to the balance of public companies that remain. These include less competition resulting from consolidation, better access to capital, and bolstered internal controls. Put simply, many of the strong have gotten and will continue to get stronger. How much the improved positioning of the public company survivors should enhance their value is debatable. It's material, however, and it's another reason why investors should avoid abandoning the public equity ship for private equity where valuations and financial leverage are often as high or higher than well-positioned public company peers.

"Parents have to really talk to their children before they leave home."
–Aretha Franklin, 1942-2018

In August, we lost an iconic figure in Aretha Franklin. Otherwise known as the "Queen of Soul," Ms. Franklin's music has touched generations of Americans from every walk of life. A trailblazer in many respects, Ms. Franklin also had to overcome a number of personal challenges on her way to achieving global fame. Sadly, while media reports estimate Ms. Franklin had assets exceeding $80 million at the time of her passing, like too many other celebrities she died with no will or plan for the assets. Please call us if you have not completed or updated your estate plan. We work with several leading estate attorneys often quarterbacking conversations between estate, tax counsel, and other business advisors.

In addition, we are available to help you think through important financial planning considerations ranging from setting a retirement spending level to deciding how to leave a charitable legacy for generations to come. Obviously shifting priorities and new developments will require plan adjustments over time. Yet a discussion of goals and analysis regarding the financial feasibility of these goals can serve as a valuable guidepost or launch point on which to build.

"We are taught to understand, correctly, courage is not the absence of fear, but the capacity to act despite our fears."
–Sen. John McCain, 1936-2018

It proved a difficult summer as shortly after Ms. Franklin's passing Senator John McCain lost his battle with cancer. His quote above on courage is particularly powerful considering Senator McCain's experiences as a North Vietnamese prisoner of war for six horrific years after he was shot down and seriously injured as a naval aviator. Whatever one's political persuasion, we can be inspired by the Senator's courage and note the charge of his farewell letter to "believe always in the promise and greatness of America" and to remember "Americans never quit...and...never hide from history. We make history."

As always, thank you for your continued confidence in Woodmont. We look forward to answering questions about your portfolios and helping evaluate and plan for your financial future.