

Markets are Acting Crazy – Again

Q2 2020

3 primary headlines:

1. Value investing is dead as low-priced companies get punished late Q2.
2. Speculation is alive as high priced companies flourish.....what pandemic?
3. Concentration of returns is back....which distorts indices.

“In the short-run the market is a voting machine but in the long run, it is a weighing machine” -Ben Graham

What is the performance of the markets YTD 2020? Depends on what index is used and the definition of the market. The S&P 500 index is increasingly influenced by recent concentration of returns among 10 holdings and is not presently representative of the market as a whole. If the intent of understanding market performance is based on the weight of some fundamental economic contribution, like net income, then no single index will presently adequately summarize the environment. Therefore, one must dig deeper at the industry and price level to gain better context.....especially in a pandemic induced world.

Things changed quickly the last 3 weeks of June.....Banks -15% and Energy -11% resulted in Q2 results that widened significantly for value based portfolios relative to growth or broader markets. Banks sold off after statements from Fed Reserve Chair Powell suggesting interest rates may stay near 0% until the end of 2022. The dual headwinds of increased credit losses and very low interest rates may impact short-term results but unlikely materially alter long-term earnings.

Meanwhile Big Tech and platformed / digitized business models continued to gain popularity along with many signs of increased speculation during Q2. The following are some examples;

Speculation #1: The average returns of 10 large Nasdaq companies exceeds 45% YTD 2020. Collectively, the 10 companies are priced at \$7.2 Trillion but generated less than \$200 Billion of income in 2019 resulting in P/E approaching 40x.

Tesla, Paypal, NVIDIA, Netflix, Amazon, Adobe, Microsoft, Apple, Facebook, Google had returns ranging from 135% to 9% respectively.

Speculation #2: The Nasdaq composite, largely technology-based companies with little earnings but high anticipation, is producing “dot.com” like returns during the pandemic. Over 500 names (25% of the total exchange) has advanced at least 25% YTD 2020. And 200 names have advanced at least 75%.

Speculation #3: Amazon’s price has advanced over 50% while expected earnings – by the analyst community – is lowered for the next 5 years. Resulting in an expansion of price relative to expected earnings beyond 50%.

Fundamental economics are not the primary focus during a speculative mania. Get rich quicker is.

Value based investing is for the long-term investor. It is hard, requiring commitment, determination, and discipline. It is the opposite of “fast money”. It also requires greater emotional stability and strength. During speculative environments, investors must remain patient and long-term oriented to resist the natural emotion of greed, fear of missing out and chasing returns. But the long-term benefits are clear.....over time the markets are a weighing machine and price matters. Over full market cycles, the economic benefits are expected to be superior. And when compounded over multiple cycles, the economic benefits are very material.

The popularity of “growth” over “value” has continued for at least 5 years and appears to be accelerating. The differential in valuation is approaching levels experienced in the late 1990s. A dollar of earnings in the “growth” bucket is priced far higher than a dollar of “value” earnings. Expectations continue to climb for “growth” stocks while lowered for “value” stocks.

Several factors are driving increased popularity (or speculation) of certain companies, including;

- Algorithmic trading / momentum bets
 - The average holding period of all shares outstanding in the US is 81 days!
- Market capitalization weighted indexes
- Day trading / the new alternative to the lack of sports gambling
- Federal reserve monetary bond buying program creating additional equity demand
- Expectation of bailouts / increased moral hazard
- Etc.

The following summarizes the major drivers of composition of the “value” vs “growth” indexes and the YTD performance through 6/30/2020.

	S&P Value %Wgt / %Rtn	S&P 500 %Wgt / %Rtn	S&P Growth %Wgt / %Rtn
-Tech	9% / -4%	28% / 15%	40% / 19%
-Consumer Discretionary	5% / -18%	11% / 7%	15% / 16%
-Financials	18% / -27%	10% / -24%	4% / -11%
-Everything Else	68% / -15%	51% / -13%	39% / -4%
Totals	100% / -16%	100% / -4%	100% / 8%

The differential in YTD performance is 24% comparing Value (-16%) to Growth (+8%) which is a differential not seen since 1999. And among Tech, Consumer Disc and Financials, the difference is +23%, +34%, and +16% respectively.

What are the drivers of performance (price expansion) differentials? The 10 Big Tech cited on page 1. Meanwhile, the “Value Tech” consisting of Intel, Cisco, Twitter also trail its “growth counterparts in excess of 20% ytd. And banks are down 35% year to date and more than many travel and tourism related industry significantly more impacted by the world shutting down.

What is causing the large difference in performance.....it’s not the change in multi-year earnings expectations but short-term price expansion.

The following summarizes the change in “price” relative to book value (which is a more stable economic result than earnings for short-term comparisons)

Price Expansion	<u>% Change</u>
S&P 500 Value (in white)	-12.2%
S&P 500 Growth (in red)	<u>14.1%</u>
	23.3% YTD Differential

See chart on next page.



What are proper future expectations? A review of prospective return on market price...the ROMP.

A company's Return on Equity relative to its Market Price to Equity provides an estimated return on market price. An example; if a bank CD paid 6% interest and it was acquired at 1.0 x equity, then the return on market price would be the same as return on equity = 6% ROMP. But if it was acquired at 2.0 x equity, then the return on market price is divided by 2 or = 3% ROMP. The following summarizes the ROMP for 3 sectors of S&P 500 value vs growth indexes.

	S&P 500 Value	S&P 500 Growth	Difference
<u>Tech</u>			
1. Return on Equity – 5 Yr Ave	29%	43%	
2. Market Price to Equity	5x	13x	
3. Return on Market Price (ROMP)	5.5%	3.2%	
$P/E = 1 / ROMP$	18x	31x	
<u>Consumer Discretionary</u>			
1. Return on Equity – 5 Yr Ave	19%	24%	
2. Market Price to Equity	4x	20x	
3. Return on Market Price (ROMP)	5.0%	1.2%	
$P/E = 1 / ROMP$	20x	83x	
<u>Financials</u>			
1. Return on Equity – 5 Yr Ave	11%	14%	
2. Market Price to Equity	1x	3x	
3. Return on Market Price (ROMP)	11.0%	5.0%	
$P/E = 1 / ROMP$	9x	20x	

Compare the ROMP of Value Financials vs Growth Consumer Discretionary. The result is 9x lower price for Financials and 9x higher return potential regarding its ROMP or earnings yield.

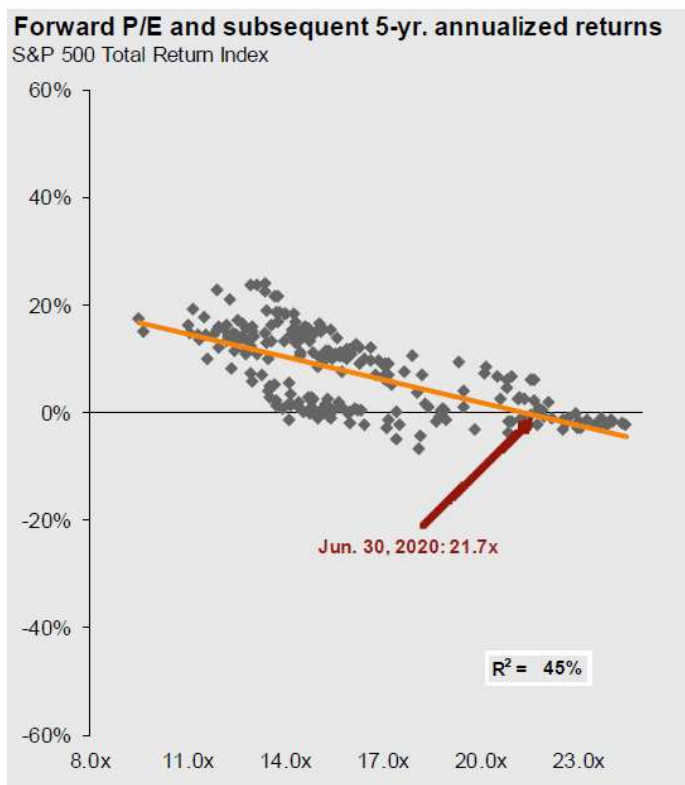
Future returns are predicated on 2 variables;

- 1) Long-term results and change in underlying economics...i.e. earnings to the owner
- 2) Change in price relative to earnings to the owner

For higher priced assets, the likely outcome is “contraction of price” relative to underlying economics. Alternatively for lower priced assets, the outcome can be aided by expansion of price relative to underlying economics as mass sentiment changes and reversion to the mean materializes.

Regarding market prices, the pendulum often swings farther than fundamental economic reality creating many over or under priced situations.

The following chart measures returns, since 1995, based on starting price relative to earnings and the tendency of outcomes 5 years later. Stocks priced higher generally do poorer over long periods of time. This has not been true for the past 5 years, but evidence suggest it is more true over multiple market cycles.



Source: Factset, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management

In Conclusion

Price eventually matters and it is central to decision-making for value-based investors. Value-based investing is only for the long-term investor that can see it through all markets and environments. It requires commitment, determination, and discipline. It requires greater emotional stability and strength. And especially during speculative environments, investors must remain patient and long-term oriented to resist the natural emotion of greed, fear of missing out and chasing returns. And the long-term benefits are clear and material when compounded over multiple cycles.