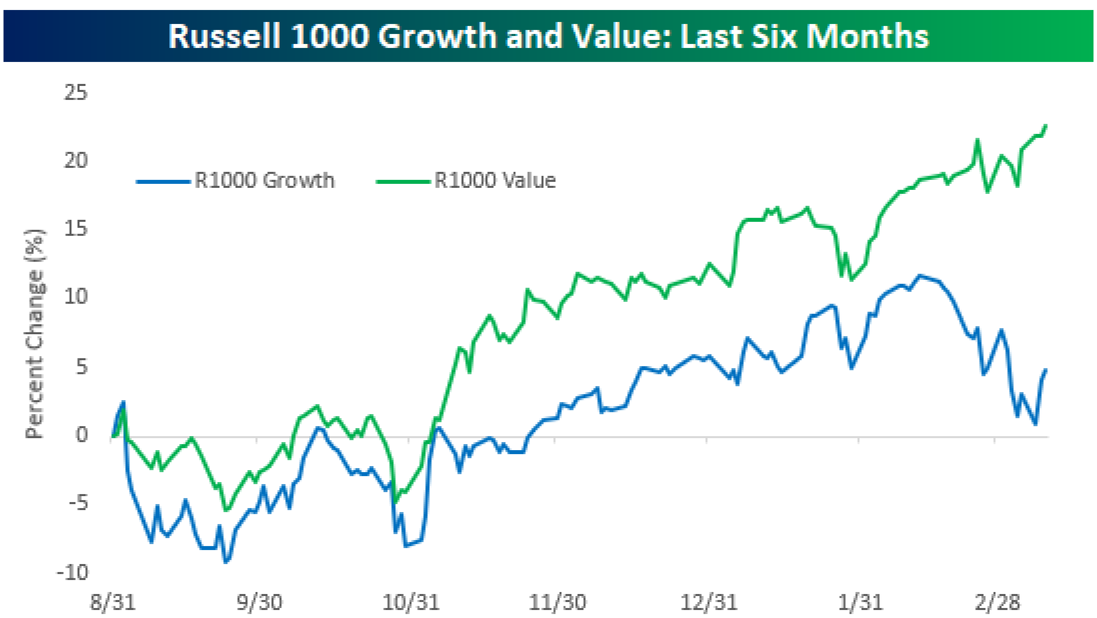
1st Quarter 2021

The year has started off on a strong note with all major stock averages rising in the first quarter. The Dow Jones Industrials finished the quarter up 7.8% followed by the S&P 500 up 5.8% and the Nasdaq adding 2.8%. The larger story for stocks during the quarter was the outperformance of value stocks relative to growth stocks, generating nearly ten percentage points of outperformance for the quarter. The Russell 1000 Value Index rose 10.66% while its growth counterpart rose only 0.75%. International stocks (MSCI EAFE Index) lagged the U.S. but rose 4% for the quarter. The bond market experienced a decline in prices from the sharp move higher in interest rates on U.S. Treasury notes. The investment grade aggregate bond index was lower by 3.7%.

A major theme in the performance of stocks for the last decade or so has been the strong outperformance of large cap growth/momentum names at the expense of smaller and value-oriented names. Lately, this dynamic has been changing, with a rotation of market leadership, and a broadening out of participation among value stocks. We had been expecting this and feel confident in our positioning to continue to benefit from the broadening of market leadership.



Even with the recent recovery in value, the gap in performance between growth and value is still wide. That gap in performance has resulted in a wide dispersion in the relative valuation multiples of stocks. Going forward we think the low expectations reflected in the pricing of value stocks vs growth stocks is setting up a favorable reward to risk potential. We view this as pent-up pressure for quality businesses that had been trading at a market discount, which are now exerting their upward force after being ignored for so long (as happens with a coiled spring). This upward force can be a result of the multiple that investors pay for the earnings of a company re-rating higher to a more normalized level. It can also come from the earnings of a business reaccelerating from temporarily lower levels. The unprecedented length of this period of value underperforming growth, reinforces our contrarian view that selective, valuation-focused investing will be rewarded in the future as the valuation gap narrows from historically wide levels.

We are in an environment where the Federal Reserve is committed to an easy money policy with rates at rock-bottom levels and fiscal stimulus is flowing. Cheap money usually ends up chasing deals that would ordinarily, in a more normal environment be shunned by prudent investors in favor of deals with a better risk/reward. That's not happening now, and it is helping to feed the frenzy.

The late stages of a bull market have historically coincided with rampant speculation. These are getting easier to spot. The share of the U.S. market made up of the highest PE companies and those with no earnings has reached a new high. The use of margin debt to buy stocks is also at all-time highs. The amount of money raised in new IPOs in 2020 has far exceeded that of prior peaks. Much of this is going to businesses with no current earnings and the promise of massive market share growth to drive future earnings. Some will undoubtedly succeed in this challenging endeavor. There will be many however that succumb to the realization that their frothy valuations simply cannot be supported.

The speculative buying in SPACs (Special Purpose Acquisition Companies), IPO's and cult stocks all add to market froth. When the money heads for the exits, the rush could be greater than the passageways, causing much pain for those who are too late to the exit. We've seen it play out many times before. The names involved may be different each time, but the story - and how at ends, is always the same.

This period of extraordinary monetary and fiscal policy support is particularly challenging to navigate given that high valuations exist in areas of both the stock and bond markets at the same time. Investors must be aware of what they own and what valuation, or embedded rosy scenario is priced in. There has been simply too much money chasing "investments" with no regard for valuations.

We have built our stock portfolios with valuation at the forefront. We do the work on the companies to understand their businesses, their markets served, and the fundamentals of their balance sheets, cash flow statements and income statements in terms of peak, trough and normalized levels of earnings and revenues. We use this information to determine if we are buying at a price that is low enough to adequately reward us for the risk we're taking. When there is enough gap (margin of safety) between the current share price and the underlying value that we see in the business, we are happy to own these businesses regardless of the market environment. If interest rates stay low and monetary policy and fiscal stimulus remain supportive, then prices can certainly stay high or move higher. But it is important to appreciate the relationship of current high prices and the forward return potential. High prices reduce the margin of safety, or margin of error for an investment. They become more susceptible to unexpected downturns and shocks to their businesses or the economy. As current prices continue to move higher, the margin of safety is diminished, and the future return potential is lowered.

We believe we are in the early stages of a multi-year rotation into stocks that reflect a better value proposition, and while we don't expect it to be particularly smooth, it should eventually unwind the extreme performance dispersion that has occurred in the market. Value stocks, but more importantly, the businesses we own and follow, continue to offer what we view as compelling long-term value. These holdings' superior upside potential relative to their downside potential is what keeps us invested even in the face of what we view as a rising risk market environment. We can't control, or predict what the market will do, but we can control what we choose to own and at what price.

Thank you for your trust and confidence.

Justin B. Whelan, CFP
President
jbw3@biechele-royce.com

Thomas A. Barrett, AAMS
Chief Investment Officer
tbarrett@biechele-royce.com

George S. Sparks, Jr., CPA, PFS
Barnes Dennig – Director
gsparks@barnesdennig.com

Tony Milburn
Senior Investment Advisor
tmilburn@biechele-royce.com

Stephen Allen, CPA, PFS
Senior Investment Advisor
Steve@allen-cpas.com

Andrew J. Bertke, CPA, PFS
Barnes Dennig – Director
abertke@barnesdennig.com

Matthew C. Sanchez, CFP
Senior Investment Advisor
msanchez@biechele-royce.com