3rd Quarter 2021 Review

After posting solid gains in the first two quarters of the year, the third quarter of 2021 ended on a down note. The month of September experienced a 4.8% draw down and was the worse month for stocks since March of 2020. Even with the volatility in the quarter, stocks are still solidly higher for the year, with the S&P 500 up 15%.

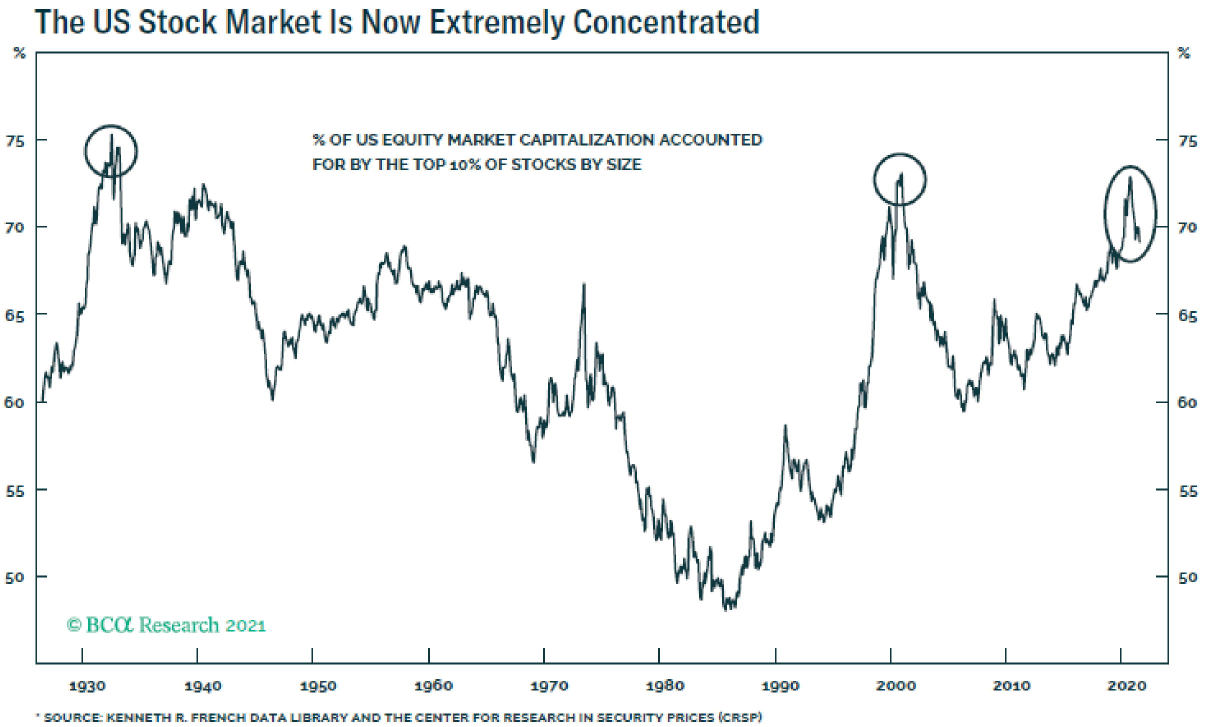
For the third quarter, the Dow Jones Industrial Average fell 1.9%, the S&P 500 was up 0.23%, the Russell 2000 Small Cap Index was off 4.6%, and the NASDAQ declined 0.38%. Emerging market stocks fared the worst in the quarter falling over 8%, while the MSCI EAFE Developed International Index fell 1.1%. A broad measure of the U.S. stock market representing an average of the 1700 stocks in the Value Line Index fell 4.27% in the third quarter. For the broad bond market, the U.S. Aggregate Bond Index fell 0.43% in the quarter.

Investors faced increased uncertainties during the quarter which in turn drove volatility higher. The markets are digesting a confluence of factors from the rise in interest rates and inflation, and what this may mean next for the Federal Reserve. Disruptions in global supply chains are sticking with us longer as the Delta variant lingers on with impacts on shipping ports, and semiconductor plants as prominent examples. We also have the still unresolved fiscal mess in Washington surrounding the government debt ceiling, budget bill and infrastructure bill. China has also become a source of angst as they deal with looming unmanageable debt obligations of a major property developer and the potential ripple effects this may have on China's growth.

When the news cycle is full of troublesome headlines and volatility resumes (after an extended period of relative calm), it is natural for investors to ask questions about the linkage of such headlines to the markets. Questions like- What is going to happen to the market given (pick any topic of the day) rising inflation, rising interest rates, uncontrolled government spending, or tax increases? Sometimes the question comes in the context of should we even be in the market at all given the state of affairs.

While these are genuine issues, and macro developments involving rates, inflation and growth do have a place in our thinking; as investors we must resist allowing the macro to preoccupy us to the point of letting emotions control our actions and miss the micro-opportunities. The types of micro questions we ask ourselves everyday are questions like: What do we see out there that is attractively priced, where the risk is fully justified by the long-term reward? And what are we finding in the way of quality businesses trading at trough-level earnings and poised for an inflection higher? Or rather than attempting to determine with any precision if the market is going to correct 10%, or 20%; we will focus on whether there are good businesses out there that have already experienced a correction in price that sets it up on its own merits for solid future returns. These are the things we think about every day because we can control them, and we have a disciplined and proven process for executing these ideas. We also believe that investing involves making solid decisions around the probability of outcomes. Our confidence interval is much higher in sizing up opportunities within individual companies and their impact on future portfolio returns and risk management than making broad economic or market calls on short term direction.

We touched on valuations in last quarter's review. This quarter we will put some additional context around valuations and future expected returns. As we have said on previous occasions, valuation is never a good short-term timing mechanism, but it is a good predictor of longer-term returns (5-10 years). Long term capital market assumptions are based on the market-cap weighted indices such as the S&P 500 Index. The U.S. stock market has become highly concentrated in the largest companies by size (market cap). This chart from BCA Research shows how the buildup in concentration of the top 10% of stocks by size leads to levels that become unsustainable. As the largest leaders of the past 10 years of returns reach overvalued levels and higher concentrations, the opportunity for them to disappoint investors over the next 10 years increases.



This is where we see elevated valuations and thus much lower forward returns for the broad market-cap weighted indices. To highlight the rich valuations concentrated at the top, according to Value Line Research, the 30 largest companies by market capitalization trade at an average Price to Earnings multiple (PE) of 31.5 and a median PE multiple of 24.6. This compares to the current median PE multiple of all Value Line stocks of 18.9.

Vanguard's most recent asset-class return projections put U.S. equities in the 2.4% to 4.3% range for 10-year annualized returns. They have U.S. bonds at 1.3% to 2.3% for the same period. These lower return projections correctly incorporate the high current starting valuations into their forecasts. The expectation is for a degree of mean reversion in both PE multiples and profit margins from these higher than historical levels. When presented with such an opportunity set, we believe investors are best served by focusing on the pockets of value that do exist in select stocks where the valuation discount tilts the odds in favor of an improved outcome versus the market. It is our opinion that with the overconcentration of already highly valued companies in the broad index, it will not be too difficult for a carefully selected portfolio of stocks focused on attractive businesses and valuations to outperform the index over the coming 5-10 years. Investors in equities need to accept that there will be periods of higher volatility to achieve these returns. This is why we focus on a minimum time horizon of five years for equity investment. Historically this is adequate time for the valuation and growth metrics that we expect to drive return potential to play out. It is the interplay of changes in earnings, dividends and the PE multiple that make up a stock's total return over time. It is much harder for earnings growth and dividends to overcome the change in PE multiple when these multiples get so overextended.

Overall portfolio volatility can be improved with the addition of lower volatility and less correlated investment strategies that are built to take advantage of opportunities such as cash flows backed by real assets, long/short equity and credit, and the illiquidity premiums in private credit and private equity. With the yield on the aggregate bond index in the U.S. of only 1.4% with a duration of 6.5 (low yield and high interest rate sensitivity), actively managed bond funds can also help diversify portfolios while managing both interest rate risk and credit risk within the allocation.

As always, thank you for the trust and confidence that you place in us.

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