

## MONTHLY COMMENTARY | NOVEMBER 2020

*"...the low interest rates represent the dominant characteristic of the current financial environment, creating the dominant consideration for investors: the lowest prospective returns in history."*

- Howard Marks, October 2020

Despite this year's extreme volatility, the past ten years have been an extraordinary time to be an equity investor. Following the last financial crisis, investors have been extremely—perhaps abnormally—well-paid for taking stock market risk. To sustain that premium for another ten years would require global equities to more than double in absolute terms from today's levels while holding interest rates constant. Perhaps an unlikely proposition with stock markets already at record highs.

The past month has been a stark reminder of how enthusiastic sentiment can shape market prices. With news of a potential vaccine being released, the resulting rise in market prices presumes economies would immediately return to a pre-COVID level. Which, of course, we all know will take much more time and patience.

Recently, a great deal is being said about the "rotation to value stocks". We have argued, here and elsewhere, that traditional value investing as espoused by Ben Graham has simply lost its way. The new world, led by asset-light technology companies, have kept value investors at bay. Similarly, value investing's focus on dividends has caused adherents to miss those companies that have focused their efforts on returning cash in share buybacks.

Yet, with the remarkable flight to quality businesses in recent years – quality defined as those with a combination of high profitability, earnings stability and balance sheet strength – has resulted in valuations that are priced to perfection, and their continued outperformance over the long term requires heroic assumptions.

Active security selection potentially offers a way out of this conundrum. While broad stock market returns have been robust, there are plenty of areas of the market that have not participated. In fact, on an equally-weighted basis, the average stock has been mired in a hidden bear market for some time. There are also substantial valuation dislocations

within markets such as those between growth and value shares, stable businesses and cyclicals, and the U.S. versus the rest of the world.

In this expensive equity market, we believe the small and mid cap market will remain a strong source of potential gains for investors in the years ahead. Small companies have been largely neglected by the "street" in recent years, leaving the opportunity for securities to be mispriced. These companies do not fit traditional models and require a more hands-on, fundamental research effort to understand the growth and market dynamics going forward.

High-quality smaller companies typically have higher P/E ratios than those in the benchmark indices. Why? High-quality companies tend to grow sales and earnings much faster than the typical index constituent. And within periodic downturns – like the current pandemic – high-quality small companies can react faster to seize opportunities and emerge stronger and better positioned for the long term.

More generally, we believe sales growth and earnings growth drive stock prices over the long term. We favor industry-leading companies that are largely able to self-fund their growth without much debt and, if possible, without high fixed costs. Where possible, we also look for sustainable competitive advantages, healthy balance sheets, high returns on capital and strong cash flows. One reason we caution against passive investing is that the index, at any moment, is biased to companies that have already shown strong operating results. Active investing is all about attempting to capture future strong operating results.

We expect our well-chosen smaller companies will benefit from the Fed's "lower for longer" interest-rate policy, which places a premium on the future. So rather than attempting to navigate macro events like vaccine development, political election results and growth versus value cycles, we prefer to stay squarely focused on assessing, and capturing, quality for the long term.