March 10, 2014

Rational Expectations through Pockets of Momentum

In February, markets (as represented by the S&P 500) recouped all of their January losses and closed the month essentially flat for the year. In our 2014 Outlook we emphasized the fact that strong market years like 2013 tend to pull forward future returns. As such, the start to 2014 is very consistent with our belief that it is "quite possible, almost probably that 2014 will be a better year for the economy than it will be for the stock market." Fear not, for this is very constructive.

There are two ways for markets to digest gains: either they can decline in price or consolidate sideways over time. Often times digestion comes with a little bit of both, and depending on your timeframe, one can see we have in fact experienced a little of each. January brought about a market decline while, after two months of 2014 markets sit exactly where they started the year. Considering the magnitude of the rally in 2013, we think this period of digestion and consolidation can and should continue.

Embedded Expectations:

In last month's commentary, we discussed the role of a stock's multiple in driving returns[1]. The multiple is the best proxy for expectations in the stock market: a high multiple is a sign of confidence, while a low multiple signals a lack thereof. We also emphasized that not all multiples are created equal. While a multiple is inherently subjective, and noisy over time, there are some tools (aka formulas) we can use to approximate what a fair multiple would look like. One nice feature of these formulas is that when we know the multiple at a given point in time, we can work backwards to solve for the embedded implications.

While most of the conventional discussion on multiples focuses on the P/E ratio, the P/B ratio is a close cousin that offers equally important insight. P/B is the price-to-book ratio, a measure of the market's price in relation to the value of the assets minus liabilities at a company (or in an index).

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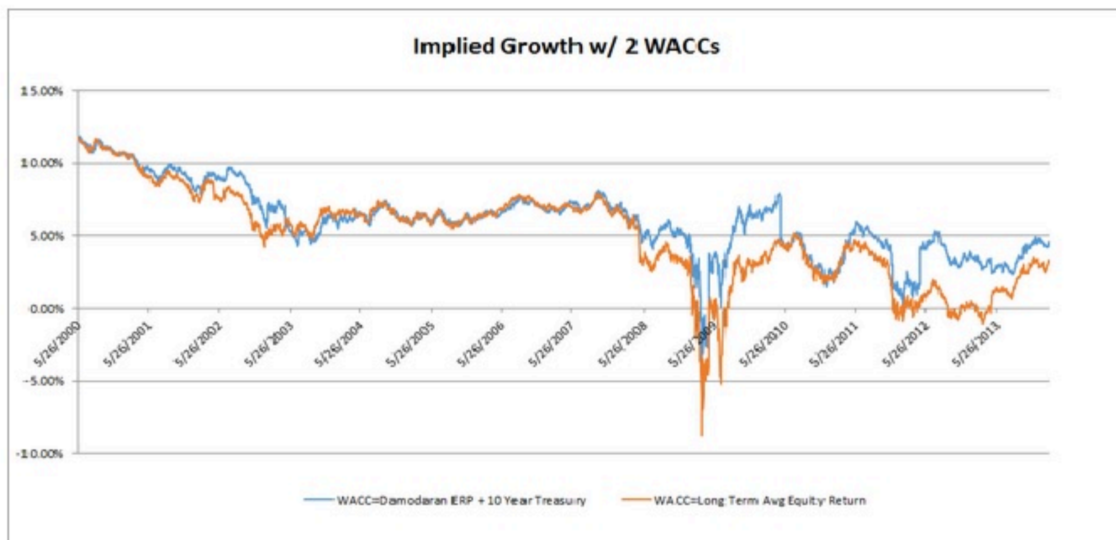
[1] http://www.rgaia.com/emerging-markets/

The formula for P/B is as follows:

Justified P/B = (ROE-g) / (r-g)

We know all of these variables except for "g"—the expected growth of earnings over time. Importantly it is expectations of "g" which influence multiples, so in solving for this variable we can learn exactly what the embedded expectations of "the market" actually are. This implied growth would tell us what level of future growth the market would need in order for an investor today to earn his expected return. Expected return here is a loaded term, and we solved for it in two separate ways, though to simplify it is a return that essentially equally the long-run annualized return (over 100 years) that has been experienced by US investors.

We worked with a friend in the investment industry to solve for the market's growth expectations over time in hopes of gaining some insight. Sure enough, the chart was rather enlightening:



The chart provides a roadmap of sorts, showing where the market has been over the past decade and offering us the threshold for growth that earnings must meet in order to earn an average return in the market over the next ten years. For an investor today to

earn 7.91% annualized (this is total return, inclusive of inflation), then the earnings of the S&P 500 would need to grow at 4.31% annually. This contrasts to the 5.3% average growth in earnings realized since 1950.

There are some further important takeaways worth emphasizing. Many have talked about the market having more lofty valuations today. While that is true relative to where we have been in the recent past, expectations remain fairly modest. The flip side of the coin is that from here on out, companies will in fact have to deliver future growth in order to rise in healthy fashion. Otherwise, expectations can quickly become detached from reality, as they did in the bubble of the early 2000s when markets were pricing in unprecedented and unjustifiable levels of growth.

Since the initial bounce-back from the Financial Crisis, implied growth has peaked near the 5% level. In other words: markets have been digesting (selling off or moving sideways) each time implied growth has reached the 5% level. This is consistent with the mainstream theme that we are in a "low growth environment." While some believe we have reached "escape speed" in the economy, meaning we will return to a pre-crisis trajectory in growth, it's clear that the markets are simply not there yet, though they are close. For much of 2011 and 2012, the market was pricing in no growth, so a substantial portion of normalization is expected on the earnings front.

If you find this topic of implied growth interesting, check out Elliot's blog for a more detailed analysis of the market's expectations[2].

Momentum Returns:

One corollary of higher growth expectations is the return of momentum. Much of the day-to-day action in markets has shifted from buying pressure from disciplined investors to speculative buying driven by momentum riders. Pockets of momentum have been visible even during the depths of the Financial Crisis, yet today that pocket has been increasingly broadened. In our August commentary we highlighted some of the embedded assumptions in Tesla's valuation[3]. This is not dissimilar from how we looked at the broader market above. Needless to say, Tesla has risen considerably since we

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[2] http://compoundingmyinterests.com/compounding-the-blog/2014/2/27/the-markets-betting-line-a-look-at-implied-growth-1.html

[3] http://www.rgaia.com/august-2013-investment-commentary-tesla/

took this first look, while the trajectory of Tesla's growth has merely continued apace. Tesla's price has gone up, while the value proposition has stayed exactly the same.

Tesla is not alone. We ran a screen for stocks with in the Russell 3000 with market caps greater than $5 billion and a price-to-sales in excess of 10x. Only four quarters in the past twenty years had a greater quantity of stocks meeting this criterion. Those four quarters are quarters one through four of the year 2000. Moreover, regardless of how broad this list is, were one to invest in such stocks as a strategy, the likelihood of poor returns is exceptionally high, with a substantial likelihood of realizing negative returns. These losses are not necessarily imminent, for the last time a similar population of richly valued companies appeared, the situation persisted for a full year. Meanwhile right now it's merely been present for part of one quarter.

Facebook is one such company. Its stock is pricing in rich expectations, and Facebook's acquisition of WhatsApp has striking similarities to behavior in the Dot.com bubble. In fact, people who are justifying the WhatsApp acquisition are using the same arguments that failed way back when, asserting "users" as value with the expectation that revenues and profitability will follow. While its certainly possible for the acquisition to work down the line, the higher the expectations the more likely it is that something can go wrong. In markets we want to pay as much as we can for what's tangible, in situations where expectations enhance, not justify our return. Clearly some have not learned the appropriate lessons of the past decade.

While we are concluding this letter on a cautionary note, it's important to emphasize the overall expectations of the market are quite rational and quite justifiable. These pockets of momentum will eventually be flushed out, and cause losses to people who are flirting aggressively in risky areas, though this day of reckoning might not happen for a while. When it does, it could hurt the broader market in the short-run, but will not have too big an impact in the long-run. All the while, we will remain disciplined and focused on owning only quality at the right price.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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