FROM THE DESK OF THE CIO

4Q2018 Market Update

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Chief Investment Officer

The following is an excerpt from the 4Q2018 update report of our Dynamic Growth Opportunities (DGO) strategy. A copy of this report in its entirety can be found here.

Macro Backdrop

The fourth quarter of 2018 marked the period where the Fed removed the training wheels that it had been deploying for nearly the prior decade; at least that's the best way to categorize the market's perception. We recently put some context behind this in our December white paper. In the post-financial crisis period, bank balance sheets required repair, the job market needed to heal, a housing foreclosure glut had to be flushed, and factories had to slowly shift gears back towards optimal production levels. All of that added up to the Fed concluding that it needed to retain "accommodative" posturing, that is, up until early October 2018 when Chairman Powell ditched the term from his commentary. In isolation, this conclusion was largely foregone. In conjunction with a handful of impacts—1) escalating trade tensions with our largest nation-state partner, 2) a yield curve head-faking flatness, 3) a midterm elections balance shift, 4) the shuttering of the federal workforce as a border wall deal pawn, and 5) an expansion that was getting longer in the tooth—these factors stacked up as too burdensome for the equity markets to sustain. As a result, December earned its Grinch-envious badge of "Worst Christmas Eve ever," and retail investors bailed from equity funds at a record pace (see Chart 1 on next page).

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Despite a soggy Times Square ball-drop that made the humans-as-sardines ritual appear even more miserable on our screens, 2019 has been a refreshing reminder on the underlying drivers to what equity prices attempt to reflect. As active equity managers, we're not hired to be optimists. We're here as impartial arbiters, bestowed with the fiduciary responsibility of our clients' capital (alongside our own) to make sense of the market's appetite for risk. In turn, we position our long-term bets with the explicit intention of providing relative value. We view the end of 2018 as being a reminder that the days of a rising tide lifting all boats, one that simultaneously inflates multiples indiscriminately, are artifacts of the past. Never is it prudent to stack a portfolio with investing acronym du jour--prepare for the "FANGs" to be replaced by the "PAULs" of Palentir/Airbnb/Uber/Lyft--as peak-to-trough draw-downs of 20% intra-quarter are not-so-gentle reminders that a risk-centric approach is imperative to the generation of attractive risk-adjusted returns. We interpret the market's 4Q volatility as a cue that our tools deployed towards relative value creation need to be sharper and more precise than any prior

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Chart 1: Weekly Fund Flows ($M)

Source: EPFR, cited via Financial Times.

The disclaimer of past performance not being indicative of future results is one plastered across every financial publication containing any hint of financial advice. And, although it's an assumption that market technicians hold as truths, we find utility in observing the past in the exercise of context. Take, for example, current concerns that we're approaching a bubble burst, specifically one associated with lofty equity prices. Diving into the setup that created the "dot-com" boom/bust is a helpful comparative exercise to gain context on the pricing of the current environment. If you dissect the S&P 500 as of August 2000, a snapshot immediately prior to the two-year downturn that eroded 47% of market cap peak-to-trough, you would see significant bloat in trading multiples. This was especially pronounced among the large caps, as the ten largest issuers traded 64.6x earnings on average, while the overall market averaged 25.3x (see chart 2 on next page). Today's top ten list averages 25.9x, a 60% discount to the Aug 2000 period, while the overall market trades 17.1x, 32% cheaper. We simply are not facing the same level of pervasive, nose-bleed valuations.

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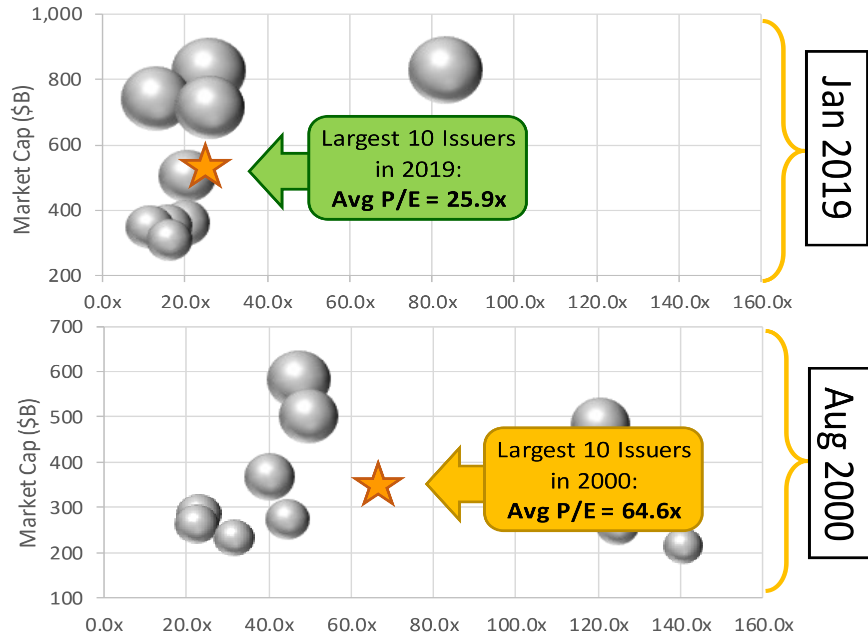
How companies were deploying technology at the turn of the century in comparison to today also translated into significantly different value propositions. As of August 2000, Time Warner was consummating its $160 billion acquisition of AOL, a business that represented the common means of US household internet access at the time. All that a company had to do was slap ".com" onto its corporate banner, and the market subsequently rewarded the move with instant multiple appreciation. Companies also had to face large Capex deployments in order to set up a distributed computing environment inside a company-owned data center. Today, we can convert what otherwise would have been multi-million dollar Capex outlays to variable-cost-based compute workloads, metered by the compute minute from the likes of Amazon AWS, Microsoft Azure, or Google Cloud Platform. In 2000, traditional fundamental valuations were also eschewed as antiquated, with

greater emphasis being placed on pre-revenue type metrics, such as counting eyeballs and clicks. This all summed to a market topography that was becoming increasingly top-heavy at the end of the summer of 2000.

Chart 2: Market Valuations: The S&P 500 in 2000 vs 2019



P/Es presented on a trailing-twelve-month basis. Average P/Es represent simple average of ten largest issuers in respective periods with positive earnings.
Source: FactSet, company filings.

We're not advocating investors draw the "2000 conditions don't exist" conclusion and march onward with a risk-on game plan. Since the tools to deconstruct business models are far more robust and data-intensive than they were at the turn of the century, we will always have to project financial outcomes further into the future.

Summary

All that said, we're not advocating investors draw the "2000 conditions don't exist" conclusion and march onward with a risk-on game plan. Since the tools to deconstruct business models are far more robust and data-intensive than they were at the turn of the century, we will always have to project financial outcomes further into the future, beyond periods where traditional forward-looking multiples may capture. However, even holding ourselves captive to the constraints of these analyses, we conclude that we are not currently suffering from bubble-inducing price inflation. Instead, we draw the conclusion that fundamental forecasts will require increasing due diligence and assumption stress-testing. As we run analyses tools across the opportunity set of our investable universe, we continue to see attractive opportunities for relative value creation and, as such, are optimistic about DGO's prospective opportunity.

About the Author

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Mike joined SWS in 2017 as its CIO and leads portfolio management, risk management and research for the firm. Before joining SWS, Mike was a portfolio manager on $4 billion of long-only equity portfolios at the Ohio Public Employees Retirement System (OPERS).

He leverages over sixteen years of experience on both the buy-side and the sell-side to bring an institutional research and portfolio management framework for SWS investors today. Prior to OPERS Mike was responsible for investment bank equity research at FBR Capital Markets. He received his Bachelor of Science in Economics, Finance concentration, from the Wharton School at the University of Pennsylvania and is a CFA® charterholder.

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