

INVESTING

MAY DAY



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What in the world is going on here? Businesses both large and small, public and private are faced with tremendous uncertainty as they struggle to keep their workforce safe and generate sufficient revenues and cash flow to support their ongoing operations. With large swaths of the economy shuttered for weeks and more than 30 million Americans filing for unemployment the past month alone, a recession is here with the only question being the severity and duration. Despite this, the stock market just logged its best monthly return since 1987, is now up nearly 30% from the lows reached in March and down approximately ten percent for the year.

We never claim an ability to predict the direction of the market even with the benefit of hindsight. There is no simple answer to why the market has been so strong of late, but it is likely a combination of several factors, so here are a few possible explanations. For one, the unprecedented stimulus measures taken by both the U.S. government and Federal Reserve have served as a safety net and potentially a bridge to get businesses back to normal and the economy functioning again. For now, the risks of not supporting American business is too great and the concern of the potential negative long-term impact of these measures is rightfully left for another day.

The breadth, or really lack of breadth, of the market is another plausible factor. Five stocks, Alphabet, Amazon, Apple, Facebook and Microsoft have a collective market capitalization of greater than \$5 trillion which accounts for approximately 20% of the entire weight of the S&P 500. All five tech giants are within 10%-15% of their all-time highs which has added further support to the market. Each of these companies reported their quarterly earnings this week and by and large their businesses are not only doing well, but in many cases are taking market share, due to their dominant competitive position. The market continues to reward these exceptional businesses with higher valuations.

Another consideration is the notion that markets tend to discount the future. Based on recent strength, the market is clearly anticipating that both the U.S. and global economies will begin to recover in the second half of the year. Despite the controversial nature of the decision, several states have begun to gradually reopen their economies, at latest count nearly 50% of the country, indicating we are clearly a step closer to a return to normal. Efforts to “flatten the curve” and rapid advancements in testing, tracing, treatment and vaccine initiatives have also progressed significantly over the past month.

There are two other likely contributing factors neither of which are well grounded but can be understood using the following acronyms “TINA” and “FOMO”. “TINA” stands for “there is no alternative”. With interest rates at near zero, cash and bonds yield virtually nothing and will struggle to outpace inflation over the coming years. “FOMO” may be a more familiar term and is short for “fear of missing out”. Right or wrong, this has had at least some influence on the market’s direction and reminds us of the old Q&A adage “Why is the market up today? More buyers than sellers”. If forced to choose between the two, “TINA” makes more logical sense to us, as investors do require a return on their capital and currently stocks appear to be the only game in town.

All of this is to say that there are multiple narratives as to why the market has rallied in the face of such dire concerns with little clarity as to what in fact has been driving this.

Over the past several decades, a pronounced shift has occurred as a majority of investors have embraced passive investing, which is the idea of “buying the market” through an index fund such as the S&P 500. This affords broad and indiscriminate exposure to nearly all companies and sectors in the economy, both the good and the bad. This certainly has its merits, and it is hard to argue against that for many it is a

prudent approach, especially for those individuals that do not have the time, interest or capability to study and invest in individual securities. We have seen an acceleration of this trend coming out of the Great Recession at the end of the last decade. Passive investing benefited from the tail wind of both economic expansion and a historic bull market in terms of its duration, which lead to the market setting an all-time high just over three months ago.

It is our belief, and we presume we are not alone, that the world has clearly changed. The economic landscape has shifted, and the path forward will be much more challenging for many businesses as they navigate the economic uncertainty over the next several years. At its core, investing is about owning the right businesses at the right price, exercising patience and always striving to upgrade the quality of your portfolio. With the market trading near its all-time highs and all of the disparate factors cited previously, we are skeptical that passive investing and broad exposure to the market today will provide a better outcome than our strategy of investing in securities of select businesses based on their individual merit.

It is exactly for this reason that we focus on active investing which is investing in individual securities. We work hard to understand both their competitive positioning (business quality) and their intrinsic value (what they are worth) and can assess how they will navigate this and any future challenges. This gives us a much higher degree of confidence in understanding what drives our investment returns over the long run. I believe that this kind of discipline and rigor has largely been lost among investment advisory firms, who have opted for the easier, cheaper solution of investing passively. Easy solutions work in easy times. Our preference, which serves us in all seasons, remains to fully understand the individual business that we own, focusing on the business' ability to navigate uncertainty effectively and working to build conviction in our estimation of a fair price for that business. We will leave the guesswork of what is driving the market to the pundits and stick to our disciplined and unique approach.