1Q 2019 Market Insights
A Value Manager's Perspective on a Frustrating Year
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"The power of value investing flies in the face of anything taught in academics. Value is the way stocks are eventually priced. It requires the perspective of patience because the market will eventually gravitate toward value." – Joel Greenblatt[1]

Many words can be used to describe 2018 from an investment perspective. Investors focusing on risk might call it scary, since we witnessed two equity market drawdowns in the Spring approaching 10% and a third, which we are currently experiencing, that at its current nadir has reached 15%. Those who take a more glass half full perspective might call it encouraging, given that, despite tariffs, trade wars and interest rate hikes, markets seem to have weathered the storm fairly well, recovering from each of the first two. Why not the third? Others, including myself, would call it frustrating.

Given a 20-year investment background, I cannot say that the events of 2018 are surprising, but they are frustrating nonetheless. What I speak of is the fact that there are always periods of time where expensive things get more expensive, while undervalued assets continue to get cheaper. It happens. In fact, it happens near the top of every major bubble that we've experienced in our history. Prior to 2018, I had experienced such events twice in my investing career, with this being the third time.

During the internet bubble, it was the dot coms and even more broadly, US growth stocks and the US stock market as a whole. Despite nosebleed high valuations, stocks edged higher throughout the late 90's, refusing to give up the ghost. In the late 80's, it was Japan. In the early years of our most recent credit crisis, it was real estate…. the list goes on and on. 2018 folks, was one of those years. The expensive stuff worked better than the inexpensive stuff. Unexpected? Sadly no. Sometimes bubbles take their time. In fact, most of the truly spectacular bubbles take quite a while until the last of the stalwarts, those who resisted the swan song, get lured in. What isn't normal is permanence. Expensive things can stay expensive for a while, but not forever. You can temporarily hold back the tide, but eventually the tide wins. First a crack, then a trickle, then a steady stream before the entire ocean washes onto your lap. Despite my frustration, I remain exceptionally confident that our approach is the correct one, near-term results notwithstanding.

2018 in Review

On the equity side of the portfolio, 2018 began with us tracking several asset classes that we believed were statistically cheap and likely to outperform over 5+ year time frames. In Table 1, we detail four of these relationships. As you can see, each asset was trading at a discount to US stocks ranging from 25-85%, depending on the asset at the beginning of the year. Now, as many of you know, one year is never our intended time horizon. Each year we look ahead in blocks of 5-7 years, so the period beginning last year now has 4 years remaining. Suffice it to

[1] *Joel Greenblatt is currently Managing Principal and Co-Chief Investment Officer of Gotham Funds and previously was the portfolio manager for Gotham Capital, which in the course of its 10-year track record achieved an average annualized compounded return of exactly 50.0% (before incentive fees). The outperformance was remarkably consistent: The lowest annual return during the entire period was positive 28.5%. Greenblatt's narrative can be boiled down to what I term Greenblatt's three rules of value investing: 1. Value investing works. 2. Value investing doesn't work all the time. 3. Item 2 is one of the reasons why Item 1 is true.*

say, the 5-year block beginning in 2018 is not off to a good start. But as the saying goes, it isn't how you start, it's how you finish that matters. As the table indicates, each of our four undervalued assets underperformed the US market by somewhere between 3% and-13%, leaving each either near where they began the year or slightly cheaper. While this was a lost year to some, we view it as a stretched rubber band. That is, unless we erred in our assessment of value, the opportunity is simply greater in the coming years…nothing is lost. We believe exactly that.

Undervalued Assets Fall in 2018

TABLE 1

Asset Class	1/1/2018 Valuation Discount vs. Average	2018 Excess Return	12/31/2018 Valuation Discount vs. Average
Int'l Developed Equity *(MSCI EAFE vs. MSCI USA)*	-33%	-9.41%	-37%
Emerging Markets Equity *(MSCI EM vs. MSCI USA)*	-25%	-10.19%	-29%
US Large Value *(Russell 1000V vs Russell 1000G)*	-25%	-5.64%	-30%
Commodities Futures *(Bloomberg Commodity vs. S&P 500)*	-85%	-6.86%	-87%

Source: MPI Stylus, MSCI, Russell, Bloomberg, iCM Capital Markets Research

While many of the undervalued assets that we favored in 2018 suffered through a poor year, the result has been to further increase the discount to US markets and correspondingly the future opportunity. Since many of these assets trade a discount in most environments, this chart shows the discount of each asset even compared to normal.

<u>Our Faith is not Blind</u>

Intuitively, buying something cheap, undervalued if you will, shares a logical parallel to buying low and selling high. But, does this strategy work? For the sake of space, I will save you the long-winded explanation and, instead, share two examples; one from our US equity valuation model and the other from our emerging markets valuation model.

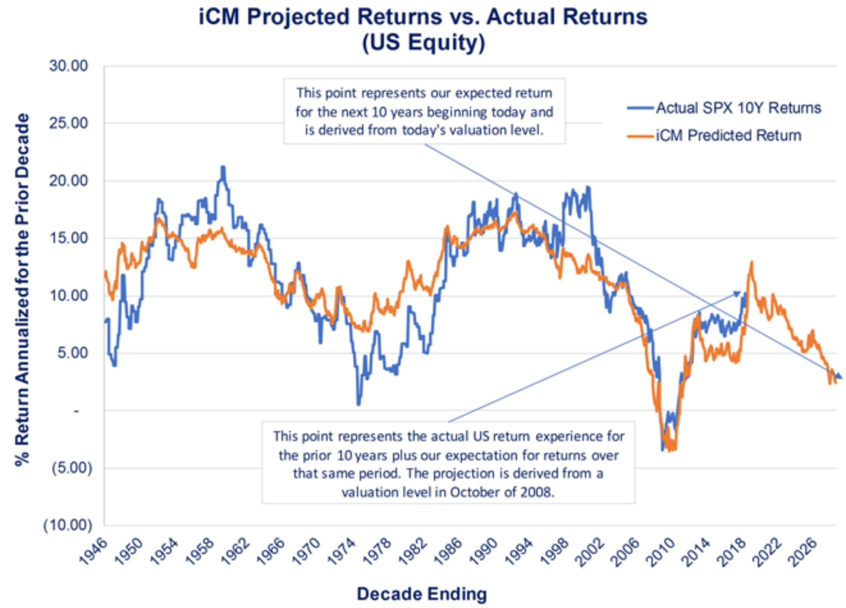
The first, the US model has data beginning in the 1940's. You will notice two lines in the chart (CHART 1). The blue line represents the actual return achieved by the S&P 500 for the prior 10 years. Therefore, any point on the line represents the prior decade of returns ending on that date. For instance, the point ending in 2018 would encompass the returns achieved from 2009-2018. Make sense? The orange line represents our prediction for the next 10 years using the same logic. As you will notice, the line ends in 2028, which is derived from today's valuation level. Remember, even though we staggered the lines, the orange line represents the prior 10 years, making the return in 2028 the one caused by today's valuation and covers the period of 2019-2028.

Given the overlapping nature of the lines, one can see that the model is a fairly accurate predictor of what happens over 10-year blocks, despite what may happen in any one year, including the first. There are a few other things that we can learn by studying some of the misses. Two of the most notable misses were in the decades ending in the late 50's into the early 1960's, as well as the mid-to-late 1990's. In both periods, the model underestimated the return relative to what actually happened. That is, stocks performed better than what the model predicted. Not coincidently, both periods concluded with major market tops, bubbles if you will. The takeaway here is that toward the end of bull markets, fundamentals may under-predict returns, while the bull has a few drops of life left in it.

So, what does that mean for today? Let me first point out what it doesn't mean and also acknowledge that this can be confusing. The blue line representing the past 10 years' return beginning in late 2008 and running through late 2018 is tracing the orange line, which jumps up in the years ahead. This occurs as you drop off the bad year, 2008, and begin from a period where valuations were depressed in 2009. The 10 years ending in 2019 should be pretty good. They were accurately predicted by the valuation in 2009, but just about all of that return has been harvested previously. It does not imply that the model is expecting next year to be good.

Valuations & Returns – US Equities

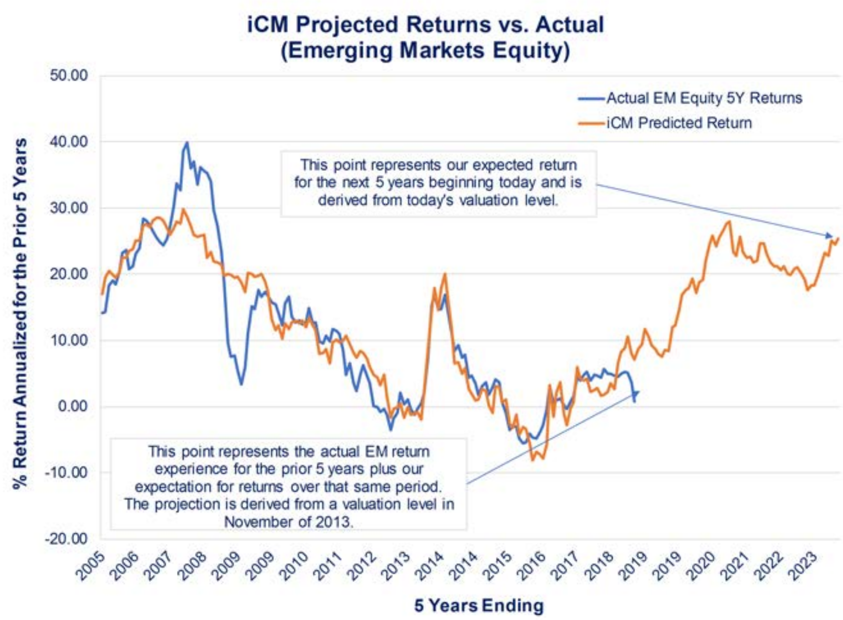
CHART 1



Source: S&P, FRB, iCM Capital Markets Research

Valuations & Returns – Emerging Equities

CHART 2



Source: S&P, FRB, iCM Capital Markets Research

The most relevant point on the orange line is the end point in 2028. This represents next year's return, as well as the returns earned over the following 9 years (remember, every point on the line covers the prior 10 years). As we can see from the chart, today's valuation suggests a rather abysmal outlook for US stocks over the next decade, predicting a return of about 2.5% annually. Could we be wrong? Certainly. But any prediction errors tend to correct themselves (i.e. they are mean reverting). That is, our recent run of outperformance vs. the model suggests that it will likely to be offset by underperformance somewhere in the next few years. This means that if our 2.5% return predication is wrong, it is likely to be too high. This is part of the reason why we have shied away from US markets in recent years. The US appears weak based on a model with an impressive track record of predicting long term returns.

The second model is our emerging markets model. Same layout, only the prediction time horizon is shorter, 5 years as opposed to 10. This is done without losing any of the reliability, which may be surprising given that shorter term predictions are generally less reliable. Once again, the blue line represents actual results, trailing 5 years in this case, and the orange line is the predicted returns for the 5-year period ending on each specific date. Again, the point that is relevant to today is the point on the orange line ending in 2023, which is derived from today's equity and currency valuations. Much like the US equity model, the overlapping line provides a visual representation of the accuracy of the model over 5-year periods. The misses, once again, exhibit a mean reverting relationship. That is, a miss high in one period is followed by a miss low in the next, with actual results trending around the predicted return level. In all, a very strong model.

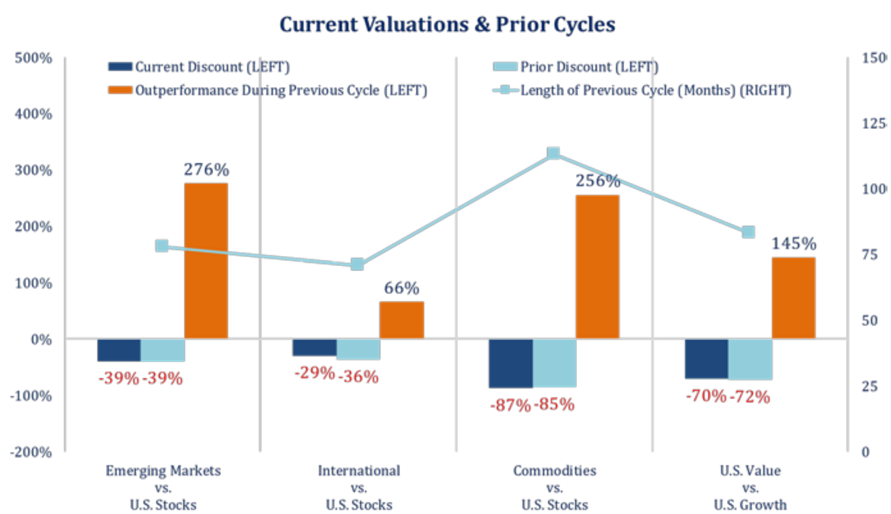
What does that say for today and for the next 5 years? The model is expecting emerging market equity returns of about 25% per year for the next 5 years. Ironically, since the most recent experience was an over-prediction/underperformance period, it is likely that if we do miss again, the miss is likely to be to the up side. That is, our return prediction might be too low! This provides additional support for our decision to aggressively allocate away from the US market. That is, not only do we find the prospect for US returns to be rather bleak, as we just discussed, be we find several assets, like emerging markets equities, to be especially compelling.

<u>But, How Long Does It Take?</u>

Despite a difficult run for what we consider to be undervalued asset classes, we continue to have great faith in this group. In the preceding paragraphs, we've demonstrated the historical accuracy of two of our investment decision-making models over longer periods, market cycles if you will. The evidence is quite compelling.

Historical Results of Undervalued Assets

CHART 3



Source: MSCI, Bloomberg, FRB, iCM Capital Markets Research

Setting all forecasting aside, what has history told us? As evidenced by Chart 3, we can see that historically, not only has outperformance been consistent with undervalued assets, but we can also gain an appreciation for the length of time involved in each of these cycles. Again, in this chart we aren't projecting anything. We are simply measuring the relative performance of 4 assets the last time each asset became as undervalued as they are currently, compared to the appropriate pair indicated in the chart. The line represents the length of time it took for the cycle to complete. Moving from left to right, we can see that the last time emerging markets equities were this undervalued, they reached a discount of 39% to the US market and outperformed the US by 276% over the length of the cycle. The cycle was approximately 75 months in length or around 6 years. This equates to an annual excess return of about 18% per year for 6 years. Today, emerging markets stands at a 35% discount to the US. The cycle for value stocks was about the same length as the Emerging Markets cycle with outperformance over growth stocks reaching 145%. The international developed vs. the US cycle was slightly shorter, while the commodities cycle, that many describe as a "super cycle" was the longest at nearly 10 years. All of them, suffice it to say, took at least 5 years for investors to recognize the attractive nature of the asset and drive prices up to fair value, and in some cases beyond.

Valuation Metrics Point to the Same Answer

TABLE 2

	Discount to Base Asset					
Asset Class	TTM PE	P/B	5Y CAPE	7Y CAPE	10Y CAPE	Adjusted PE
Int'l Developed Equity (vs. MSCI USA)	-28%	-52%	-29%	-29%	-33%	-35%
Emerging Markets Equity (vs. MSCI USA)	-35%	-50%	-39%	-41%	-44%	-47%
US Large Value (vs. MSCI USA Value)	-33%	-62%	-35%	-38%	-37%	-42%

Source: MSCI, Russell, iCM Capital Markets Research

<u>Summary</u>

Despite a difficult year, where many of the assets that we favor failed to live up to our expectations, we remain more confident than ever in our approach and believe that it is the correct one for long term investors. As value investors, to be successful, we don't need to time the bottom or obtain the best possible price. All we need to do is get a good one. As indicated in the table above (Table 2), each of the aforementioned assets are undervalued relative to its pair, not only on one valuation metric but on seven! There are no conflicting signals or items that are subject to interpretation. As we began the article with a quote from legendary value investor Joel Greenblatt…. Value *"requires the perspective of patience because the market will eventually gravitate toward value".* We remain ever vigilant, and immovable in our resolve to remain focused, patient and disciplined in our approach, despite an admittedly frustrating period. Thank you for your trust and confidence.

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