4Q 2020 Market Insights
Party Like It is 1999
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"It is ludicrous to believe that asset bubbles can only be recognized in hindsight."
- Michael Burry[1]

With the lingering economic effects of the pandemic forgotten (but certainly not gone), let's focus our attention on a few important concepts that have drawn media attention as it relates to skyrocketing stock prices. It's disturbing to a stodgy old value guy like me, and eerily reminiscent of the late days of the Internet Bubble, to hear with great frequency, that nothing matters except the Fed and liquidity. Surprising as it might seem, I will agree that there is a bit of truth to that statement. Nothing matters, <u>at this very moment</u>, other than the Fed and liquidity. The permanence that has been implied in these statements, or even the implication that liquidity can save us until our business environment snaps immediately back to prior levels without even the smallest hiccup, is to what I take great exception. Earnings matter folks. The rest is nothing more than hocus pocus and sleight of hand that is, in all likelihood, temporary.

Earnings and cashflows are what provide investors with sustainable returns from equities. Period, end of sentence, mic drop, out...yet, I'm still typing. Liquidity does, however, have a near term cause and effect relationship on asset prices. I'd like to explore this concept a bit further along with the concept of fair value. What is it and why is it important? Is it static or does it change over time? If it does change, what impact does that have on your long-term sustainable level of return?

<u>The Basics</u>

Why do earnings matter to investors? After all, we simply want someone to buy our shares for more than we paid, right? To understand this best, let's simplify and examine this from the perspective of a private business. When you buy shares of stock, you are buying ownership in a business. It doesn't really matter if those shares are public and exchange traded or private. In any private business venture, there is a price that you pay to acquire the business, either in the form of startup costs, blood, sweat, and tears for no compensation, or by purchasing it from someone else. Your hard work or purchase is the value of your investment. Your return on that investment, while you operate each year, is your earnings. Invest $1mm in startup costs, earn $100k per year, and your return is 10% per year, as you operate your business.

The second source of return is the price that someone else is willing to pay when you get ready to sell this business. This, of course, may be more or less than your initial investment. For argument's sake, let's assume you operate for 10 years. After finding a willing buyer who has offered to pay you $2mm, you decide to sell. Your return is $100k per year x 10 years + ($2m - $1mm) = $2m total profit from the transaction of buying, operating, and selling this business. Annualize that over 10 years…your return is 14.93% per year.

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[1] Michael Burry is an American physician, investor, and hedge fund manager. He was the founder of the hedge fund Scion Capital, which he ran from 2000 until 2008, before closing the firm to focus on his own personal investments. Burry was the first investor to recognize and profit from the impending subprime mortgage crisis. Burry is portrayed in the film *The Big Short* by Christian Bale. Source: Wikipedia

Conversely, what if your start-up yields nothing each year in cash flow, but pays you double your initial investment in a lump sum at the end? That would result in the same $1mm profit you received in installments in the first scenario, but your return in this case is lower, only 7.17%. The reason, the present value of a near term cash flow is higher than a distant one. The point is that the annual earnings you receive from the business are more valuable to the equation than the payout at the end. Hence, earnings matter.

There is a second reason that earnings are more important to the equation. They are more reliable. The purchaser of your business is a fickle individual acting in their own interest. The most certain way for that would-be buyer to enhance their own return is to pay you less. $1mm invested with annual earnings of $100k is a 10% return. $2mm invested with the same earnings is a 5% return. Obtaining a higher price than what you paid (the greater fool[2]) is quite simply less reliable than the bird-in-hand earnings that you receive. Environments change, risk appetites change, but ultimately that would-be buyer is motivated to pay you as little as possible to enhance their own return. Finding a greater fool is not always as easy as it might seem, but enjoying the successes of the business as an owner, who shares in the profits, is your right as an equity owner of that business.

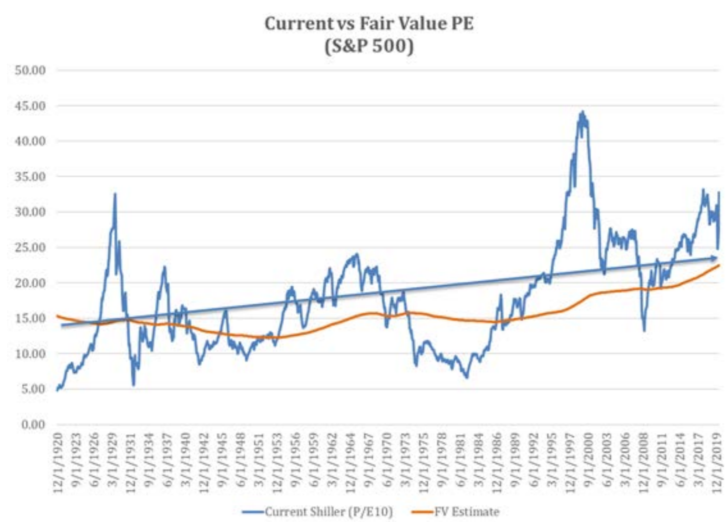
The concepts I've illustrated align directly to your publicly traded equity market investments as well. When you buy stock, you are buying a business with earnings and cashflows. The realized return you receive annually comes through the dividend yield. The price that you receive when you sell is determined by an increase or decrease in valuations (i.e. the Price to Earnings or P/E ratio), earnings held constant. You need that very fickle greater fool to pay you more. With the payout at sale being somewhat unreliable, is it at all reasonable to think that the cash in hand from earnings paid along the way does not matter at all? Its perhaps the most important thing. Without earnings, there is nothing of value to buy.

<u>Fair Value</u>

The concept of fair value in equity investing matters for one very important reason. From fair value, you have an equal likelihood of that greater fool offering you more or less than your investment is worth. In some periods you'll get more, in others less. Over the long-term, it's

Does Fair Value Change?

<u>Chart 1</u>



Source: Standard & Poors, iCM Capital Markets Research

Fair value, in equity investing, is the level at which the probability of valuations contributing either positively or negatively to future return is equal. It has moved higher over time for a variety of reasons including declining risk, lower required rates of return by investors, as well as declining interest rates.

[2] The Greater Fool theory states that it is possible to make money even when securities are overvalued if there is a "greater fool" willing to pay an even higher price.

very likely to even out. Taking that out of the equation, you are left with earnings - the more reliable source of return.

While fair value acts as both an anchor and the driver of your long-term sustainable performance, it is not static. It can and does change over time. Chart 1 on the previous page illustrates this concept by showing the current valuation (blue line) plotted against our model's estimate of fair value (orange line) dating back to the 1920's. The chart clearly illustrates an upward trend in fair value that has persisted for the better part of a century. This model currently estimates fair value at about 22x 10-year earnings.

Fair value does change and has moved higher over time. How is return impacted from a higher fair value? We can witness this occurring historically by examining the 40 years pre- and post-1980. While return levels have been similar in the four decades prior to 1980 vs the four decades after, one data point jumps out as striking. The level of "reliable return," earnings and dividends, declined substantially. Have earnings or dividends gone down? Certainly not, they've increased greatly. But, remember in our prior example when we illustrated that $100k profit on a $1mm business yields 10%, but paying $2mm reduced your return to 5%? The same thing happened here. From 1940-1979 real earnings growth plus dividends contributed about 7.12% per annum on average to return. From 1980 – 2019 it was 5.23% per year. Earnings grew at a nearly identical 2.6% per year in both periods. The price was just higher. The last 40 years has been able to keep pace with the prior 40 years only because we've skated by relying on someone to pay more, making up an even larger portion of the gap than they have previously. Investors found a greater fool this time.

From a higher fair value, we all feel safer that there is less room to fall in an overvalued market, but investors will need the price to move continually higher to get anywhere close to the normal return of 10% most of us associate with the stock market.

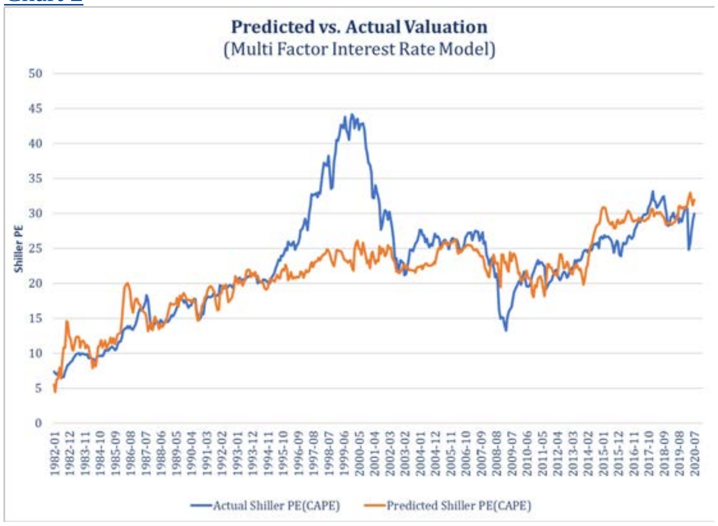
The Fed & Liquidity

While fair value has moved higher over time due to a variety of reasons, our expectations for future returns must be adjusted correspondingly lower with every inch that fair value advances. This is disappointingly missing when financial pundits, even those that I respect greatly, speak about fair value. One of the reasons for fair value moving higher can be attributed to interest rates and liquidity.

Interest rates have moved persistently lower over time creating greater liquidity in our economy, more dollars chasing goods, services, and financial assets than ever before. So, to the question of are stock valuations higher because of low interest rates? Surprisingly to some, I will answer yes. For that, I reference Chart 2. This is a model that we introduced in a quarterly Market Insights letter several years ago. The model attempts to predict the current valuation level of the S&P 500 using only interest rates. The model considers both the overall level of rates along with the slope or steepness of the yield curve. In fact, slope is nearly four times more important than the overall level of rates. The model is quite strong with an r-squared of about .80, meaning that the model accurately predicts about 80% of the change in the current valuation by examining the level of rates and slope of the curve. Its most notable miss was during the Internet Bubble when prices overran just about everything reasonable, including rates. Again, perhaps surprisingly, the model suggests that valuations, even at this lofty level, are reasonable given the level of rates. Now, before I have my long-time value readers jumping up and down about the highest valuation in the last 140 years (excluding the Internet Bubble) being reasonable…. better said, current valuations can be explained or expected given the level of rates. If rates change, so will fair value.

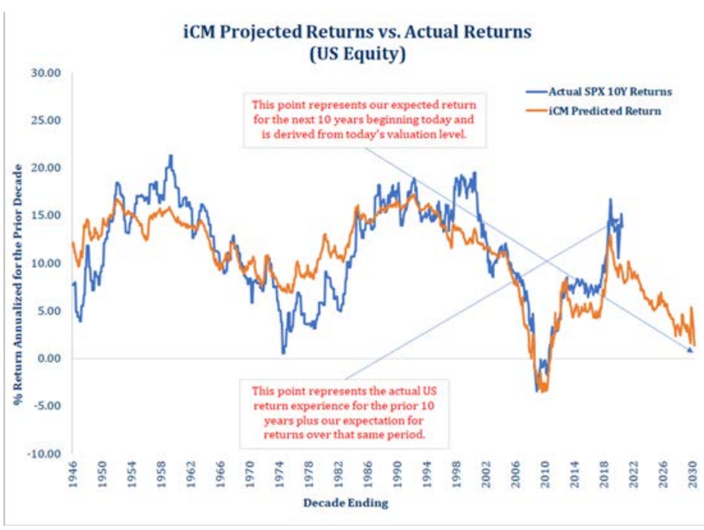
Interest Rates, Valuations & Future Returns

Chart 2



Both the level of rates as well as the slope of the yield curve contribute to fair value. Low rates with a flat yield curve, as we have today, are most conducive to causing elevated valuations.

Chart 3



While low rates and a flat curve causes valuations to rise, elevated valuations tend to lead due low returns. While interest rates support a P/E of more than 30x, the corresponding predicted return from this level is only 1.59% per year for the next decade.

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

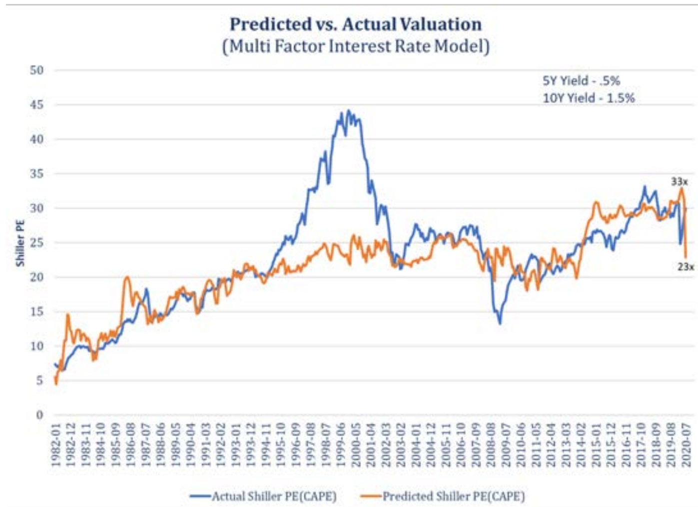
But what if rates don't change, what are my risk and return prospects? As discussed previously, while fair value might be higher, future return prospects are impeded by this higher price. For that, I give you Chart 3. This model predicts the next 10 year's return using today's level of valuations, while plotting next to it the actual return achieved, so that we can evaluate the accuracy. Again, a highly accurate model with a high r-squared, as evidenced by the close tracking of the lines. The model assumes that valuations will mean revert to normal, which as we stated previously, we have at a fairly lofty level by historical standards of about 22x. In this scenario, over the next 10 years investors should expect a level of return from the S&P 500 of about 1.59% per year. Come again? That's right, 1.59% per year assuming valuations fall back to about 22x. If we set that assumption aside and hold valuations constant, over 10 years we should expect about 2% per year plus inflation or conservatively 4.0-4.5% annualized, well short of the historical average of 10%. To get to 10% will require a meaningful contribution from the greater fool.

But what about that liquidity thing that everyone is talking about? Well, that's what got us here, and is essentially reflected in the level and slope of the curve (flat and near zero). To push fair value even higher would require an even lower level and flatter curve than we are experiencing currently. With rates near zero and the slope half of what it's been historically, it becomes a gigantic leap to assume that liquidity is anything other than, at best a temporary solution or, put more bluntly, the cause of the bubble that we are experiencing. Even so, for liquidity or anything else to solve this problem by elevating our previously estimated 4.0-4.5% environment to a 10% environment, would necessitate lining up enough investors willing to pay more. Our currently bubbly P/E multiple of 30x earnings, nearly double the historical average, would need to expand further to 45x earnings 10 years from now to get to 10%.

Ok, what happens if rates change by moving up? Afterall, they probably need to move meaningfully upward to disrupt this, right? For that I give you Chart 4. If we simply hold the 2-year yield constant, move the 5 year yield up to a 0.5% yield from 0.3% and move the 10 year up to a 1.5% yield from 0.67%, the fair value PE supported by interest rates falls from 33x to 23x…a 30% decline. What can cause this? A variety of things including allowing inflation to run above average, much like the Fed said it would do when they formally announced their inflation averaging strategy at the end of August.

Hypothetical Change in Rates

Chart 4



Source: FRB, iCM Capital Markets Research

A small shock to interest rates reveals that by increasing the yield of the 5-year bond to .5% and the 10-year bond to 1.5% would be expected to cause the fair value P/E to decline by about 30%.

Conclusion

Several well credentialed pundits have recently offered that nothing matters for future stock prices other than the Fed or liquidity, not even earnings. Dangerous remarks that are eerily reminiscent of the four most dangerous words in investing, "this time it's different[3]." While I would agree that liquidity has caused our current valuation level, it is incorrect to imply any permanence to this phenomenon. Low interest rates, a flat curve, and high levels of liquidity have at best caused our current valuation level and, at worst, can be assigned the blame of creating a bubble. Regardless, while we have shown that low rates cause higher valuations, they do not fundamentally alter the level of long-term return one can expect. Dividends and earnings are the most reliable source of return. From elevated price levels they simply contribute less to the bottom line, placing an even larger burden on someone being willing to pay more if investors are to achieve anything remotely close to that historical average of 10%. A lofty expectation to say the least and perhaps a very costly error for those choosing to ignore this. Remember, earnings do matter and when someone tells you that it's different this time, it rarely ever is…Two thousand zero, zero, party over, oops out of time…so tonight I'm gonna *Party Like its 1999*[4]. Thank you as always for your continued trust and confidence.

[3] Sir John Templeton
[4] Prince - 1999

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