December 10, 2019

Making Sense of the Markets

The investment process at First Long Island Investors involves many elements including company specific research and analyses, extensive dialogue with our outside managers on companies, sectors, and the markets overall, interaction with economists, both independent and those affiliated with large organizations, as well as the investment professional networks of our team members. Robert ("Bob") Rosenthal, our Chairman, CEO, and Chief Investment Officer, is part of an investment "think tank" alongside longtime mentor and acclaimed investor, William P. Stewart, and other respected market analysts. Recently this group engaged in a conversation that was sparked by comments made by The Blackstone Group, one of the world's largest private equity firms, and touches on the issues weighing heavily on many, including some clients. Bob's perspective is below:

The current "wall of worry" is made up of concerns regarding: the timing of the next recession; the state of the (messy) political situation in Washington, including but not limited to the trade situation with China and ongoing impeachment proceedings; negative sovereign yields in Europe and Japan; IPOs of companies with no profits; income and wealth inequality; and other subjects.

While it is true that there is a fair amount to be concerned with, many (including Blackstone) are quick to ignore the strength of the consumer, continued GDP growth in the U.S., low unemployment, and growing corporate earnings. (We do not see a recession in the near future.) There is no distinction being made by Blackstone between high priced bonds and private equity versus a reasonably valued, but not cheap, stock market. And of course, their approach takes a "market" perspective instead of viewing the opportunity through the lens of a concentrated portfolio of fine growing businesses, which is what we at FLI utilize for client assets and our own assets.

Of the various concerns we are hearing, the biggest is the unknown effects of negative sovereign interest rates. These negative rates are also keeping our treasury rates lower as Europeans and Japanese investors buy our bonds to earn a positive return on their capital. The thought is that negative rates will boost economic growth in those regions. I do not know if this will prove true and we at FLI have underweighted foreign equity investment as we do not like the lack of growth and socialist tendencies in many countries (e.g. France). The outcome of these negative rates is one we will be sure to watch.

In looking at valuation excesses we reference late 1999/early 2000 when the S&P 500 was trading at a price-to-earnings ratio[i] of 31 and the ten-year Treasury was 6.5%. These numbers are quite different from today, but that is not to ignore the point that the equity market is not cheap today. Furthermore the great businesses that are leaders in secular growth including credit cards/ electronic monetary transactions, cloud computing, and streaming of content (to name a few) do not typically trade at 100 times earnings as they might have back in 2000. Valuations are loftier for durable growing businesses perhaps, but not nose bleed by any stretch.

It is easy to find danger in a bull market lasting ten years. It is easy to worry about very low interest rates and central banks trying to stimulate growth and employment. It is easy to look at IPOs where the share price declines after going public at absurd valuations while they seek their first dollar of profit. It is easy to paint a bleak picture of business growth in the midst of a trade war. It is also easy to fear the unknown of a political situation that could lead to socialism in the greatest economy in the world. But it is harder to stay the course with a prudent allocation to fine businesses that can see growth for years to come or companies that have strong balance sheets and offer stability, growing dividends and market dominance. This, in our opinion, is the alternative to very low to negative interest rates on sovereign debt or bloated private equity funds chasing too few really good investments, especially when most consultants have for years shunned the domestic equity market and pushed clients into private equity and hedge funds.

At the end of the day, things have not changed. A prudent asset allocation reflecting current valuations for each asset class category coupled with the recognition of one's age, goals, and risk profile, while never losing sight of needing to invest for the long term (which will vary for each individual), makes the most sense. But as we all know, there is always a "wall of worry" to be navigated.

So, we remain cautiously optimistic; we are somewhat defensive; and we are concentrated in our investments. We do not own a "deworsified" portfolio in any of our strategies. Third quarter earnings have come in very well for the market in general and specifically for the companies we invest in. Guidance is also quite reasonable. Our Dividend Growth strategy is enjoying a strong year with dividend growth increasing for the portfolio by 10.4% on average. (The strategy for the year is up over 22% which more than makes up for a slight loss last year of minus 4.4%.) The two-year average appreciation is not at a nosebleed level nor are the valuations. As for the market as a whole, currently the S&P trades at a P/E of 20.9[i], which in an environment of a ten-year Treasury at 1.9% to us is also not nosebleed by any means. For perspective, the dotcom bubble in late 1999 traded at a P/E of almost 31[i] when you could buy a ten-year Treasury at 6.5%. That was considered nosebleed territory with a bond alternative that was attractive. That is not the case today.

In summary, we have a defensive tilt; we are long term investors; we invest in concentrated strategies with companies that are doing well and have financial strength. The environment of investing always has a wall of worry. Today is no different, but the fundamentals still suggest that gains can be achieved.

A synopsis of the Blackstone interview can be found here:
https://www.investopedia.com/blackstone-group-warns-of-the-mother-of-all-bubbles-4775625?utm_campaign=quote-yahoo&utm_source=yahoo&utm_medium=referral&yptr=yahoo

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[i] Price-to-earnings ratio is based on a trailing twelve-month basis