Value Investing in a Big Wave Market

January 28, 2020

Key Takeaways

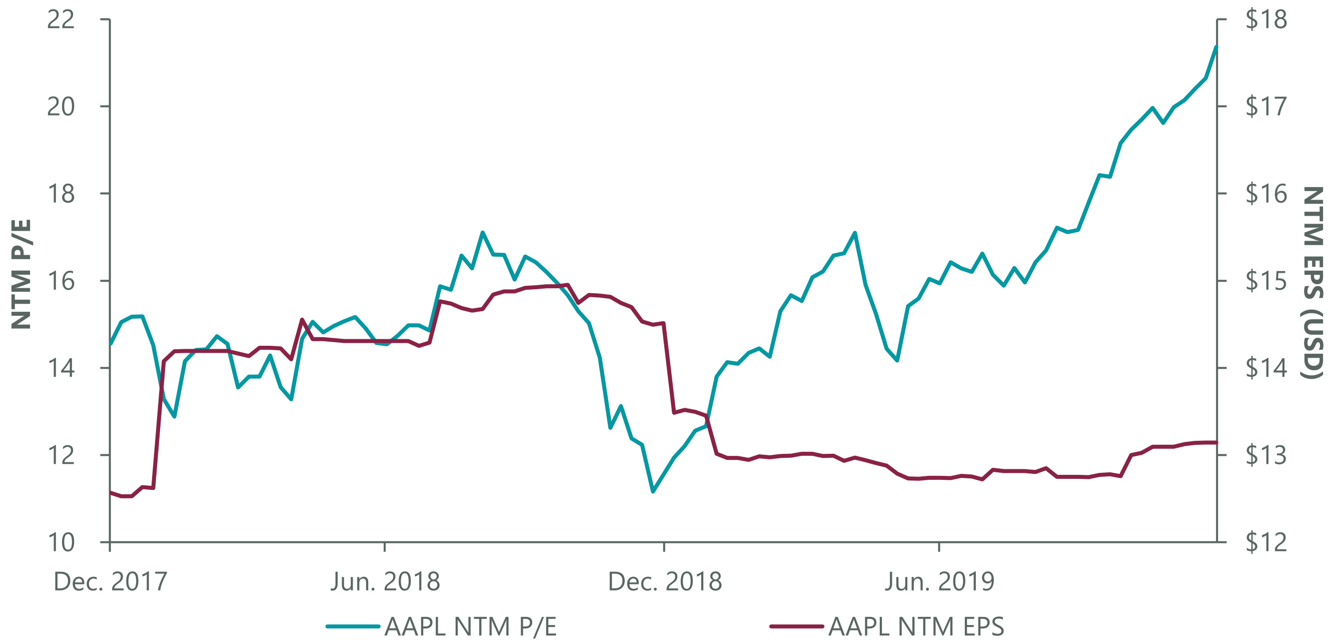
- A quasi-recession for earnings in 2019 was more than offset by multiple expansion that drove the S&P 500 Index to a total return above 30% for the year.
- A potential classic debt cycle has us concerned with the absolute risks to investor capital growing beneath the Fed liquidity tide.
- We are making an active choice to stick with stocks where embedded expectations are well below their current fundamentals and long-term potential.

Untethered Valuations Call for Discipline

As value investors, a principal driver of our investment case is that embedded expectations priced into a stock are too low. We are right when reality plays out better than what the market originally priced, and wrong when it doesn't. The key here is that we are reacting not to price moves, but rather to how observed events update an investment case. This updating discipline is essential because in an increasingly passive and momentum-dominated market, the causal and correlative glue between price and fundamentals has in many cases melted. This erosion of the market's focus on the logic of basic math is a major performance challenge for disciplined value investors like us.

Our biggest headwind in 2019 was not owning enough semiconductors, the best-performing sector, and owning no Apple, which is the biggest weight in our primary index. With the semiconductor SOX index up 63% and Apple stock up 89% last year, you would think fundamentals must have been terrific. In fact, semiconductor revenues and earnings both fell dramatically, and came in well below expectations. Apple also suffered from negative estimate revisions during 2019, as revenues and earnings growth stalled. Yet despite negative revisions and no growth, Apple's valuation multiple exploded (Exhibit 1). Semiconductor stocks were also blessed with an even greater explosion in their valuation multiple.

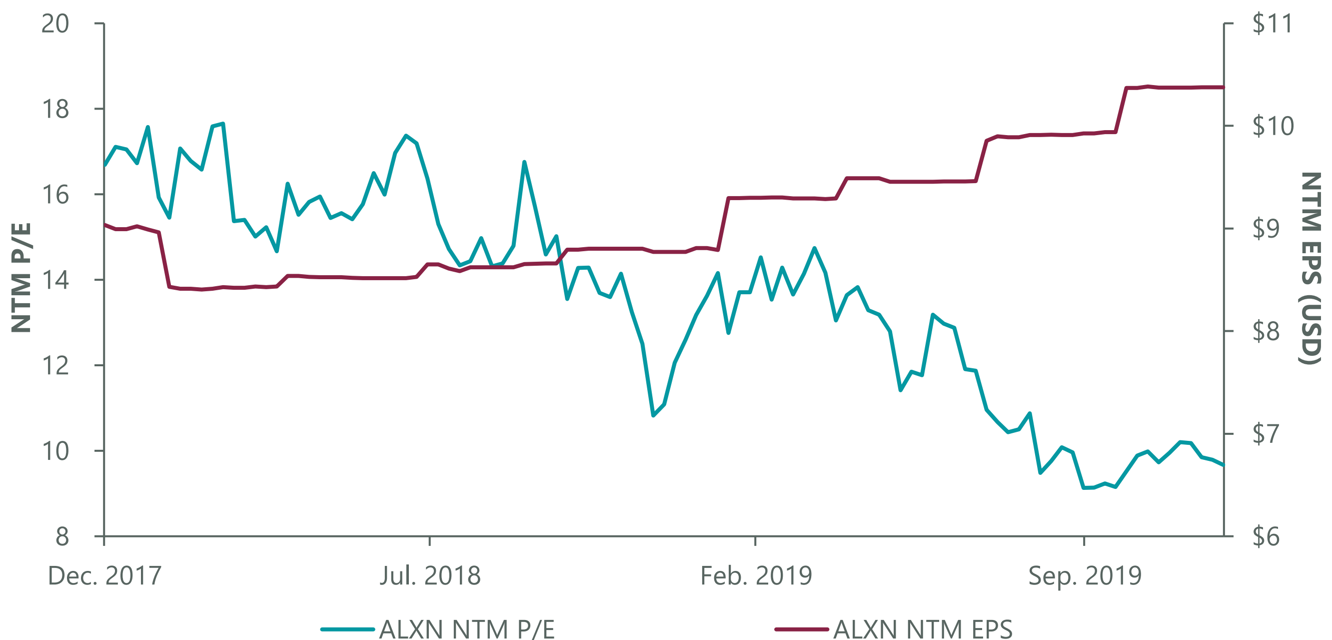
Exhibit 1: Apple's Multiple Expanded Despite Tepid Earnings Growth



As of Dec. 31, 2019. Source: ClearBridge Investments, Bloomberg LP.

Conversely, many of the stocks we hold suffered the inverse: growth in revenues and earnings beat the market's and our original expectations but were partially or completely offset by multiple contraction. One of the best illustrations of this inverted logic was Alexion Pharmaceuticals. Alexion blew away original expectations, with revenue growth of almost 20% and earnings growth exceeding 30% in 2019. Despite these great fundamentals, Alexion's valuation multiple was more than cut in half (Exhibit 2).

Exhibit 2: Alexion Has Earned, Though Its Multiple Contracted



As of Dec. 31, 2019. Source: ClearBridge Investments, Bloomberg LP.

With the market clearly not playing a game that rewards a focus on fundamentals and valuation at the security level, our challenge is to figure out what game the market is playing, so that we can adapt as much as possible without sacrificing the discipline of our investment process. So what game is the market playing?

Market performance in 2018 and 2019 strongly supports the old trading maxim that investors "should never fight the Fed." In 2018, the Fed was tightening monetary policy and draining liquidity from the system. Despite good earnings growth for the market in 2018, it was a tough year as valuation multiples compressed and then collapsed in a historically weak December. With the Fed tightening, investors learned the global economy was much more sensitive to lower liquidity and higher interest rates than most investors expected.

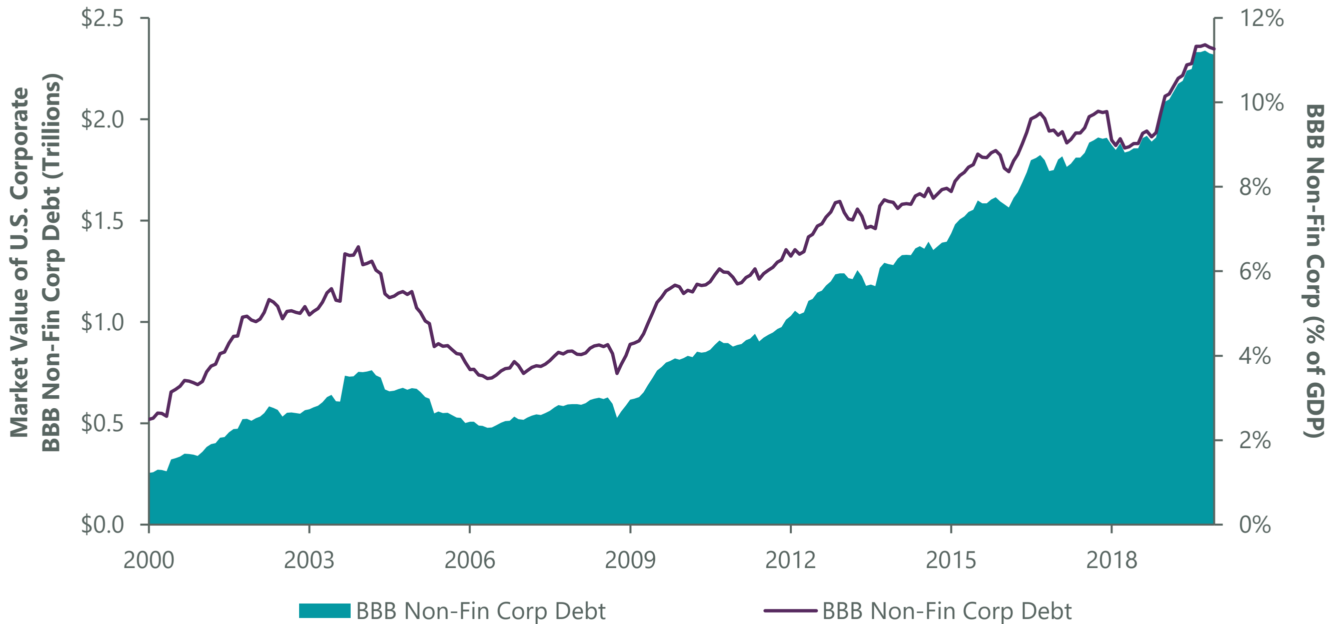
Then in 2019 we got the logical inverse of 2018, as the Fed pivoted and committed to restoring a high tide of liquidity to hide all the ugly risk rocks. The result was a global restoration of liquidity that took out the old high-tide records and manifested itself in late summer when over $17 trillion of global debt enjoyed a negative yield. Mirroring the 2018 experience, despite a quasi-recession for earnings in 2019, it was more than offset by multiple expansion that drove the S&P 500 Index to a total return above 30%.

So, the first rule of the current game is to follow the Fed-driven liquidity tide, as it will power markets through valuation changes that overwhelm earnings growth. The Fed has signaled that in 2020 it will keep the liquidity tide high and supportive of valuation. Global liquidity should also support faster global growth. Thus, the big change in 2020 is that investors should enjoy both liquidity-driven valuation support and earnings. With the two classic drivers of stocks in place, markets are very much embracing risk as 2020 begins, and you cannot rule out that we could get a late-cycle melt up in the market's favored sectors: large-cap tech, semiconductors and low-volatility defensive stocks.

Which leads to the second rule of the current game: the liquidity tide doesn't lift all boats. There has been a huge divide between winners and losers this cycle. This divide is accelerating as price momentum has been amplified by passive flows that ignore fundamentals and valuation. The aggregate multiple change between Alexion and Apple stocks in 2019 alone was almost 100%! As a result, good relative performance increasingly requires surfing the most crowded waves. We fully recognize we have the choice to move closer to the index, and we have stuck with some index darlings, like Microsoft. We are also constantly looking for opportunities across the market, including in the boats flattered by Fed liquidity. However, we will not sacrifice our investment discipline and are making an active choice to stick with stocks where embedded expectations are well below their current fundamentals and long-term potential.

A late-cycle melt up would bring risk of poor relative performance, but we are more concerned with the absolute risks to investor capital that are growing beneath the Fed liquidity tide. The main risk is a classic debt cycle, as we keep adding more debt relative to the overall economy with each market cycle. As a result, during every down cycle ground zero for the crisis is typically where the most debt gets added. This cycle it is in U.S. corporate and government debt. On the corporate side, BBB-rated debt has tripled since the Great Financial Crisis to almost 12% of GDP and could prove to be a major issue as this debt is downgraded to junk during the next downturn (Exhibit 3). This abundance of corporate debt has fed potential excesses in private equity and sustained some business models that will not be able to endure a higher cost of capital. The debacle with WeWork is the most dramatic recent example of this dynamic.

Exhibit 3: BBB Debt has Tripled since the Great Financial Crisis



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The question, of course, is what could trigger a problem? The Fed's about-face in 2019 clearly demonstrates that it has the debt market's back, but our biggest concern is that with monetary and fiscal policy both targeting reflation and faster growth we may get higher rates as inflationary expectations start to rise. This risk may seem remote, but 2018 clearly demonstrated that the global economy and risk markets will not smoothly transition to higher interest rates and lower liquidity. For now, the Fed's turn has given a green light to surfing risk waves, but big wave surfing is dangerous. Especially when the waves are increasingly crowded.

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