ClearBridge Investments

Volatility and the Active Stock-Picking Opportunity:

A Q&A with Co-CIO Scott Glasser

Key Takeaways

- Strong cash flows and strong buybacks should continue to support equities.
- The proliferation of sector ETFs is playing a larger role in market dynamics.
- We believe the most important factor affecting returns in 2019 won't be earnings; it will be liquidity, spreads and interest rates, with leverage also a determinant.

Volatility returned to the market in the fourth quarter. What does that mean for active equity managers?

Fourth-quarter volatility is not unexpected, and in fact is a function of a market that has been incredibly resilient and has had low volatility. Suddenly, the market faces an increase in the 10-year Treasury, an increase in the term premium for bonds, increased worries for China, some high-level earnings disappointments and an acknowledgment it's probably as good as it gets for earnings. At the same time, stock buybacks were off the table in October because companies were reporting earnings, so that support was removed temporarily. Generally, it's not surprising to see a return of some of the volatility that's been missing for years. Importantly, for active investors there is something to like about volatility: markets that only trend up create less opportunity to make changes.

Periods of volatility allow active managers to ask very productive questions: are there stocks in the portfolio that should be let go, even though they are down? On the other hand, is there a stock that you have been researching for some time in which an indiscriminate selloff has now created an opportunity?

How big of a factor were trade tensions in fourth-quarter volatility?

In the fourth quarter the market became more sensitive to comments about trade. It largely ignored trade for months, then for some reason it became more sensitive. The important thing to remember about trade is how difficult it is to grasp the real effects of proposed tariffs: trade touches so many products and areas that it's quite difficult to grasp the true impact of $250 billion in tariffs: there are so many variables. Yet the market tends to take it as either very positive or very negative. The research reports that I've read put the potential impact, assuming another round of tariffs, at 0.2% to 0.5% of future GDP.

How will the Tax Cuts and Jobs Act of 2017 affect the market going forward?

It is important to remember the front-ended nature of tax cuts creates six to eight quarters of benefit before growth rates revert. The U.S. economy peaked at 4.2% growth in the second quarter and is likely to return to 2.5%–3.0% as one-time benefits fade. Early in 2019 investors will start seeing the tail end of those benefits and the second derivative of growth: growth and earnings will remain solid but will be on a declining rate from recent highs. Markets generally don't like negative second derivatives — when earnings are great but about to be less great but still good. The market sees this as a decline. Markets like positive second derivatives — when earnings are poor but about to be less poor.

How are valuations looking to you?

The market does not have a valuation problem either way: it's not cheap enough that it brings money into the market, and not expensive enough that it keeps money out of the market. And valuations have always been terrible timing mechanisms for buying or selling the market. Exhibit 1 illustrates how P/E multiples often do not accurately reflect broader market or economic conditions.

Sentiment is a better longer-term mechanism, as it tends to be a very powerful indicator at market extremes of market tops and bottoms. But it's also hard to measure. Bottoms are made over very short, compact, emotional times, and tops are made over longer emotional periods of time.

Highly negative earnings create bottoms. The market does better when earnings are down 20% year over year and improving than when they're up 20% year over year and declining. This is different from the way most people think.

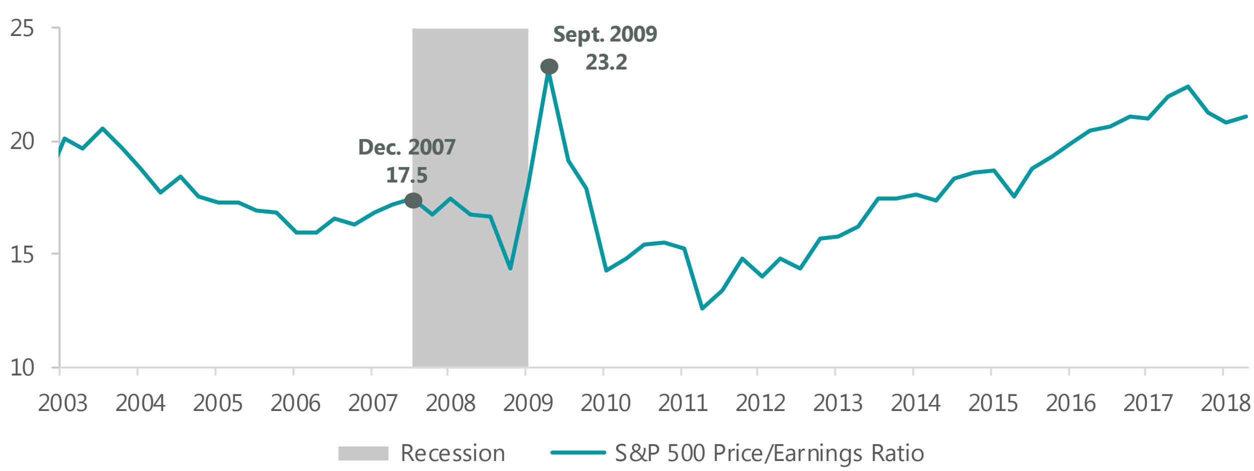
What areas of the market are you finding opportunities in?

Biotech is an interesting one, but on a longer-term basis. Biotech has not acted defensively despite what we believe are very reasonable valuations that have gotten cheaper along the way. Yet we find the sector to be among the most attractive across the market. Many biotech companies don't have many financing needs and have good balance sheets, though there is some concern on the generic side with biosimilars, and pipelines have been less productive than in prior years.

What other themes are taking your attention right now?

The correlation of markets given the proliferation of ETFs, especially sector ETFs, is one. Market structures have changed over the past 10 years because of the proliferation of index funds and ETFs — perhaps more so ETFs. Some of the funds more focused on specific factors, like quality, weren't picking up ground during some recent selloffs like they had in the past because in a world where so much of the flows on a big down day are dominated by ETFs (30%–40%), everything's sold as part of a basket. An ETF doesn't differentiate between a Berkshire Hathaway and a bad conglomerate.

Exhibit 1: P/E Not the Only Indicator to Watch



As of September 30, 2018. Source: ClearBridge Investments, Bloomberg LP.

Everything is really a beta of 1. So the high-beta stocks don't get sold down as much, while the low-beta stocks actually get sold down more. Because of that market structure, the first selloff in a market is generally liquidity-driven, meaning people are just taking money out of the market, and it affects stocks across the board: there is little differentiation between good and bad, high and low. And that's happened in some cases, while in others it's been more sector-specific. In this drawdown, it's been more sector-specific, primarily because of technology. What that tells me is that while market ETFs have an effect, sector ETFs are having even more of an effect. Before, it was market-driven ETFs; now the proliferation of sector ETFs has played a big role in this selloff. This is actually preferable: you'd rather have no differentiation in a sector when it sells off than in the whole market. It's easier to reduce exposure to a sector that is extended.

What do you think will be the biggest factor for returns in 2019?

Many say the most important factor affecting 2019 stock market returns will be earnings. Earnings were the most important factor driving 2018 stock market returns, and it's easy to extrapolate that to 2019, but we think that could be wrong. We believe the most important factor affecting returns in 2019 will be liquidity, spreads and interest rates. The biggest risk to 2019 is that at some point there is a curtailment of liquidity that in 2019 or 2020 creates the next bear market.

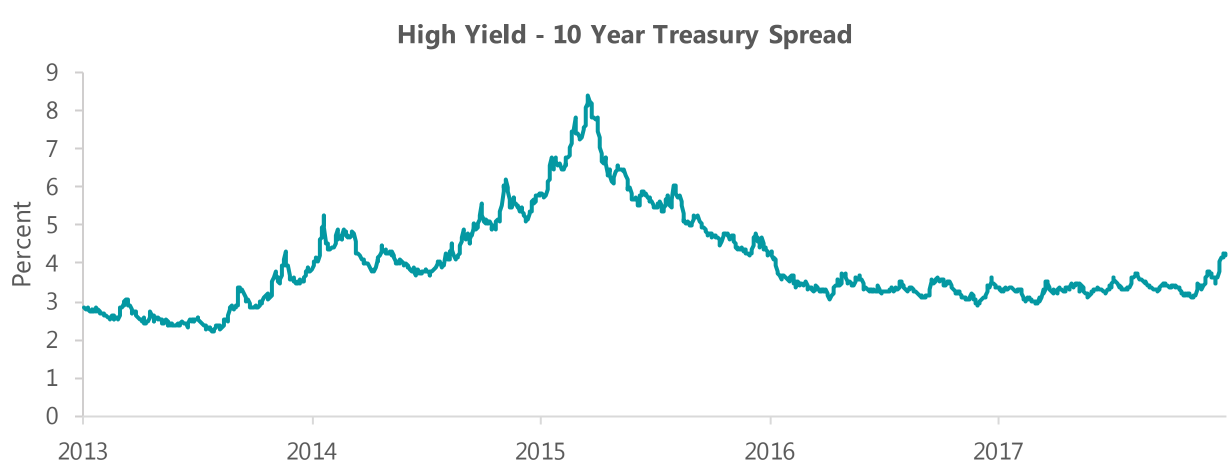
Liquidity is defined by many things. Let's look at three. First, liquidity is defined by the dollar. The U.S. dollar continues to surge, and that's a negative for liquidity. The world buys raw materials in dollars; a higher dollar therefore raises costs. So while there may not be a tightening of liquidity yet in the U.S., there is a tightening globally. And in fact, growth is slowing globally more than in the U.S. Secondarily, liquidity can be just interest rates, which are up 60–70 basis points from a year ago. Perhaps more importantly, liquidity is interest rate spreads, which is the cost people borrow at. And there has been some small, yet not dangerous, widening of spreads, which prompts the question: was it as good as it's going to be, and is it now just backing up? The Fed reducing its balance sheet is another form of liquidity tightening. And there's been speculation that they're going to be more aggressive than many think.

How do you approach liquidity concerns from a portfolio management perspective?

For one, a widening of spreads should have the effect of separating leveraged companies from those with less leverage. Spreads widening should be a good thing for active management as a whole. Certainly, you have to look at leverage among your portfolio holdings: we look at credit default swap spreads, among other debt measures. Quite simply, as we get later in the economic cycle and as spreads start to widen a little, some companies become more sensitive to market drawdowns or weakness.

But for active managers, in some cases you have perfectly good companies with high leverage and fine coverage ratios, but they'll get caught up in a basket of so-called highly leveraged stocks and they'll come down just as much as others. That will sometimes create opportunities.

Exhibit 2: Credit Spreads Widen but Remain Moderate



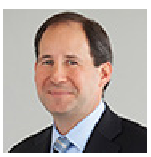
As of November 26, 2018. Source: ClearBridge Investments, Bloomberg LP.

Active management should have a good deal of opportunity, given so much of the market is quantitatively driven. A quant program that's selling highly leveraged companies does not take the time to go stock by stock and see which have good coverage ratios, or whether a given company has assets to sell or if the first time it has to pay money is 2025. They sell on a screen. That creates opportunities to differentiate a quality company with a smarter debt structure that might get sold off in a basket.

What is your outlook for 2019?

My expectation is not for a bear market, but recent weakness may continue, test a low, then rally and make new highs. Earnings are fine but peaked last year. In my opinion, markets have become too pessimistic on 2019 earnings growth. A step down in growth is to be expected given the front-loaded aspects of the Tax Cuts and Jobs Act of 2017; this would be consistent with past tax breaks with similar characteristics. Interest rates will continue to climb, though at a somewhat subdued rate, while the Fed will also continue to shrink its balance sheet. Therefore, liquidity will continue to tighten and will remain a key variable to monitor. I expect strong cash flows and strong buybacks to support stocks and for quality-oriented stocks to outperform in 2019.

About the Author



Scott Glasser
Managing Director, Co-Chief Investment Officer, Portfolio Manager

- 27 years of investment industry experience
- Joined predecessor firm in 1993
- BA from Middlebury College
- MBA from Pennsylvania State University

ClearBridge Investments
620 Eighth Avenue, New York, NY 10018 | 800 691 6960
ClearBridge.com