ClearBridge Investments

Podcast: Contrarian Growth Investing in an Evolving Market

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With Aggressive Growth and Multi Cap Growth Portfolio Manager Evan Bauman and Investment Strategist Jeffrey Schulze, CFA (JS)

JS: Hello, and welcome to the latest ClearBridge podcast. This is Jeff Schulze, CFA Investment Strategist at ClearBridge Investments. ClearBridge is a Global Equity Manager with 126 billion in assets under management, committed to delivering long-term results through authentic active management. ClearBridge channels our strategies to meet three primary client objectives in our areas of proven expertise; high active share, income solutions and low volatility. We integrate ESG considerations into our fundamental research process across all strategies.

And speaking of high active share, I'm excited to be here today with my colleague, Evan Bauman, Portfolio Manager of the aggressive growth and multi-cap growth strategies. Evan has managed the strategies with Richie Freeman for over 20 years. And this is the second year that Evan has kicked off our podcast schedule and we're happy to have him back.

Once again, unfortunately, Duke is a favorite to win the National Championships, and in the markets, we're discussing a change in leadership away from the FANGs. And the topic of today's is "Contrarian Growth Investing in an Evolving Market". We'd love to get your feedback about the topics we cover and how we can make our podcasts better. You can contact us with questions, comments and suggestions by emailing us at podcast@clearbridge.com. Evan, welcome back to the booth.

EB: It's always a pleasure to be here, Jeffrey.

JS: You're our first three-time guest making an appearance on the podcast series.

EB: Hopefully this is the first time Duke follows through on the ...

JS: I think the last time I had you here in we had you and Margaret, two Duke grads, were ganging up on me. I'm a Kentucky fan, for those of you who haven't listened to the series. It's been a demoralizing year for me as a Cats fan, especially after that first loss that we had against Duke. I think it was, what, 30 points?

EB: It was 20-something, but who's counting? But it's January, remember. We start counting victories in March, so we'll see how it plays out.

JS: Well, unfortunately in two months I'm going to have to see that 24/7 loop of Laettner hitting that shot in the NCAA against Kentucky, which I'm not really looking forward to. But speaking about leadership, right, obviously, the FANG stocks have been market leaders since we bought them in 2009, which has really been led by a momentum driven environment. So, we've seen a pullback in a lot of those names in the fourth quarter. Is this the start of a turning point? I know you've been talking a lot about this over the last couple of years.

EB: Yes, I think things changed a lot in the fourth quarter, you know, obviously and you can give the macro perspective on it, but the market itself I think had a major shift in a lot of areas. One was volatility, right, where the VIX came into the early part of the fourth quarter around 10 or 11, I guess 11 and change, and spiked as high as 35 or a little over 35, which an extreme level, generally indicative of a market low. So, there was a return of volatility.

I think clearly what had been somewhat best described as complacency in terms of ... we'll call it mega cap technology names ... and the market, in general, clearly was replaced by enormous levels of skepticism, panic, fear as measured by a lot of indicators. You had extreme levels across sentiment indicators during that fourth quarter drawdown, which was only about 20 percent peak to trough, but clearly read as the first, I'd say, major correction at least in terms of magnitude that we've had really in a number of years.

Remember, as you said, we're ten years into this bull market and clearly the market, which really for the last three years, even though it's been for a while, really the last three years was becoming narrower in terms of leadership and, again, I think what was ironic about it was it was very much driven by IT. In this case, it was the mega cap IT stocks. You know, 20 years ago it was a different kind of market that was driven clearly by overvaluation, a true valuation bubble.

JS: The dot com bubble.

EB: Exactly, back in the late '90s. This was similar in that it was, again, it was very much driven by IT and you had five or six stocks making up more than a quarter of the growth indices. For the most part, all of those names had done quite well and you clearly, I think, right as the market reversed, late third quarter, early fourth quarter, you had a lot of fear in the market. You didn't have overvaluation, you actually had a lot of healthy dose of skepticism for certain sectors that I'm sure we'll talk about, like media and healthcare, but you obviously had rising complacency or rising optimism for companies that were at 7-, 8-, $900 billion market caps that were all competing for the same piece of the pie.

So, the last three months I think, the last three-plus months have changed dramatically. You've had a selloff in a lot of those big cap names. Apple, for example, which has retreated I think almost 40 percent off of a $1.1 trillion market cap level and now what you've seen emerging from that selloff is some different-looking leadership. This year I think has been very different. Just in two to three weeks, I think you've seen sectors like energy start to emerge, you've seen deal activity in other areas that are starting to lead to a rerating of valuations in some of these laggard parts of the market.

Yes, so generally when you get this type of violent, meaningful selloff in the market, particularly if, as we all I think believe, it's a correction in an ongoing bull market, actually a pretty healthy and not completely unexpected one. The subsequent rally or the subsequent years actually look very different in terms of leadership and I think that's what we're starting to get in the early weeks of this year.

JS: To your point, this is a bull market correction on our opinion. The ClearBridge Recession Risk Dashboard still flashing a solidly green signal, which doesn't mean we're not going to have pockets of volatilities, you know, some bumps along the way, but the market should look through this because the economy is still on a healthy foundation.

But just coming back to this idea about the FANGs, right, they've gone through their super growth phase, now they're spending money in order to keep their growth rates up and maybe I'll just look at Amazon really quickly. They're opening 3,000 stores, the Amazon ghost stores by 2021, it's going to cost them about 3 billion and usually when that super growth phase is over, you start spending a lot of money. Investors intend to hurt, you know, they sell those stocks because maybe the valuations aren't necessarily warranted at that point.

I mean, you talked about Apple. Apple had a huge miss. People here in the US aren't upgrading their iPhones, they're changing their batteries, a lot of competitors in China in the emerging markets, the handsets(?) are 3- to $400 cheaper. So, you know, if you think that the competitive advantage that these FANG stocks has had is starting to erode, they're going to be spending a lot of money in order to keep up those growth rates. As you mentioned, Evan, it does seem like a shift of market leadership could be at hand.

EB: I think one of the biggest misperceptions in the market place is that FANG is one entity, you know? I think, yes, they all basically traded together on the upside in 2017. I think on average, the FANG names were up about 40 percent across the board and they all seem to trade together. And we can debate maybe why that is the case.

I think a lot of it had to do with money flow into passive products. I mean, we as a growth manager, we are business owners, we own companies regardless of benchmark positioning and our active share, or how different we are from the bench is extraordinarily high. But if you're a traditional growth manager or a traditional large-cap growth manager and you haven't owned those names, it's been an extraordinarily difficult market to outperform.

And so, I think what's ironic is I made the reference to the previous dot com bubble. This was never a bubble. I mean, this was certainly not a valuation bubble. You could argue some of those names, like a Netflix, are clearly on the higher end of valuation metrics like price to cashflow and price to free cashflow where there isn't any free cash right now, but other companies like Apple and Facebook have true valuation support and they have rock-solid balance sheets.

I think my sense was you had so much passive ownership of these names, both in terms of ETFs and active managers feeling pressure in order to, frankly, keep their jobs, to have to buy these stocks. I think one the reasons that I was very sort of negative on the big stuff at the beginning of the fourth quarter was you're hearing more and more anecdotes about growth managers feeling as though they had to at least neutralize these positions in their portfolios. And we look at everything from a bottom-up perspective.

We look at businesses. You're looking at sectors and subsectors or industries like biotechnology companies where you have true exclusivity in IP, very little competition in some of these nascent markets and you're paying ten times earnings for these companies.

JS: Which is almost unheard of, especially ...

EB: Yes, it's the first time in history, certainly. Yes. Whereas everybody was falling in love again with big tech. And when you talk and you say, we don't own Apple and clients argue with you, again, it had a lot of the qualities, to me, of a market that was going to ... assuming new money is not coming into the market, in order to bid up some of these undervalued, under-owned areas, you have to take money from somewhere. And the definition of a crowded part of the market is that when money starts to rotate, even if the market caps are large, that can be pretty violent. It can be pretty volatile. I think that's played a role in what we've seen.

JS: So, stocks obviously are up fairly nice here in 2019. We're seeing a nice rebound. Obviously, Pal's(?) comments a couple of weeks ago soothed the market fears that the Fed is going to do a policy mistake and overtighten. I'd make the argument that given the fact that the yield curve is only 30 basis points steep, the last thing that they want to do is raise rates and potentially, in advertently invert the curve with the ten-year selling off.

So, Fed policy is not going to get in the way of the markets and also you had a really healthy jobs number a couple weeks ago, which takes that recession fear off the table, as well. So, coming back to the fact that we have seen a nice rebound here in 2019, besides just the fact that the Fed paused and that you've seen a nice jobs report. What else is encouraging to you about what's changing in this environment? You know, the return of volatility is an active manager's friend, is it not?

EB: It can be. I mean, we own businesses for decades. Some of the companies that we own today we've owned since they were much earlier in their life cycle, since they were small and mid-companies, and today, in some cases like Biogen, and Comcast and some of the other names that we own in the healthcare and media space. They're actually larger, even borderline mega cap names.

So, the idea of this strategy is to take advantage of volatility, to know what we own, we tend to do a lot of research before we buy. But when the market goes straight up with no liquidity and no volatility, it can be difficult at times when you have these pockets of volatility and I think we'll probably get back to the market in general, but by no means would we say the market can't retest the lows that we saw in December, nor would it be unhealthy for the market to have what normally happens, which is a retest, causes, again, a healthy dose of panic and fear because of the fact that, as you said, we're about 10 percent off the lows.

A lot of investors feel like the coast is clear and then when you retest, as it has almost every time you've had one of these cascading waterfall selloffs, it can drive negativity up significantly from the retail investor and from some of the sentiment indicators. So, I think we just pick our spots. We're very valuation-sensitive. We have a portfolio that even though the market is still only 10, 12 percent off of all-time highs, is close to its historical lows on a valuation basis, both absolute and apropos to the index versus the market itself. So, yes, I don't think volatility in and of itself is a bad thing.

As you said, you take a step back and you look at the threats to growth that were present in the third quarter last year and a lot of those have actually retreated. The Fed was clearly a threat to the market and many, including yourself, were talking at least about two potential hikes in interest rates. The ten-year was at multi-year highs, the dollar was rising, you had, again, low volatility and rising complacency and you had, again, what's interesting about this market if you want to say broadly speaking, you never had a bubble in valuations. Even at the peak you were at 20-ish times earnings on the S&P and now ...

JS: It's as close to the long-term averages?

EB: Exactly. And that's ten years into a bull market. Now with this correction, that growth actually probably has the potential now to surprise ... and you could tell me your thoughts on the upside ... valuations have compressed down to crazy levels. I mean, the strategy itself, trade are around 13 times earnings.

And again, reminding you, the name of the fund is Aggressive Growth and the name of the product is Multi-Cap Growth on the SMA side.

So, there's some pretty attractive opportunities in the market, I think. Like I said, if you think of the first couple of weeks, first month as, you know, proxy for the year, the next couple of years, there's just going to be different-looking sectors that lead us out of this.

JS: Well, the (Inaudible) perspective, if you looked at the PE contraction that we saw last year, over the past 40 years, it was the third biggest PE contraction that we've had in four decades. The other years that were close to it, 2000, 2002 and 2008. So, the PE levels coming in three and a half turns makes it a lot more attractive to be a long-term investor. You also mentioned something about sentiment. You used a number of different gauges to look at sentiment.

One that I like to look at is the AAII bull/bear ratio. Traditionally when it gets below one, it represents a pretty good contrarian buying opportunity and we did get below one at the end of last year, as soon as the selloff was really taking effect. But I do agree, though. I think we probably are going to be due for a retest here sometime over the next month or two as earnings for the fourth quarter come in, expectations going forward for 2019 come in a little bit more, but again, volatility is an asset to an active manager, especially ones that are long-term business owners like yourself.

Now, you had mentioned healthcare as an area that you have a pretty hefty overweight to. It's been depressed for some time. Last year may be the year where healthcare is starting to get a little bit more fanfare. It was the only one of two sectors that was positive in total returns in 2018 and you've seen some positive news around some mergers, specifically Celgene and Bristol-Myers. So, what are your views in this space? Is this kind of the beginning of a period of outperformance?

EB: Yes, you said "depressed" and I was just thinking we're depressed when our stocks underperform. But yes, I think there is actually some ... again, early in the year, but I think there's been numerous positive signs coming out of the healthcare industry. Now, again, we've owned the sector since ... you can go back to, really, the inception of the strategy back in 1983, so our history with the group goes back quite a long time.

I referenced earlier how we've never seen ... one, we've never seen companies, the bigger companies this profitable. Two, you've never seen valuations of the profitable companies trading like utilities, trading at ten- or twelve-times earnings. In some cases, even less than that. We have companies like Allergan that are trading at less than ten times base business earnings, companies like Biogen generating what will be north of $28 per share in earnings over the next 12 months and trading at, again, less than a market multiple.

So, valuations are good. I think what doesn't get discussed enough and, you know, it's in this environment of concerns over drug prices, and reimbursements and all sorts of political issues, but you have so much innovation occurring right now in the industry that you've never had before, that last year in 2018 you had a record number not only of approvals of NDA's new drug applications, but you had a record number of first-cycle approvals of these NDAs.

So, you have FDA right now that I think is really trying to separate the industry into companies that are selling me-too products, where there are generic options and have the opportunity to bring down costs through competition and more generics and then you have the companies that we own, which are actually finding these treatments and cures for unmet need, whether it's neurology, Alzheimer's, ALS, Parkinson's disease.

You have rare disease where you're seeing new methods of treating rare disease or orphan diseases, which are relatively smaller patient populations, but where there's nothing on the market, nothing approved right now for a lot of these end markets that are keeping people in hospitals just for standard of care. And now you're finding new mechanisms like gene therapy which are keeping people safe and healthy and actually keeping them out of the long-term care centers. So, I think there is a lot of really good things happening.

You had a record number of approvals, you had actually record capital markets activity last year. The fact that you're getting deals now, both the smaller names. Lilly made a purchase of an oncology company for about $8 billion. Relatively expensive price for an early stage asset, but it helps to bolster the pipelines of the pharma companies. Then the big one you referenced, Bristol buying or making a bid for Celgene I think is ...

JS: What was it, 74 billion?

EB: Yes, it's a big one. And it's more indicative of a Roche for Genentech kind of deal where the company is transforming itself by buying the innovator and spending cash along with stock and actually placing a CVR, contingent value rights unit, on some of the earlier stage assets that Celgene owns, saying essentially their current business model is no longer effective and they need to continue to buy the innovators. I think that is a very meaningful deal for the sector.

I think you can see similar deals from some of the other big pharmas that need to acquire growth, need to a prior both approved product, as well as pipelines of drugs. And that's I think the kind of deal we haven't seen in a while and could be very favorable for the group.

JS: Let's not forget, right, a lot of this money coming back home from overseas is repatriated assets, healthcare and information technology by far and away have the lion's share of that $2.6 trillion in unremitted foreign earnings, so bring that money back home with valuations being as cheap as they are, it makes sense from a corporate management perspective to buy your competitors, and strip out those costs and make your business a little bit more comprehensive.

EB: Yes, and I think, again, it's funny how the market reacted to the announcement of the deal, which was Bristol stock dropped 15 percent. Celgene still trades well below the deal price. So, there's a lot of skepticism around everything, the strategy and how the deal will be perceived in the longer run. It's a little bit like media a few years ago where you had a lot of depressed assets, companies like Fox and Sky and some of the assets that ultimately received multiple bids, saw their share price go for north of 100 percent higher than they were trading at before the deal activity started.

So, again, I think there's still a lot of negative sentiment in the group. I think there are a lot of very favorable things happening, both at FDA and at the company and the pipeline level for a lot of these names. But it's going to take I think a couple more deals until investors realize that these are not one-offs. That maybe Celgene receives another bid from somebody else. It may be Bristol receives a bid. There could be multiple moving parts even in that particular deal.

But I think what you need to see is the market is starting to reflect that assets ultimately are dramatically underpriced and they're going to get monetized either over time in the stock market or by these third-party transactions that start to rerate the group higher. I think that is setting up the stage. It's a very under-owned area. I think it's setting up a stage for a much, much better year for those companies.

JS: And I'd make the argument that drug price regulation is one of the key reasons why valuations are still relatively attractive. You think about the companies that you owned, they have pipelines. They're trying to address unmet needs, right? So, even if you do come to market with your particular product, if there's no competition, you're going to have a lot more flexibility and pricing power than somebody who has something that is a little bit more commoditized.

EB: Well, if you want to foster innovation, you need to price the innovators. I mean, that's the key is these are long cycle clinical activities. They could take up to ten years to bring a drug to market to prove safety and efficacy. I think what the reality is, you know, FDA Commissioner Gottlieb is actually very much focused on promotion of innovation, allowing these companies, if they prove a drug is safe and efficacious, get it to market sooner.

Get it to market sooner in disease progression, before patients had Alzheimer's for 12 or 15 years and they're so impaired that there's no reversing ultimately the symptoms in the course of the disease. Try to actually figure out through genetic testing who might be at risk of getting some of these diseases. A lot of the rare diseases are inherited. So, figuring out who might be at risk, finding drugs that work and allowing companies to price that way, I think those are all very favorable long-term trends that right now the market is not looking at.

I think the market is so fixated on the headlines that come out of D.C. They're so focused on every political announcement around drug pricing, but when you really read the fine print, I think that impacts the pharmas much more than the biotechs and it's part of the reason why I think they're going to be very inquisitive of those biotech companies.

JS: Well, biopharma is trading at a multiple that's less than the market and there's only been two times over the past 30 years where that's been the case when drug price controls were on the table with Hillarycare back in the 1990s, when Obamacare was originally brought to the forefront in '09 and 2010, and as you mentioned, I think as the clouds start to dissipate, you could see a nice rerating higher of the sector.

Let's move over to another area that you have a pretty nice overweight to compared to the underlying benchmark, which is energy. Crude has rebounded fairly smartly here in 2019. I think we're officially in a bull market territory for a barrel of oil. But what do you think it's going to take in order for energy stocks to take that leap forward without performance, as well? And mind you, energy is the best performing sector so far year to date, up roughly 7 percent at this given time.

EB: Yes, quietly. I mean, it doesn't feel that way and it also feels like we're the last manager long only or hedge fund that owns them.

I think there's an idea of trying to find unloved sectors, particularly a more cyclical area like energy than some of the other areas that we own like healthcare and media. There's an understanding that these companies are price-takers, they don't set price. They ultimately have to react, the markets themselves have to react to volatility and commodity prices. I think what you had in the fourth quarter was a combination of fundamentals and then just market-related activity that really dramatically in my view exaggerated the move and everything.

JS: And then tax loss selling, right?

EB: It's all of that. I think you had a number of desks and hedge funds that actually ceased to exist after the volatility in natural gas prices in mid-November and then all the volatility around oil prices in late December. I mean, I think there's clearly an oversupply situation in the global markets that needs to be corrected.

Generally, price will cure price. These are self-correcting markets and we've already seen a reflex reaction from OPEC and some of the US producers speaking more cautiously about raising production aggressively in the low 50s as opposed to where prices were three months ago in the '70s. But I also think, as you said, you had an enormous amount of end-of-year selling. I think there was de-risking after the fact. You had a tremendous amount of tax law selling across the commodity complex and that obviously impacts energy significantly.

I think what you did is you set up again another interesting dynamic where all of the fears that we had, similar to the market fears, all the fears about energy four, five months ago which were record amounts of production coming out of everywhere in the world, you had potential for slowing global demand and obviously I think fears there ... and you can give your take ... I think fears there are probably more perception than reality as it pertains to oil prices, but you had a lot of fears of rising CapEx, rising production and then that was a point where companies were actually raising CapEx 10 or 15 percent. All of those fears have been reversed. It probably results in ...

JS: In short order.

EB: ... in very short order, exactly. It probably results in an industry that finds supply-demand balance much quicker because of the quick reaction of both countries and companies this time around at a time when balance sheets, for the most part, are in much better shape than they were three years ago. A lot of the service companies are trading at big discounts on an equity basis to where they were in early 2016 and that was coming off of an oil price crash and a lot of companies had significantly less capital and more leverage at the time.

Now, a lot of the E&Ps, a lot of the independents are actually generating free cashflow, albeit at a lower priced environment because of good cost management. This is going to sound similar to healthcare in that you have the potential for consolidation with the majors now in a much better financial position and a ton of private equity money out there. We've already seen a couple of smaller bids and both for assets and for smaller companies, but that can be a trend. I mean, there's no more I'd say disliked or under-owned area right now than energy in terms of the equity markets. And you could probably argue the debt markets, as well, and generally again there it takes one or two actions, whether it's through an independent investor, like we've seen over time in the media space. Sometimes someone will walk in, pay a big premium and take a big investment in an area, but these are good cash flowing assets and at some point, there will be a clearing price where you're going to see I think strategic buying.

I think you have right now valuations looking very good and the markets themselves from a commodity-priced debt perspective have probably seen the worst because I think a lot of that move was exaggerated by the end of the year stuff.

JS: I would echo exactly what our energy analysts recently came out with. He just got back from a large industry conference and he said, this may be the most bearish that he's seen anybody at the energy conference in his entire career. That's what happens when everybody gets washed out twice over the course of three years. But ultimately, I think a lot of the fears are overblown. You've seen demand hold up relatively well, a big reason why you've seen the price of barrel of an oil go down is because Iranian sanctions didn't go into effect.

Ironically, this cash discipline that everybody got back in 2016 may sew the seeds for the next real big boom in energy prices, right? CapEx is down 40 percent from where we were back in 2015 and '16. A lot of companies aren't investing for the future. They're just relying on shale production. I think if the global economy doesn't fall apart, which is what our base-case expectation is, you could see a potential issue in the Middle East where some of that supply comes offline. With the IMO regulations that are coming forward in 2020, which is the International Maritime Organization, they're changing the rules on what type of fuel large tankers can use. They used to use the bottom of the barrel, if you will, the high sulfuric acid as fuels and one of the tankers out there put as much emissions into the ozone layer as 380 million cars. So, they changed it from that to something akin to diesel.

So, you're going to have to bring on another million barrels of supply over the course of the next year and a half. I think all of these come together and end up seeing a bull market resume here in the energy markets with the price a barrel going higher, but of course, some of these beaten-up areas, these beaten-up companies in the energy patch are going to rerate higher.

EB: Yes. You hit a good point there, also, for the service names or the equipment companies. You've had a four-year depression in spending. At some point you're going to hit the point where inventories are too low and you're going to have, I think, a major refresh cycle in new technologies, new equipment, better technologies embedded in the equipment, smarter rigs, for example, and I think that is another, if you want to talk about the levered plate of the upside, it's some of these oil service companies where the balance sheets aren't as strong as the E&Ps. They have more leverage, they're not right now breaking even in terms of operating net income, but you also have enormous leverage to the upside if and when the cycle turns.

So, that's part of the portfolio is some of those more technology-enhancing service names that, again, I think you have probably higher risk because of the leverage, but also the reward profile is pretty significant at these levels.

JS: You talk about risk and rewards. Let's maybe take a step back. I know we've talked about a couple of companies that you have in the portfolio, but what are some of the key metrics that you look for in a company that you're looking to hold over the course of ten to twenty years. Why are these different characteristics important?

EB: Sure. So, I mentioned innovation in healthcare. I think innovation in technology enhancing companies is core to the philosophy. Owning businesses for decades, you want disrupters. You want companies that are changing the way that medicine is prescribed or the way the technology is enhancing your lives. But what's interesting about our philosophy is being such long-term shareholders, probably the most important thing is exclusivity or intellectual property, owning the asset and having ...

JS: The moat.

EB: ... the moat but having a real moat. Having either a monopoly or a duopoly in a business where if somebody is going to compete with you, you're going to get paid, you know, license and royalty type stream. But ultimately, I think when you talk about technology, and we had some earlier comments about this sort of love affair with big tech again, and I think investors, I've said a number of times, when tech is going up, everybody loves them, but you forget that inherently IT companies are relatively deflationary and they're in very, very competitive markets.

Most of the FANGs compete against each other for basically consumer market share and we've seen so many examples of where a device maker or a TV company had a big market share, missed a product cycle and lost it, and had a big market cap and went down significantly. Whereas, what we're trying to find is companies, if it's a program asset in the media space, ultimately those programs are their IP. They can distribute them over different sources, over different means, over an over-the-top type service or over traditional cable or satellite, but they're going to get paid because they ultimately own the asset and they own the IP there.

Same with even the energy names that we discussed. We want to own great quality assets where the companies can return cash to us as shareholders and longer-term, I think the key for all of the names that we buy is the ability to generate meaningful amounts of free cashflow. We don't buy concepts, we try not to overpay for companies that are either cyclical or obviously are in industries where the valuations to us don't seem appropriate, but at the end of the day it's about IP, it's about sustainability or durability of growth, the ability to grow for years, not just for a cycle or two. And then making sure that we don't overpay and get caught up in fads.

What we're trying to find is trends that are sustaining, and we own companies that ultimately can get monetized by the market or by other companies. We don't look, we don't seek out ... I know we spoke quite a bit about consolidation and industries, and I think it's natural that you're going to see more in certain areas, but you can never buy something and hope it gets bought out.

What you want to buy is a great business, great IP, great management that ultimately is accreting value to us as shareholders over decades. Then if we're right, then other businesses, other enterprises should see similar value or private equity, or strategic buyers should see that same value. So, those are some of the things that we look for as long-term owners.

JS: You mentioned companies that are attractive. Might we see a name or two or addition to the portfolio this year? If you could, look into your Magic 8 Ball and tell me what are your expectations for the upcoming year?

EB: So, I would think so, simply because we haven't bought a lot of new names in the last couple of years. I mean, we'd rather buy companies that we know that we've done multi-years of research on. I think I mentioned earlier management teams are very important to us.

We don't screen. We'd rather really get to know a business inside and out, get to know a management team and how they think about accreting value to us as shareholders over the long-term, what they're going to do with the balance sheet during periods of stress, what they're going to do with their free cashflow and how they're going to return cash to shareholders.

So, yes, just by nature of the fact that we haven't bought a lot recently in terms of new names and the fact the market has obviously gotten more downside volatile, so it's created opportunities for us to buy into some of these names, both that we own already, but some of the prospective holdings that have now come down to levels that are significantly more attractive than they were three or four months ago. Yes, I mean, there's going to be more activity on the new stuff.

When you own a portfolio of cheap companies, I mean, one of the things Richie has always said to me is if you know you like the companies that you own and they're really cheap, so you buy something new that you hope to like and do you sell something you know you like to do it? So, where we have some cash there will be some new additions. There will be some dollar cost averaging and to some of the other names that we own, but yes, just by the nature of the market getting more attractive to us, there will be some new stuff.

JS: So, I'm taking that as 2019 will be a positive year for the market, the expectations at this point?

EB: There is a higher likelihood today, a significantly higher likelihood than there was three months ago. And you know the off-presidential year cycle which tells you generally the third year is a pretty good one and you usually get the buying opportunity in the second year. So, I think that's probably, when we look back, you won't know until ... you're a couple years from now and you look back.

But I think this is going to set up like another classic second-year off-presidential election year correction that led to a much better market the next couple of years. I just think it's going to be different-looking leaders in the market.

JS: Yes, since 1950, if you look at the presidential cycle, we have never had a recession in year three of a presidential cycle, which 2019 is year three of Trump's presidency. If you look at year three returns, if you look at first and second term presidents, your average return this year is 16 percent in first term only, which is what we happen to be in, that number jumps up to 19 percent, which both of which are a well above the long-term averages.

So, with the market essentially giving us a gift with the volatility in the fourth quarter, recession risk not on the horizon. I'm going to agree with you, Evan. I do think that there's a pretty good chance that the markets are going to rerate higher this year. But Evan, thanks again. That's all the time that we have in the booth here. I appreciate you being the first three-peat, first.

EB: Cheers. Yes, cheers. My pleasure.

JS: And then hopefully next time that we sit down early 2020, at least one of us, and I think it's more likely going to be you than me, we'll have a national championship to gloat about to the other one that's talking about this.

EB: And hopefully it's a one-peat for Duke for these kids because I don't think you're going to get them there three years. So, we'll take one in a row.

JS: Well, you know, the way that Coach K has recruited, you'll just have an all-new host of top-five prospects.

EB: Got to learn new names, that's right. Yes.

JS: (Laughs) Well, thanks, everybody, for joining us here today ... (Music)

JS: ... and hopefully everybody has a great rest of your January and we hope to have you back on the next ClearBridge podcast. Take care. Just as a reminder, we welcome any questions, comments and suggestions, which you can email to us at podcast@clearbridge.com.

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