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UNCERTAINTIES MOUNT INTO THE FOURTH QUARTER

In a year unlike any other, investors face a rising tide of uncertainties during the upcoming fourth quarter. Health officials are concerned that colder weather could lead to a second wave of the pandemic, perhaps prompting another round of economic restrictions. The timing of a COVID vaccine and its effectiveness have yet to be determined. The passage of a follow-on stimulus bill by Congress is now in question. Regulators in the U.S. and Europe continue their examinations of big technology and they may decide to increase restrictions on some of the well-known companies. Escalating tensions between the U.S. and China could jeopardize the recently negotiated trade agreement. And to top it all off, the outcome of the Presidential election and the control of the Senate could impact economic and tax policies for years. Even this is far from an exhaustive list.

The stock market's loss of momentum during September may reflect some level of unease over these issues. The pullback of the major indexes so far has been relatively mild, so it is difficult to determine whether the recent bout of weakness was simply a normal correction after an abnormally sharp rally or if it signals more serious worries about next year's market prospects. Under the surface, there has been much churning within the stock market in the past few weeks, with frequent shifting in relative performance among economic sectors and between growth and value stocks. No clear change in long-term trends is identifiable, but there does seem to be more hesitation among investors as to where portfolios should be positioned for the future.

As we have noted in past letters, 2020 has seen especially strong performance from the Growth stocks, capping a decade of relative outperformance. In 2020, economic forces driven by the pandemic affected businesses differently from prior recessions, resulting in the uncharacteristic outcomes. Growth stocks maintained their market leadership during the economic downturn, a time when Value stocks normally tend to do well. While Americans sheltered in place, the role of technology altered how business was conducted and changed the lives of many consumers. As these transformations occurred, investors began to extrapolate that the pace of technological change was likely to accelerate in the future, with expectations that the largest technology companies would become even more unassailable. The result has been a spike in Price/Earnings ratios for large capitalization Growth companies and the spread in multiples between Growth and Value Russell 1000 Indexes surpassed levels only seen during the Internet Bubble. While there have been previous examples of Growth outshining Value, this has been the longest such period in over 100 years of data. This dominance in relative performance has led many to question if a paradigm shift has occurred in the stock market that will keep Value stocks at a permanent disadvantage. With the imbalance in style performance leading to larger, more concentrated positions of very expensive stocks within the major indexes, the answer to this question is of vital importance for investors.

WHY VALUE INVESTING LED FOR SO MANY YEARS

The well-established, but recently overturned, trend of Value stocks tending to outpace their Growth brethren was widely researched. Finance professors published countless papers examining the so-called Value Anomaly, providing various explanations as to why value investing seemed to have such an advantage, both here and abroad. The traditional explanation was that investors were overly emotional and tended to become too exuberant when stocks were rising and excessively pessimistic after they fell. Researchers in Behavioral Finance uncovered some evidence to support this idea, finding that investors tended to overestimate how long a company's high rate of earnings growth would last. Proponents of the Efficient Market Theory found this explanation troubling, however. If markets are effective in absorbing new information about companies, then informed investors shouldn't broadly misjudge the investment potential of such a significant portion of the market. Their explanation of the Value Anomaly centered on the concept of risk and reward. It is axiomatic that risk and reward are highly correlated. Since investors were being rewarded with better returns, then Value stocks must be inherently riskier. Again, there is some evidence to support this idea. Value companies generally are found in less buoyant and more cyclical areas of the economy, with greater variability in results. A third explanation came from economists, who pointed to the influence of inflation across Growth and Value sectors as the reason behind the long stretch of outperformance for Value. Inflation did provide many companies with enhanced pricing power, especially in economic expansions. As input prices rose, like raw materials or labor, it became a justification to raise prices. Often corporate executives were able to tack on a little bit more than the amount justified by the higher costs. This additional revenue essentially dropped to the bottom line, increasing profitability and enhancing returns. Looking back at the data, most of the time that Value stocks outperformed, inflation was a consistent presence, with the Federal Reserve often challenged to restrain it. Some economists believe that inflation impacts Growth and Value performance indirectly, through inflation's effect on interest rates. As we discussed in last quarter's letter, the level of interest rates affects the present value of future earnings by adjusting the discount rate. While very high interest rates can drive the present value of distant earnings to almost zero, a low discount rate can raise the value of future earnings significantly. The level of interest rates tends to impact the prices of Growth companies' stocks far more than Value firms.

WHY DID LEADERSHIP CHANGE FROM VALUE TO GROWTH?

There is no question that many of the major Growth companies are great businesses that are increasingly part of all of our lives. For the first eight years coming out of the Financial Crisis, large Growth companies, especially the big technology firms, delivered earnings growth on a scale that had rarely been seen before. Virtually all of the gains in the Growth stocks early on was due to these superlative earnings, which far outshone the rest of the market. For the past two or three years, however, this has been less true. Although the earnings differential between Growth and Value has narrowed, the relative stock performance has continued to widen as investors were willing to pay higher multiples for Growth companies, based on the assumption that the prior trend would assert itself again. This is despite the fact that, historically, corporate results tended to mean regress over time. Followers of Behavioral Finance would suggest that investors are being too optimistic in their growth projections, but there is some evidence that this may not be the case this time.

Through the pressures of competition, managements at struggling companies tend to reduce costs and invest capital in ways to enhance returns. At the same time, successful companies often find themselves challenged by new competitors that are drawn by the profitability available in attractive markets. Return-on-equity (ROE) for the inferior companies tended to improve over time, while it was likely to deteriorate for the superior firms. This relationship continues, but it has become less prevalent the past two decades, with high performing companies better able to maintain their high ROEs. The brokerage firm, Sanford C. Bernstein, analyzed their research universe and found that over half of the companies that were in the top quartile of ROE five years ago were still ranked that high now. Prior to the early 1990's, only about a third of qualifying companies managed to remain on top for that long. We believe the explanation is that corporate concentration has grown significantly in recent years, bringing better efficiencies and higher margins through the advantage of scale.

Larger firms generally enjoyed better access to capital in the wake of the Financial Crisis. As lending standards tightened many smaller companies struggled for funding and put themselves up for sale when they might have chosen to remain independent under different circumstances. Whether the sector was technology, health care, telecommunications or entertainment, investment bankers were burning the midnight oil, trying to put deals together. Technology companies proved to be particularly astute in acquiring smaller firms, enhancing their existing line of products and adding innovative employees to their payroll. Engineers at many of the big technology companies had a front row seat to see which start-up firms had the most promise. By moving early, they were able to buy the best smaller firms before they had a chance to fully establish themselves and become viable competitors. Also, the advantages of scale in technology often go beyond simply added efficiency. As the number of users increases, the product or service tends to become increasingly beneficial to consumers. This can create a reinforcing cycle, ending in a winner-takes-all outcome.

Efficient Market advocates simply note that Value's underperformance merely indicates their inherent riskiness. With two major economic disruptions in the past ten years, Value stocks responded consistently with their sensitivity to economic conditions. When economic conditions improve, they would expect Value to reassert its prior dominance. Not all risks are economic, however, and many of the large Growth companies are facing increasing regulatory risks here and abroad.

CHANGES IN THE REGULATORY CLIMATE

If future acquisitions are well selected and appropriately priced as earlier ones, then the growth stocks could see several more years of enhanced profitability and growth. The large companies have easy access to capital and their high stock prices give them a solid currency to exchange for an acquisition. Regulatory acceptance of any mergers may be more difficult, however. Proposed deals are likely to be put under tighter scrutiny, with longer examinations and fewer approvals. The regulatory climate has changed.

For example, the House Antitrust Subcommittee recently completed seven separate hearings that were held over the past fifteen months to investigate concerns over excessive market power in the technology industry. From the tough questioning on both sides of the aisle, it appears that Congressional support for these companies has waned. House lawmakers released a 449-page report outlining where they saw an abusive use of monopoly power by large tech firms, which will be hotly debated within the industry. We expect that discussions on modifying the current antitrust statutes will come next, although the legislative process will take time. Also, while technology has not been a central issue in the Presidential race, the Trump and Biden platforms appear to have more similarities than differences when it comes to regulating technology firms. While we doubt that a break-up of existing companies is likely, European regulators have been more restrictive on technology companies for years.

THE LOW INTEREST RATE ENVIRONMENT

After cutting interest rates to near zero and adding $3 trillion to the Fed's balance sheet, Chairman Jerome Powell also clearly indicated that interest rates are unlikely to move higher any time in the near future. After years of stressing the importance of lowering the general rate of inflation, new policies will allow inflation to surpass the Fed's internal targets significantly, before actions will be taken to tighten monetary conditions. Since the Financial Crisis, overall price increases have remained relatively low and the Fed has been unable to reach its inflation targets. The excess capacity in the economy from the recession is likely to dampen the rate of inflation for now, which should provide the Fed with enough headroom to keep rates at current levels for many months.

RECOVERY'S STRENGTH WILL AFFECT RELATIVE PERFORMANCE

While economic conditions in the U.S. have greatly improved since April, recently released data has raised concerns that the recovery is weakening. Small businesses that have managed to survive this far may be pushed beyond their limits if the economy stalls, especially without additional relief payments from the Government. While investors are focused on larger, listed companies, it is worth remembering that small businesses account for half of all U.S. jobs and generate about 40% of GDP. It is vital that these firms are able to regain their footing. So much depends upon the medical advances in both prevention and treatment of COVID-19. As we have commented in past letters, we remain encouraged by the flow of information on both of these fronts. If these efforts are successful, we believe the economy should gain increasing momentum as these breakthrough products are eventually distributed to the wider population. Based on current Wall Street estimates, if this occurs, the more cyclically sensitive companies will produce earnings gains next year at a pace well above the established growth corporations. If the pandemic worsens, or a vaccine is delayed, then aggressive earnings expectations would be much less likely to be realized.

MAINTAINING SUPERIOR EARNINGS GROWTH IS DIFFICULT

The obvious challenge that all companies face as they grow larger is maintaining their rate of growth. The incremental revenue necessary to sustain a high rate of growth for a smaller, more agile firm is more challenging for a behemoth. Over the past forty years, very few of the S&P 500 Index companies have been able to post earnings gains above 5% consistently year after year. Less than a fifth of companies could do it for three sequential years, only 6% for five years and a mere 1% for ten years. Historically, technology has been a particularly challenging area to sustain growth, since innovations occur so rapidly. At one point, IBM was considered to be as dominant in technology as any of today's leaders are. Back in 1985, IBM represented 6.4% of the S&P 500 Index, a tech-stock weighting that was only surpassed this year when Apple represented 7.3% of the Index. Despite its former preeminence, IBM isn't even among the list of the ten largest technology companies within the Index today. Many of the largest tech stocks from the 1990s, like Lucent Technologies or Nortel Networks are no longer with us. While today's top technology companies may be in a better competitive position than those in the past, the pressure to constantly innovate will not lessen any time soon. There are a limited number of rapidly growing markets and eventually large companies may need to enter another firm's market to sustain their own growth. If the pandemic accelerated the use of technology in society, perhaps some of the future demand was simply shifted into the present. This could make it more difficult for the big Growth companies to generate the necessary revenues to maintain their rapid pace of growth.

LOW YIELDS AND BONDS

With interest rates extremely low and likely to remain there, bond yields are unlikely to keep pace with inflation, making it challenging for investors to conservatively protect their purchasing power. Despite this disadvantage, we still see a role for bonds in a balanced portfolio. While expected returns have dropped, short-to-intermediate term bonds should retain much of their historic low level of volatility. Bonds would provide an island of relative stability and we believe their proper role in this environment should be seen as a means of dampening any potential downside volatility.