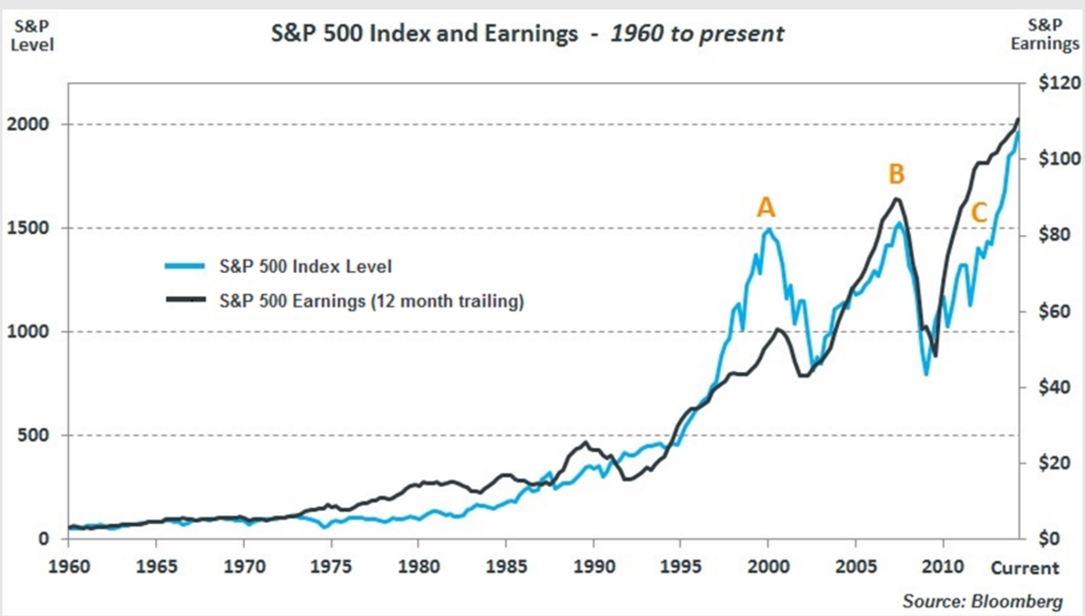
Portfolio Commentary

Third Quarter, 2014

Follow the earnings path

Major equity markets ended the third quarter with a whimper, retreating enough in the last days of September to erase most or all of the gains accumulated since our last report. Understandably, this bout of weakness elicited a few nervous phone calls from clients and, of course, reinvigorated pessimistic commentators (many of whom no doubt wait for their bearish narratives to finally be fulfilled after years of being epically wrong). Despite a rough few weeks, however, our appraisal of underlying conditions still doesn't leave us terribly concerned that the current setback will amount much more than a typical fluctuation along the market's sawtooth path.

In our last commentary, we examined some of the more immediate attributes that bode well for stocks, including near term economic and earnings data and the persistently accommodative interest rate environment. This quarter, we pull the lens back further to check where we now sit relative to the very long term continuum of equity prices, earnings, and valuation. Using the broad S&P 500 Index as our proxy, the chart below describes these variables going back all the way back to 1960.



As you can see, when the profit and price lines for the aggregate market stray too far from one another, they eventually work their way back to harmony, usually by way of price adjustment. In fact, this relationship is so powerful that one can comfortably say that earnings generated and the price paid for them are the most important determinants of equity performance.

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To ascertain whether stocks represent a reasonable value proposition today – or instead, an imminent danger to portfolio health – it is most instructive to examine the extreme periods which have occurred within the past two decades. Point A on the chart marks the zenith of over-enthusiasm that developed for stocks in the late 1990's when almost anything with ".com" in its name was granted immediate blue-chip status, whether it made money or not. As much as the subsequent tech meltdown was about illuminating the dubious nature of many of these businesses, it was also about restoring the linkage between share prices and realized corporate earnings. In hindsight, it's easy to see that things were going to end badly for many stock portfolios as the calendar turned to the new millennium. If we cast our eyes forward on the chart to the current condition, it is apparent that the stocks have not dramatically overshot fundamentals as they did a decade and a half ago and that today's market level appears to be a rational expression of actual profitability.

The beginning of this century's second major market decline is denoted by point B. In this case, however, it wasn't a valuation problem that brought stocks down, but rather a collapse in earnings. With the near failure of the financial system, economic activity ground to a halt and so did company profits. Could a similar profit plunge repeat itself today? Anything's possible, but if one were to continually plan around such a "three sigma" event, capital would never see the light of day from between the mattresses and the real value of one's savings would eventually be depleted by inflation.

The final area highlighted in the chart is the gap that opened up between corporate earnings and stock prices during the long recovery from the 2009 economic and market nadir. Skepticism about the robustness of the recovery, distrust of the financial system, and reluctance amongst investors to put money back to work caused stock prices to lag the bounceback in business income experienced over this period. Because of this, a significant portion of the spectacular gain produced over the past few years has actually just been catch-up, with stock prices recovering to match actual earnings according to roughly the same ratio that has endured over the past half century. With this perspective, recent market performance is more accurately viewed as a "reset to normal" rather than a swelling of speculative excess.

Stocks are unquestionably more fully valued now than they were a couple of years ago, meaning that the extraordinary returns of the recent past are unlikely to be repeated in the near future. At the same time, valuations remain reasonable and supporting fundamentals have strengthened alongside share prices. This underlying improvement is tangibly reflected in S&P dividends, which have actually grown at a faster rate than the index itself since the third quarter of 2010; so, by this measure at least, the market has actually gotten *cheaper* during its rise of the past four years. For all of these reasons, we do not feel that our work at the individual stock level within your portfolio is likely to be undermined for a prolonged period by aggregate market behaviour. Accordingly, we will continue to use periods of volatility such as this to deploy accumulated portfolio cash and reallocate assets toward compelling opportunities in the pursuit of rising equity cash flow and long term capital growth.