4Q 2014 Market Insights
What's in Your Wallet?
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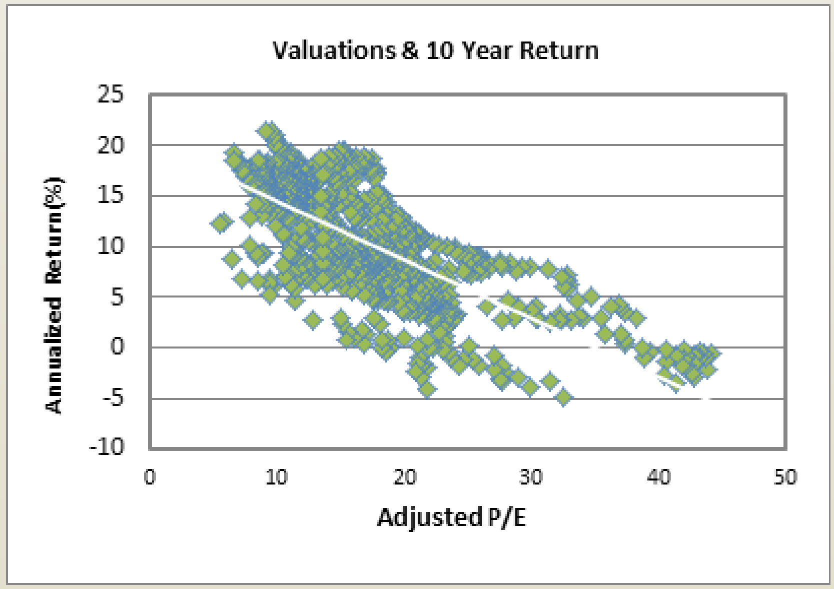
"Know what you own, and know why you own it." - Peter Lynch

The past five years have been outstanding for investors. As markets recovered from the depths of the financial crisis, the S&P 500 soared by 181%. US Small Cap Stocks climbed to even greater heights, rising nearly 200%. I have one better. US Low Quality Stocks, companies with high levels of debt and with boom or bust cyclical profit profiles, advanced by 287% over that same period. If this isn't clear already, allow me to put it into further perspective. The companies that have the least stable profit profiles and who carry the most debt (aka, those that are most likely to experience a solvency issue) are trading at three times the price they were just five years ago. While the gains have been great, one needs to begin to question what is reasonable and where this ends. To those of us that would be described as risk-focused, price-conscious investors, this is downright scary stuff.

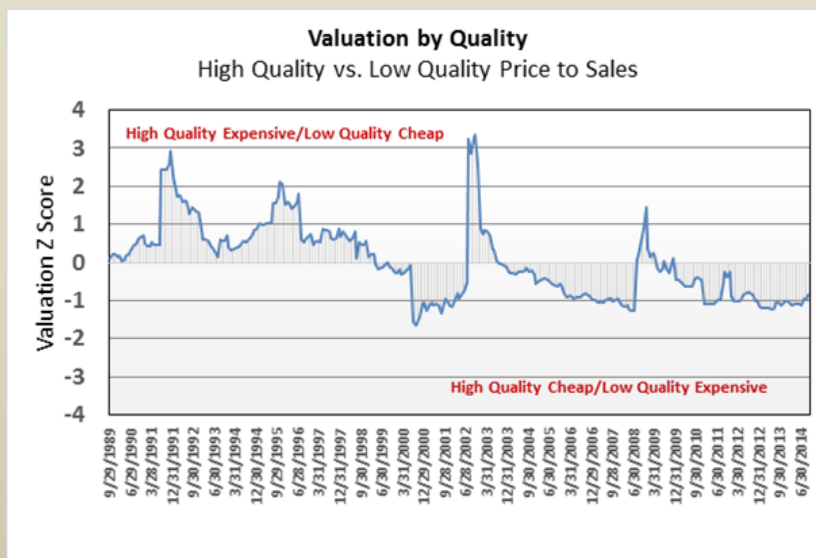
The solution to some is seemingly obvious, but perhaps one not quite as easy as it would appear. That is, avoid the junky companies, a strategy that we would certainly advocate. If only life was that simple. Sadly, and what's even scarier, is that low quality equities don't announce themselves as such. They come in many different flavors and with many close cousins. Much like junk bonds have come to be known as high yield bonds, low quality companies are rarely overtly classified as such. While a new or more tactful naming convention may be less abrupt in polite company, it really does nothing more than provide a marketing spin and otherwise disguise the risks that exist within the asset. Honestly, what better characterizes the risk of low credit quality bonds, the junk or high yield label? Obviously junk, yet few refer to them by that name even though it's probably the better descriptor. So let us pose the following question. What's in your wallet or in this case your portfolio? The topic of this quarter's letter will be to identify the factors that lead us to believe that low quality is vulnerable, as well as to provide an example of a space where low quality is not obvious, but may be lurking beneath the surface.

The Valuation Argument

As we've stated previously, beginning period valuations can have a tremendous impact on future performance. This impact tends to be seen over longer periods and can be drowned out over the short-term by a variety of factors, both behavioral and macro-economic in nature. The chart on the following page details this relationship. Over 10-year periods, the highest stock returns tend to be produced by inexpensive valuations, the section represented by the upper left quadrant of the chart. The lower right quadrant represents periods of high valuations and subsequent periods of poor performance. While this chart details the relationship between valuations and total returns, valuations are also relevant in driving relative returns. That is, which asset class should out or underperform. While the performance picture for low quality has been rather rosy, the overall valuation landscape actually looks quite bleak. This may be less surprising than the 287% appreciation by highly levered, cyclical businesses. As one can see, low quality companies were overvalued leading into the 2008 financial crisis and as a result fell by nearly 50% from September of 2008 through February of 2009. While the poor performance was painful for those that owned this asset class, it caused the valuation dynamic to swing decidedly in favor of low quality. These highly levered, cyclical companies hadn't been cheaper in 30 years, the root of the 287% performance. Does that mean it was justifiable? Yes and no. The excess performance required to return the asset to fair value was certainly justifiable. However, we got that and more. In fact, we can attribute 106% of performance to a rebound in valuations from cyclical lows to fair value. At the same time, sales and earnings growth also rebounded, contributing 55% to results. This accounts for 221% of the 287% in performance, or a 30% gap driven by the move from fair value to overvalued. When you consider the inexpensive nature of high quality, the relationship becomes even further stretched.



The chart above details the relationship between valuations and returns over the subsequent 10 year period for the S&P 500 beginning with the valuation date. As one can see, high valuations tend to lead to weak future returns and vice versa.



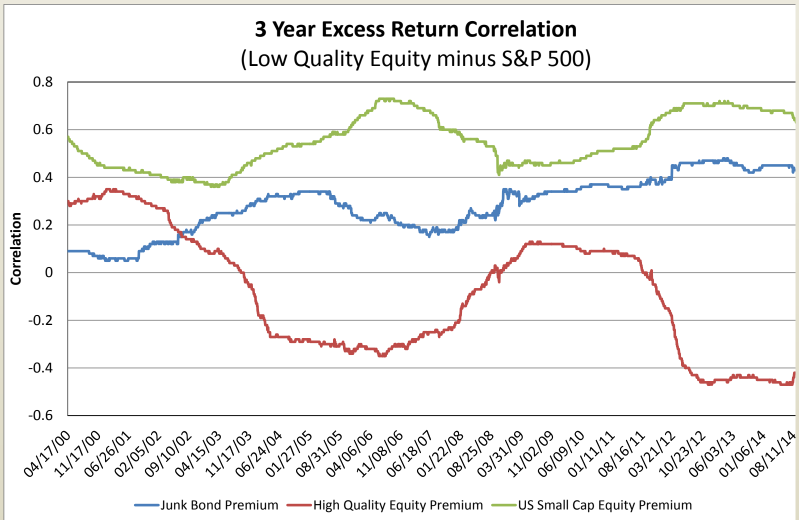
The chart above reflects the relationship between high and low quality equities. High quality equities can be defined as those companies carrying low debt with both high and stable profit profiles. Low quality equities tend to be highly levered with boom or bust profit profiles.

Data Source: S&P, Russell Investments, iCM Capital Markets Research

<u>Wolf in Sheep's Clothing</u>

Several quarters ago, in a piece about high quality equities, I described quality as a characteristic that transcends style and market cap. While this is true, high, and for that matter, low quality companies can exist along the market cap and style spectrum. The presence of each varies over time, becoming more prevalent in certain periods than in others. Despite the varying prevalence of both, each is far more common in some spots than in others. Along the cap spectrum we find that small cap stocks exhibit a greater frequency of low quality names than their large cap counterparts. Of the 194 names in the Russell 200 Mega Cap Index, 87 of those names meet our definition of high quality; low debt, high and sustainable profitability along with sound shareholder stewardship. This equates to 47% of the total. By contrast, only 15% of the 1797 small cap names would qualify under our definition as high quality. The reverse is also true. While only 3.89% of our large cap universe would qualify as low quality, nearly 25% or a whopping 440 names would meet the definition of low quality in small cap space.

Not surprisingly, the greater presence of low quality names becomes visible in returns, specifically the movements that are common between assets or correlations. When studying



Junk Bond Premium is the excess return of the Barcap High Yield Index over the Barcap Treasury Index; High Quality Equity Premium is the excess return of the S&P 500 High Quality Index over the S&P 500 Index; US Small Cap Premium is the excess return of the R2000 Index over the S&P 500 Index.

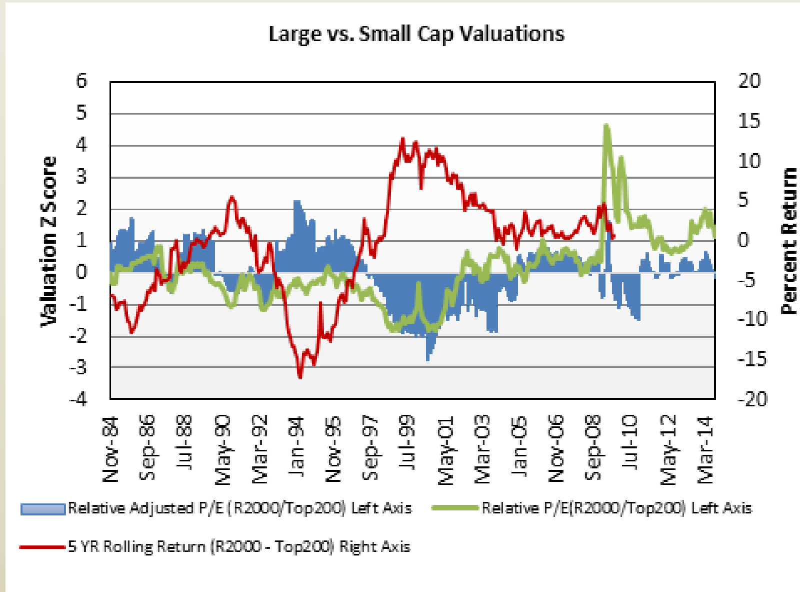
The chart above depicts the correlation various relative returns (the out performance of one asset against another) compared to the relative performance of low quality equities over the S&P 500. The point of the exercise is to illustrate which assets are out or underperforming at the same time as low quality and which may share a common risk characteristic.

Data Source: BGI, S&P, Russell Investments, iCM Capital Markets Research

correlations, one typically finds like movements among asset classes within a broad segment like stocks. Said differently, US stocks, whether large or small, growth or value, tend to move up or down together. While their overall movements are dictated by broad characteristics like stocks vs. bonds, subtle differences can be gleaned by understanding when each asset class out or underperforms. Specifically, it is meaningful to understand the degree of out or underperformance that is correlated or common among asset classes. Allow me to explain. The correlation of both high and low quality stocks to the S&P 500 is .94 and .95, respectively. What have we learned other than both asset classes have a strong relationship with the broad market? Probably not much by the .01% difference in correlation. But what about if we study what outperforms at the same point that low quality outperforms? Wouldn't we understand what assets share the same risk factors? The chart to the left details this analysis by comparing the junk bond, high quality, and small cap premiums to the low quality premium. Not surprisingly, we see that the outperformance of junk bonds (low quality bonds over treasuries) exhibits a positive correlation to the outperformance of low quality stocks (junk stocks over the S&P 500). Naturally, they both share the same low quality characteristics. The opposite relationship exists for high quality stocks. That is, high quality equities tend to zig when low quality equities zag. The surprise here is small cap. While being small doesn't necessarily translate to low quality, the high frequency of low quality names within small cap cause the asset class to share a strong correlation with low quality. Notice also the changing nature or time period dependency of the relationship. Valuations have a modest influence here. While leopards rarely change their spots over long periods, excessively expensive or inexpensive valuations can cause a momentary shift. This was the case with small cap leading up to the internet bubble. Given their inexpensive nature, small cap out performed during the downturn, while low quality trailed, which is reflected in the declining correlation prior to 2003. This period also corresponded with a declining market, a period where small cap names typically do not perform well. In this case, their inexpensive valuations changed those spots as well!

Today, we are faced with a precarious position. In addition to (or for that matter because of) expensive valuations in low quality equities, coupled with their larger presence within small cap space, we are left with an overvalued small cap asset class. As we can see by the chart on the following page, expensive valuations (the blue area map) have a strong degree of causation as it pertains to small caps underperforming large cap stocks over the following 5 years. While lagging performance this year has moderated small cap valuations, overall they remain expensive mostly due to the larger presence of low quality.

The reasons to steer clear of low quality equities are fairly apparent. In addition to being highly levered businesses, their cyclical nature leaves them vulnerable to spectacular booms and busts. Couple this with expensive valuations and this potentially leads to a bad scenario. What's not as obvious is where low quality may be lurking. In this article we identified one of the spots, small cap, which also shares the characteristic of being overvalued. We began this article by asking, "What's in Your Wallet?" If you aren't sure, we encourage you to find out before you are surprised by the answer. Thank you for your trust and confidence.



The chart above plots relative valuations (left axis) between small cap and large cap US equities on a P/E basis as well as a margin adjusted P/E basis. In addition, the subsequent 5 year performance (right axis) is plotted so as to illustrate the impact that valuations have on the next 5 year performance results.

Data Source: Russell Investments, iCM Capital Markets Research

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