JAG CAPITAL MANAGEMENT LLC

QUARTERLY COMMENTS
3rd Quarter 2017

3rd Quarter 2017: Climbing the Wall of Worry

Norm Conley | CEO & CIO

The bulls continued to run on Wall Street last quarter, pleasantly surprising many individual and professional investors. The S&P 500 Index gained over 4% for the three months ending September 30, 2017, bringing its year-to-date total return to 14.24% (including dividends). The benchmark index has now returned more than 278% since March 2009, which works out to an average annual return of almost 17%, since stocks put in a generational bottom during the Great Financial Crisis of 2008-2009. Those who maintained a steady hand during the last big bear market have been handsomely rewarded.

We have no special insight into what the equity market will do in the coming few months. Thankfully, neither does anyone else. We all look through a glass darkly when it comes to the future. That said, there are several arguments in favor of continued gains. The global economy is perking along nicely, inflation and interest rates remain low, and corporate earnings are generally healthy. We are not yet sure what the final version of tax reform will look like, but both parties seem to show interest in lowering corporate taxes and reducing the number of individual tax brackets and deductions. Our educated guess is that a bipartisan tax package of some sort will come to fruition by early 2018. These positive factors may not yet be fully "priced in" by stocks, which could leave room for a year-end rally.

On the other side of the coin, bears can point to elevated valuations, widespread investor complacency, and geopolitical concerns as reasons for caution. At 19.3x forward earnings, the S&P 500's valuation is more expensive than it has been since 2001 and is in the highest 16% of all such values recorded since 1990. To continue to leap higher, stocks could get still more expensive (as they did between 1996 and early 2000), earnings could grow faster than expected, or some combination of both. But it is no longer fair to say that stocks are "cheap" by this or most other measures. Investors may also be getting a little too comfortable with the false notion that stocks only go up. Dating back to the first quarter of 2013, the S&P 500 has delivered gains in 18 of the last 19 quarters, a streak that has never occurred before since at least 1930. Markets have been so kind, for so long, that some investors may be forgetting how painful corrections can be. The political backdrop is a wildcard. Love him or hate him, President Trump is a unique politician in American history. His off-the-cuff comments, impulsive leadership style, and proclivity to be a gadfly could result in unexpected consequences domestically or with international relations.

S&P 500 P/E Ratio
Blended Forward 12 Month

Source: Bloomberg, JAG Capital Management

As long-term investors, we will continue to avoid adding our voice to the hour-by-hour noise of the investment media. We think those with truly long investment horizons should do the same. In the meantime, as the old saying goes, "markets climb a wall of worry," which they have been doing very successfully for the last eight years.

> "Schoolboy days are no happier than the days of afterlife, but we look back upon them regretfully because we have forgotten our punishments at school and how we grieved when our marbles were lost and our kites destroyed – because we have forgotten all the sorrows and privations of the canonized ethic and remember only its orchard robberies, its wooden-sword pageants, and its fishing holidays."
>
> *Mark Twain, The Innocents Abroad*

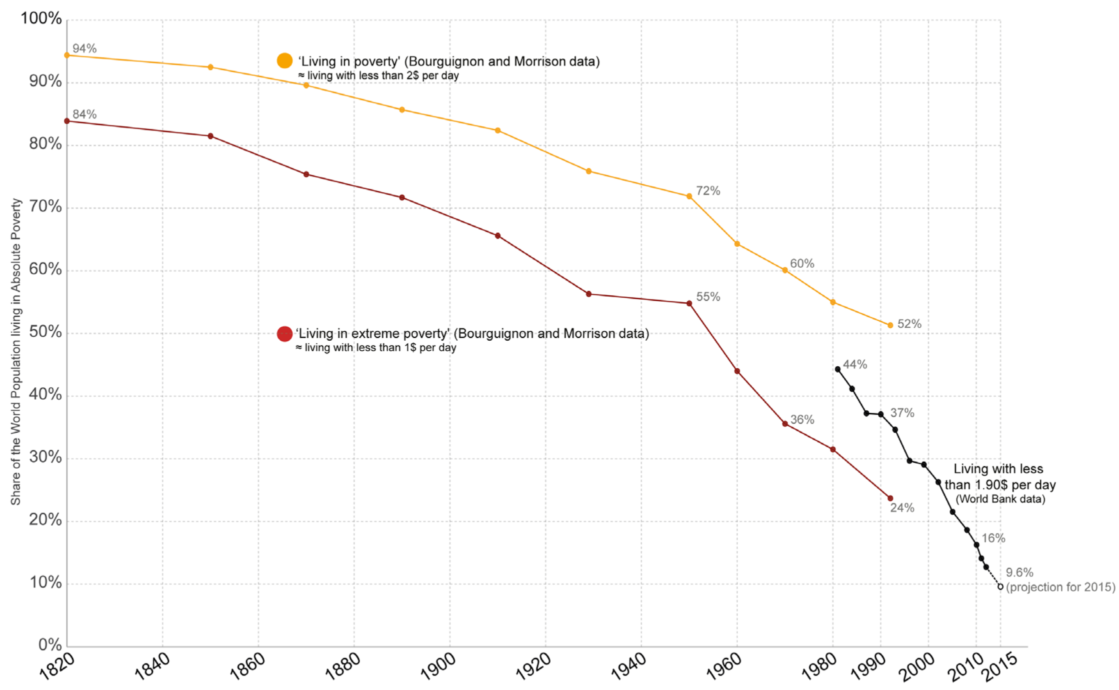
The ~~Good~~ Slow Old Days

Many of us are lucky enough to have fond memories of times gone by, family members who have passed away, the street we grew up on, our school experiences, childhood friends, etc. However, as Mark Twain noted in The Innocents Abroad, we tend to view the past through rose-colored glasses. This is true of both our personal memories and of the way we think about history. An unvarnished and honest look at our collective past reveals that the "good old days" were never unblemished. In fact, virtually all aspects of human life are objectively better today than they were decades or centuries ago.

Consider the amazing progress we have made in just the last 100 years. Life expectancy in the U.S. has increased from roughly 54 years in 1917 to more than 78 years. We still wrestle with ethnic and gender discrimination, but most of us would agree that civil and employment rights are vastly more equitable today than they were even 50 years ago. Voting rights in the developed world are now available to all adult citizens, not just members of privileged classes. Hunger and poverty are still too prevalent, but according to metadata collected by **OurWorldinData.org**, the percentage of the world's population living in extreme poverty has declined from more than 65% to less than 10% in 2015. More broadly, there have been innumerable advances in our general quality of life since the early 1900s. These include radically better workplace safety conditions, the existence of a social safety net for the elderly and disabled among us, broad access to cheap and fast means of travel via automobiles and aircraft, and wide access to computers and information via the internet. Humans will never run out of problems to solve, but as a species we specialize in continuous improvement. Betting against the continuation of this trend is almost certainly a losing proposition.

Share Of The World Population Living In Absolute Poverty, 1820-2015

All data are adjusted for inflation over time and for price differences between countries (PPP adjustment)



Source: 1820-1992 Bourguignon and Morrison (2002). Inequality among World Citizens, In The American Economic Review; 1981-2015 World Bank (PovcalNet)
The interactive data visualization is available at OurWorldinData.org. There you will find the raw data and more visualizations on this topic.
Licensed under CC-BY-SA by the author Max Roser.

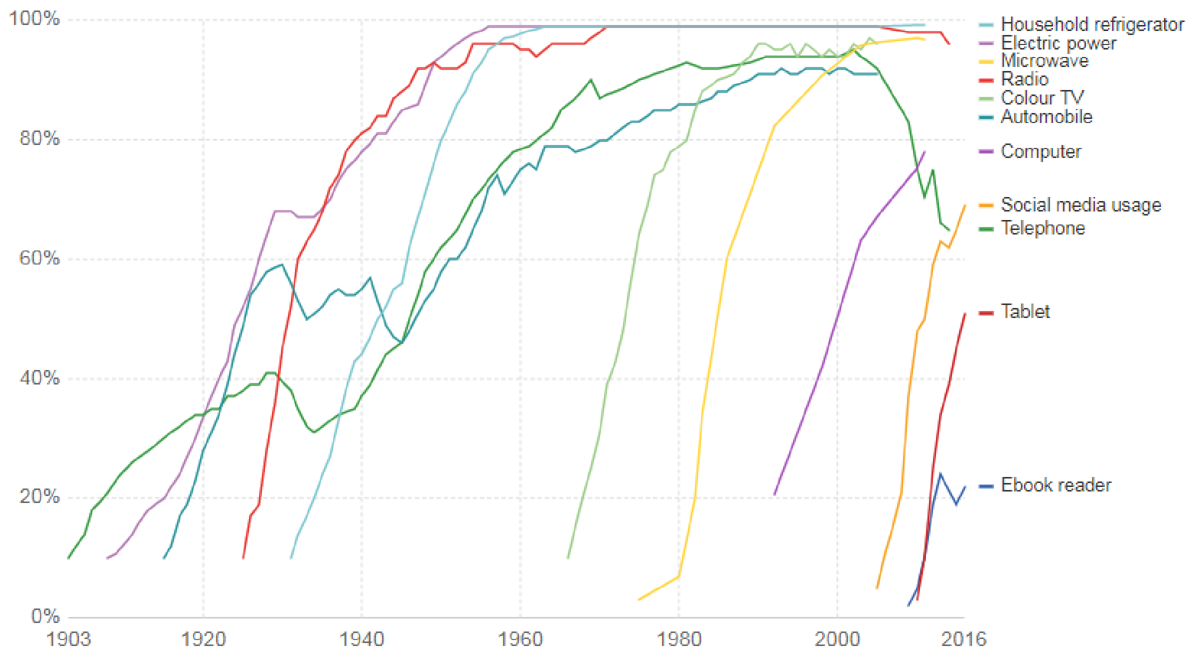
Number Of Years It Took For Each Product To Reach 50 Million Users

Source: Interactive Media via Twitter, September 2017

The "good old days" may or may not have been really great, but they were certainly slower. The speed with which new inventions become essential parts of our lives has accelerated dramatically over the past century. As the infographic below shows, it took more than six decades for automobiles to reach 50 million users. It is almost impossible for us to imagine modern life without the telephone or electricity, and yet it took each of those inventions more than 40 years to become commonplace. By way of contrast, the modern internet exploded to 50 million users in only seven years, and Facebook got there in only three years.

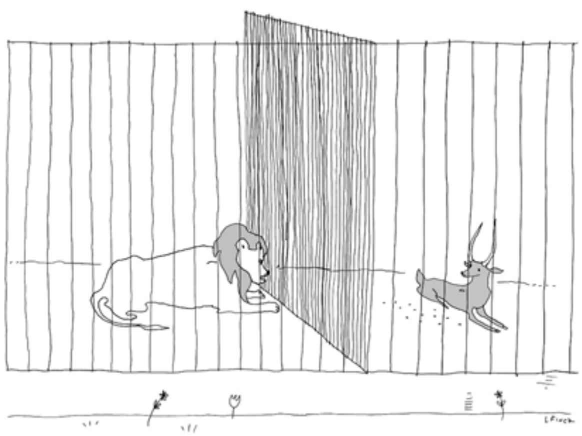
Technology Adoption by Households in the United States

Technology adoption rates, measured as the percentage of households in the United States owning, or the adoption rates of, a particular technology.



Source: Comin and Hobijn (2004) and others
OurWorldData.org/technology-adoption/ · CC BY-SA

Another way to look at the quickening pace of innovation is to consider the length of time it has historically taken for a new technology to be adopted by a large percentage of the population. The chart on page three does just that, on a time scale extending back to 1903. Notice how the colored lines become more vertical as the dates get closer to the present day. This means new technologies are growing from birth to mass scale more quickly today than they had in the past. The explosion of social media (i.e. Facebook, Twitter, Instagram, etc.) is a striking and recent case in point. Social media began with an essentially 0% adoption rate in the mid-2000's, but grew to be embraced by more than 60% of the U.S. population in less than a decade. Along its astonishingly short path from concept to commonplace, the industry has created hundreds of billions of dollars of shareholder wealth and hundreds of thousands of jobs.



"I miss when we were free, and I could eat you."

As famed Austrian-American economist Joseph Schumpeter once declared that "... the heart of capitalism is creative destruction." He elaborated on this statement by noting that "... Capitalist economy is not and cannot be stationary. Nor is it merely expanding in a steady manner. It is incessantly being revolutionized from within by new enterprise..." We think Schumpeter was dead-on, and we also believe that the process of creative destruction is happening faster today than ever before. Indeed, thanks to the power of technology, it appears to be accelerating.

The consumer is ultimately the big winner in the system Schumpeter described. Free market innovation forces companies to compete aggressively for our dollars, which ultimately pushes the market to provide us with better products and services at better prices. The picture is mixed for shareholders. Ever-faster cycles of creative destruction will allow some companies to create enormous wealth for their owners over shorter timeframes. On the other hand, many companies will be unable to compete effectively in this new world, leaving them and their shareholders by the wayside. Investors and their advisors should be aware of the shifting – and sometimes cruel – winds of innovation. We are not sure it has ever been advisable for investors to buy and hold a few individual stocks "forever," but it probably is not a good idea at all in 2017. We think stock investors should consider being more diversified – and nimbler – today than in the past.

Have a wonderful and prosperous Fall and holiday season,

Norm Conley
CEO & CIO

Disclosures

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