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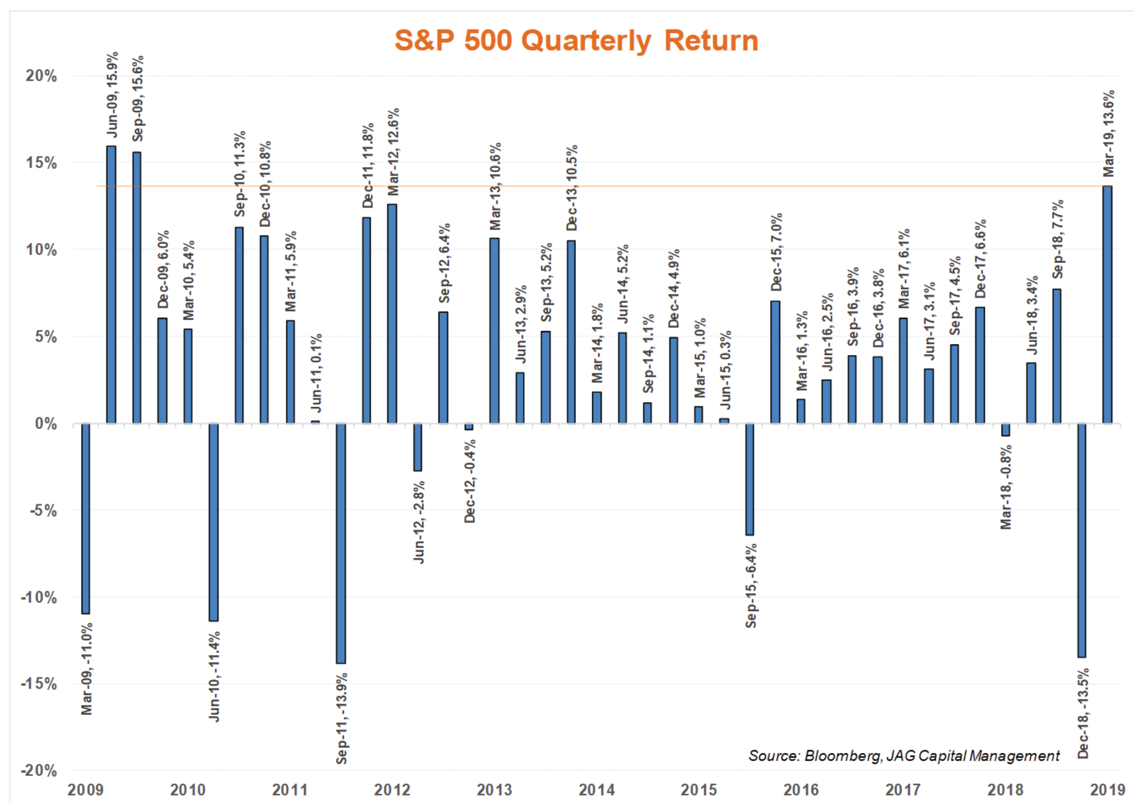
CAPITAL MANAGEMENT LLC

1Q 2019: Rebounding Returns

Storm clouds gave way to sunshine for investors during the first quarter of 2019, resulting in very strong returns for risk assets. The S&P 500 Index posted a 13.65% return in the three months ending 3/31/19, representing its best quarterly gain since late 2009 and its best first quarter since 1998. As if investors needed to be reminded, the last seven months have provided yet another example of the fickle nature of financial markets. In that short span of time, the S&P 500 has gone from setting all-time highs last September, to a roughly 20% decline that bottomed with climactic selling on Christmas Eve, only to rally furiously back to within 3% of the record high. Besides providing an excellent example of the futility of market-timing, recent experience buttresses the point that short-term volatility is the price equity investors must pay to capture the premium long-term return potential of stocks. Decades of evidence has shown that investors who overreact to the inherently schizophrenic nature of stock prices tend to earn substantially lower returns than they would have otherwise (more on this in a moment).



Federal Reserve policy has been in the spotlight in recent months. Remember that after years of maintaining the Fed Funds rate at zero, the Fed began raising short-term rates in December 2015. Including the most recent .25% increase in December 2018, the Fed has hiked rates nine times over the past three years. Furthermore, as late as early October of last year, the Fed was indicating that future rate hikes were likely to occur into 2020. But as is always the case, investors and markets get to "vote" on central bank policies. The Fed heavily influences short-term bond yields via their power to set the Fed Funds rate. But market forces set equity prices, intermediate-to-long term Treasury bond yields, credit spreads, currency exchange rates, and a variety of other tradeable instruments.

Late last year, investors began to signal that the Fed's hawkish tone on interest rates was wrong-footed. Stocks sold off by almost 20% between late September and late December, and credit spreads widened materially. By early January, bond investors were demanding .64% more yield to finance BAA-rated bonds than they had during the first week of last October. That might not sound like a lot, but this was the biggest 60 trading-day increase in investment-grade credit spreads since late 2011, and it translated into much higher costs of debt capital for domestic corporations. In effect, the markets tightened financial conditions all by themselves, and in doing so they did much of the Fed's heavy lifting for them. While we have no special insight into the mindset of Fed Chairman Powell or his colleagues, their recent comments have downplayed the prospects for further rate hikes in 2019. We think this dynamic has contributed to the strong rebound in stock prices so far this year. More importantly, we think the Fed would be correct to keep future rate increases on hold in the coming months. After all, inflation remains subdued, the US and China remain embroiled in contentious trade negotiations, and the pace of global economic growth is slowing. In our opinion, this is not the type of environment that would indicate aggressive or hawkish Fed policy.

March 2009: An Important Anniversary and its Aftermath

Last quarter marked the 10th anniversary of the final act of the most traumatic bear market since the 1930's. Capping a harrowing decline of more than 55% over the preceding 17 months, the S&P 500 closed at 676.53 on March 10, 2009. At the time, investors were understandably terrified that conditions would get worse before they got better, and there was no shortage of pundits stoking their fears. In fact, some smart people made the case that investment markets would never get better. Bill Gross, a famed bond fund manager at PIMCO who was one of the most visible investment prognosticators in the world, went so far as to say that "things will never be the same…stocks will be more of a subordinated income vehicle as opposed to a 'stocks for the long run' growth vehicle." Mr. Gross made these comments on February 26, 2009, less than two weeks before what was to become one of the best buying opportunities for stocks since the Great Depression.

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After finding its footing in March 2009, the S&P 500 has returned more than 338% including dividends over the past ten years. This translates into an average annualized total return of 15.9%, which ranks it in the top 20% of all 10-year periods since 1936. On an inflation-adjusted basis, the post-Financial Crisis bull market has been even more impressive. The 13.9% annualized trailing 10 year "real" return of the S&P 500 ranks in the top 12% of all 10-year periods in the last 83 years.

Unfortunately, it appears many real-life investors have not fared nearly as well as the major indexes over the past decade. Since 1994, the research firm DALBAR has published annual reports that detail their analysis into the effects of investor decision-making on investor results. Their methodology examines monthly data on mutual fund sales, redemptions and exchanges to provide a measure of investor behavior. They use these behavioral findings to calculate the average investor return in the underlying funds, which can then be compared to respective indices. DALBAR's 2019 Quantitative Analysis of Investor Behavior (QAIB) Report details some fascinating findings. Their data shows that the Average Equity Fund Investor earned an average annualized return of only 9.66% in the ten years ending 12/31/18, compared to 13.12% for the S&P 500. Over the past 30 years, the S&P 500 produced annualized returns of 9.97%, almost 6% higher than the 4.09% returns earned by DALBAR's Average Equity Fund Investor cohort.

	Average Equity Fund Investor (%)	Average Fixed Income Fund Investor (%)	Average Asset Allocation Fund Investor (%)	S&P 500 (%)	Bloomberg-Barclays Aggregate Bond Index (%)	Inflation (%)
30 Year	4.09%	0.26%	1.79%	9.97%	6.10%	2.49%
20 Year	3.88%	0.22%	1.87%	5.62%	4.55%	2.17%
10 Year	9.66%	0.70%	4.53%	13.12%	3.48%	1.82%
5 Year	3.96%	-0.40%	1.50%	8.49%	2.52%	1.56%
3 Year	5.58%	-0.11%	1.84%	9.26%	2.06%	2.04%
12 Month	-9.42%	-2.84%	-6.97%	-4.38%	0.01%	1.93%

Source: 2019 DALBAR QAIB Report, www.dalbar.com

It is worth noting DALBAR's methodology calculates the returns earned by the average investor. As such, some investors earned more than the average, and others less. For those who earned less, the magic of compound interest can result in large differences in long term wealth creation. Consider two investors, both who invest an initial amount of $100,000 for 30 years. One earns average annualized returns of 10%, while the other earns returns of only 4% (note that we are intentionally using 30-year rates-of-return that approximate to the S&P 500 and the DALBAR Average Equity Fund Investor from the table to the left). $100,000 compounded for 30 years at 4%/year grows into $324,339. This sounds impressive, until one realizes that the same $100,000 compounded at 10%/year grows into over $1.7 million!

Of course, "average annual returns" can be reduced into clean facts and figures, but real-life experience is much lumpier. In practice, investment returns for any given year are rarely "average." Markets zig and zag – sometimes wildly – over various time intervals, and it is only in the fullness of long spans of time that the average rates of return become evident. In practice, price volatility compels many investors to make mistakes. They switch investments too frequently, they buy when markets are high, and they sell when markets are dropping. Over long periods of time, the cumulative effect of these errors can be profound.

Looking Forward: Our Thoughts

In our last Quarterly Comments, we pointed out some reasons to be optimistic on the stock market's valuation and technical picture. To summarize, while we avoided making any predictions, we noted that the near-20% correction had created a supportive valuation backdrop. As of the end of 2018, the S&P 500 traded at multi-year lows on a forward P/E basis, and its forward earnings yield was at multi-year highs. There were also technical signals that tilted us into the optimistic camp, including a variety of signs of historically capitulative selling activity on Christmas Eve. While the current rally in stock prices has been impressive in its speed and magnitude, it is important to note that the S&P 500 remains at roughly the same levels it traded at last October and last January. With apologies to Shakespeare, the last 15 months of price action in the broader market has been a lot of "sound and fury, signifying nothing."

"HEY, YOU'RE LUCKY TO HAVE AN IMAGINARY FRIEND AT ALL, DON'T EXPECT STOCK TIPS TOO."

Looking forward, there are a variety of puts and takes for equity investors to consider. Well-publicized headwinds abound, including the rising probability of a disruptive "hard Brexit," slower economic growth here and abroad, continuing US/China trade tensions, ever-present political risks here in the US (i.e. Trump tweets), and decelerating corporate earnings growth. That which is well-known tends to be well-discounted by market participants. Therefore, we doubt that any of these specific pain points will end up having a significant impact on financial markets in the coming months. We do see a few other, lesser-known risks. One of these is the prospect of more supply being infused into the publicly-traded equity markets. Several large, well-funded "unicorn" stocks are expected to join Lyft (LYFT) in conducting initial public offerings in the coming months, including Uber, Slack, and Airbnb. These companies could introduce as much as $180 billion of new shares to be digested by investors. While some pundits argue that strong IPO performance could drive better investment sentiment and spur multiple expansion, we continue to carry the scars from the 1999-2000 boom in IPO activity (which, to put it mildly, did not end well). At the margin, we think a material ramp of new supply into the public markets could be a headwind to the broader markets.

While it is vanishingly unlikely that stocks will be able to maintain the first quarter's torrid pace throughout the remainder of 2019, we continue to see more roses than thorns for equity investors. As we alluded to earlier, the Fed's tightening cycle appears to be on hold for now. Hand-wringing over the small inversion in the 10yr/3month Treasury curve aside, a dovish Fed makes it more likely that the curve may normalize a bit in the coming months. To the extent that overall interest rates remain subdued, equity valuations have room to expand from here. Indeed, if we could know with certainty that 10yr Treasury yields would stay below 3% for the next 10 years (note: we cannot know this), stocks would be indeed very cheap at current levels. For those – like us – who are inclined to take cues from the credit markets, yield spreads have been tightening for both investment-grade and junk bonds since late last year. Historically, this sort of benign environment for risky corporate credit has indicated low odds of a near/intermediate term recession.   We are also heartened by the fact that investor sentiment remains subdued. According to Bank of America/Merrill Lynch's Global Fund Manager Survey, portfolio managers' allocation to equities recently sank to their lowest levels in over two years. Their equity allocation levels are now similar to previous levels that corresponded to stock market bottoms, including 2011, 2012, and 2016. Similarly, according to ICI, equity mutual fund and ETF flows have been consistently negative over the past year. Where is this money going? A good chunk of it is flowing into super-safe money market funds. Thomas Lee from FundStrat notes that money market balances have rocketed by 10% over the past 4 months, to their highest levels since March 2010. High pessimism, stoked by well-known challenges, has historically tended to precede subsequently bullish market outcomes.

Norm Conley
CEO & CIO

Disclosures

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