On Volatility and Opportunity, Part II

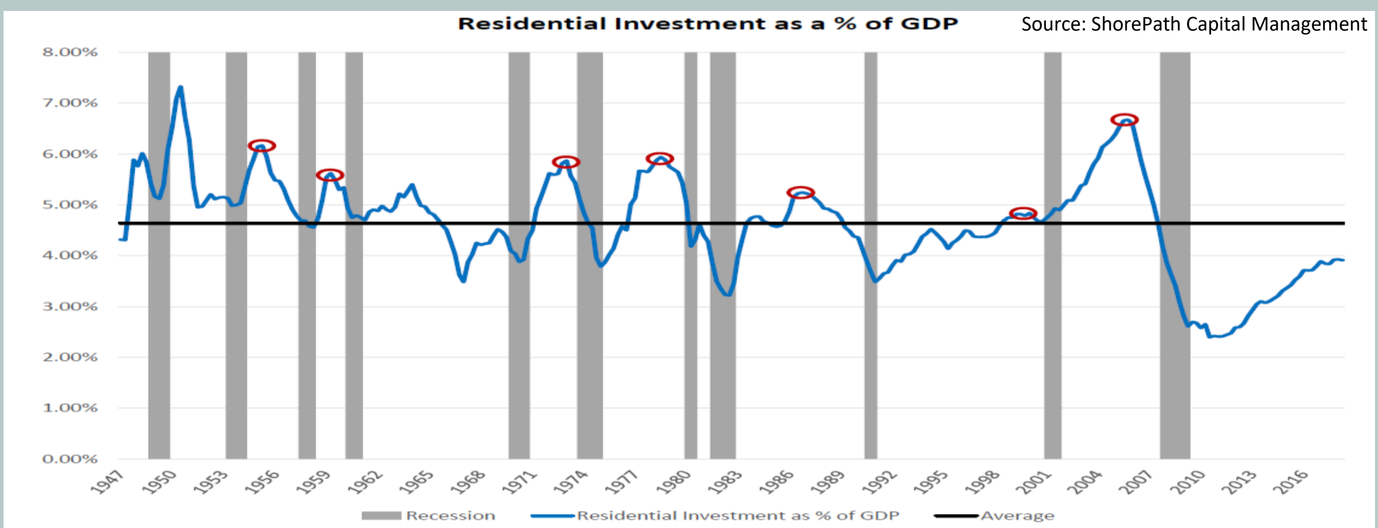
While we've been calling for increased market volatility for two years, that doesn't make it feel any better when it happens. The violent volatility of December has been a jarring affair. If you took the monthly returns for the S&P 500 over the last 50 years – 600 months – and ranked them from worst to best, December 2018 would be number 16 on the list. Had the month ended on Christmas Eve at the market's low, it would have ranked number four on the list.

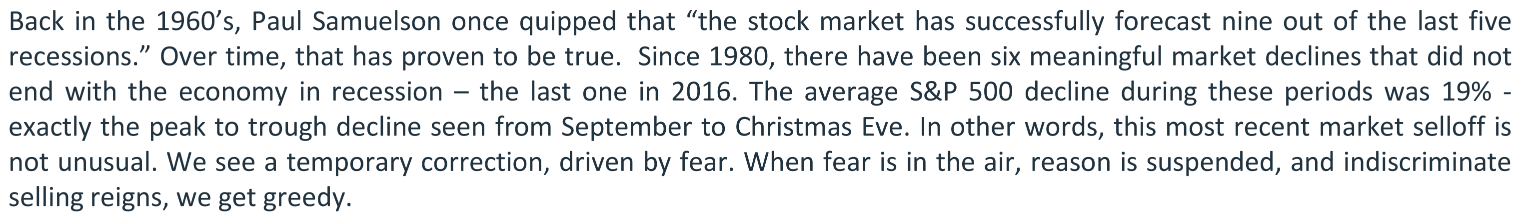
We're writing to breakdown this episode, to understand why it occurred, and to determine the best course of action. Investors sold due to a litany of global issues: US rising interest rates, China trade disputes, election results, Brexit, Italian government breakdown, tax losses, and/or Presidential tweets.. They sold everything: emerging markets, US stocks, international stocks, high yield bonds, bank loans. It all declined. Fear was in the air. Any asset with risk sold off.

When we look a bit more closely, the primary fear is that of recession and global economic slowdown. Recession would result in decreased company earnings and, in turn, lower stock prices. Recessions are built out of excess – excess real estate debt (2008), excess tech investment (2000), excess bank lending (1987), etc. Analyzing economic indicators today, there is a remarkable lack of excess. Global measures of PMI (Purchasing Managers' Index), capital spending, real estate investment, and industrial capacity all are at normal levels.

Historically, we don't see the economy rise from the depths of recession, go to normal and then back fall into recession. Economies eventually overheat into excess and then recess. As we survey the usual suspects of excess in the US economy, we see nothing but normal. Equity price to earnings multiples of 15.5 are slightly below historic averages. Consumer debt, which drove us into the prior crisis is currently at healthy levels.

Our favorite leading economic indicator is residential investment. Prior to a recession, we typically see US residential investment rise significantly above the historical average. This makes sense as consumers feel good with excess income, borrow money and invest into their homes. Residential investment has a high multiplier effect on the broader economy as it leads to employment for contractors, purchases of furniture and appliances, and increased debt loads. When rates increase, that can stamp out residential investment and eventually lead to a recession. Per the chart below, residential investment following the financial crisis still has a long way to go before overheating. This, too, appears to be normal.





Back in the 1960's, Paul Samuelson once quipped that "the stock market has successfully forecast nine out of the last five recessions." Over time, that has proven to be true. Since 1980, there have been six meaningful market declines that did not end with the economy in recession – the last one in 2016. The average S&P 500 decline during these periods was 19% - exactly the peak to trough decline seen from September to Christmas Eve. In other words, this most recent market selloff is not unusual. We see a temporary correction, driven by fear. When fear is in the air, reason is suspended, and indiscriminate selling reigns, we get greedy.

The following is a sampling of quotes from some of our underlying equity portfolio managers:

"We have wrung our hands. We have questioned everything. We have viciously interrogated every theme and idea. And yet we've emerged with the same level of high confidence that we started with… We know that the best managers in the world are the ones who maintain their convictions with consistency and courage. So, we're staying the course. In fact, we're doubling down."
– Ben Hirsch-McShane, Ibex Investors

"During the fourth quarter sell-off, we took the opportunity to add investments in blue chip companies to the long portfolio at healthy discounts to net asset value, while largely maintaining our activist core positions…"
– Jonathan Litt, Land & Buildings

"We were able to invest our excess cash we have been carrying most of the year at very favorable prices… While this opportunity wasn't visible in our poor returns over the past few months, we do feel optimistic about the prospects for the portfolio over the coming year."
– Scott Wallace, ShorePath Capital

"Despite feeling a little battered because of the recent underperformance, we are more motivated than ever. We will continue to build upon an already great investment framework as we look to take advantage of opportunities created in this upheaval."
– Anton Schutz, Mendon Capital

As we write this, mid-January results are indicating a strong comeback. In general, managers have not recovered all that they lost in December; however, they are well on their way. As long term investors, we view the recent sell off as an opportunity to improve our entry point. Most equity portfolios are held in our Generational portfolios. These portfolios are designed to provide excess return over a five to ten year period. In some years, such as 2017, we outperform, other years like 2018 we underperform. It is only by staying the course and even adding exposure in the down years that we can produce our desired returns.

We look forward to meeting with each of our client families over the coming months to review the 4th quarter performance. In our conversations, we will remain focused on protecting capital while achieving our long term investment goals. As always, we remain honored so serve you and your families. Thank you for your trust and partnership.

Rael Gorelick
Head of Investments

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